Week 1&Week 2	➢ **Financial instruments**
Financial System - System that enables lenders and borrowers to exchange funds - Acts as back-up system to economic production of goods and services - Hence a direct link between economic production and financial systems: -an efficient and developed financial system should ensure best allocation of resources to most productive uses **An efficient financial system:** - encourages savings - directs savings to the most efficient users - provides a variety of choices of financial instruments (assets and liabilities having the desired attributes of return, risk, liquidity and timing of cash flows) - has a variety of financial institutions and financial markets - Is essential to ongoing economic growth and development **In financial system, there are:** - **Deficit units** save LESS than it invests ☹ need funds (business firms & Govt.) - **Surplus units** save MORE than it invests ☺ supply funds (mainly households) Its **component**: describe and provide example of each - **Financial institution** - Banks (commercial banks) - Non-banks financial institution (NBIF'S) such as *(credit unions, finance companies, life insurance, superannuation, building societies etc.)* - Provides financial intermediation (indirect financing) or can act as ***brokers***-middleman (bringing savers and borrowers together) with no intermediation occurring	-provide holders with entitlement to future cash flow **Provide through EQUITY/DEBTS instruments** Debt: this provides the holder with a **contractual claim** to defined periodic interest repayments and the repayment of principal, e.g. commercial bill, corporate bond. (focus of week 5) Equity: this provides the holder with an **ownership** interest in an asset, e.g. ordinary share, preference share. (focus of week 6) **Other** important FI'S are derivatives and hybrids. Derivatives**:** allow management of certain risks and speculation. Derivatives **don't** provide funds to borrower. These include *futures, forwards, options and swaps* (discussed later in week 8) Hybrids**:** this type of instrument incorporates characteristics of debt and equity. Preference shares are a hybrid instrument as they have both equity and debt characteristics (discussed later in week 6) **Can be issued through:** Public offering**-** instruments are issued to the general- public Private placements- instruments are issued to single investor/group ▪ Simplest method of transferring funds b/w savers & borrowers ▪ A deficit unit (usually a large corporation) sells an entire security issue to a single institutional investor (such as life insurance/ superannuation company) or to small group of investor. **Can be traded via:** Exchange-traded Market where instruments are dealt via centralised exchange facility such as share market (ASX) Over the counter When the securities are issued and exchanged through a dealer/ bank there is no formal market for such instruments (Foreign exchange market)

Types of financial market:

Money Market	Capital market
-financial instruments with high liquidity and very short maturities are traded Short term (less than 12 months) FI's e.g. bank bills & promissory notes	Long term(12 months or greater) FI's e.g. shares, corporate& Gov. bonds
Wholesale Market	**Retail Market**
Financial flow transac occur directly b/w institutional investors & borrowers larger transactions	Transac are conducted primarily with financial intermediaries by the household & small to medium size B's sector smaller transaction is the planning and process of selling goods or services directly to consumers

Efficiency

An efficient financial system is fundamental to supporting Australia's growth and productivity. An efficient system allocates Australia's scarce financial and other resources for the greatest possible benefit to our economy, promoting a higher and more sustainable rate of productivity, and economic growth. The Inquiry is concerned with three distinct, but interrelated, forms of efficiency:

Operational efficiency — where financial products and services are delivered in a way that minimises costs and maximises value. This largely depends on how effectively firms deploy labour, capital and technology, and the regulations with which firms comply.

Allocative efficiency — where the financial system allocates financial resources to the most productive and valuable use.

Dynamic efficiency — where the financial system delivers price signals that induce the optimal balance between consumption and saving (deferred consumption).

Information efficiency- refers to degree to which stock

- **Financial Market**

- provide a forum for the creation and exchange of financial instruments
- transfer funds from borrowers to lenders (*fund from surplus units to deficit units)*
- allocates funds b/w alternative use

Classified as:

Primary markets:

- investors purchase financial instrument from its original issuer
- market where financial instruments are created
- might take place through an INTIAL PUBLIC OFFERING (IPO) to the public or through private placements

Secondary markets:

-investors trade their securities with other investors

-previously issued financial claims are exchange among investors

liquidity and how is it measured? Important?

Market liquidity

- refers to the ease with which securities can be bought and sold at 'representative' prices.

An asset that takes considerable time to be sold or which can only be sold quickly if its price is reduced significantly below **intrinsic value (actual value)** would not be considered a liquid asset.

- Liquidity is often measured by trading turnover, however, this may be an imperfect measure.
- Traders typically look for 'smoothness' in price movements over time when assessing the liquidity of an asset.
- An asset showing sharp jumps in prices, followed by periods of little or no price movement (representative of the silhouette of a city skyline) would be regarded as having low liquidity. These cases are sometimes described as "one-sided markets",
- e.g. only sellers are entering the market. In that case a large change in price would be necessary to clear the market.

prices and other securities prices reflect all available, relevant information.

Direct Finance:

- Same as indirect finance but ***without*** an **intermediary**
- No **transformation** of financial claims in the in the process
- Allows deficit units to issue financial claims(bought & sold in financial markets) on themselves & sell them for $$ directly to surplus unis
- SUR & DEF deal directly with each other therefore !!preference must match!!
- A broker/dealer may be involved in getting these parties together but no INTERMEDIATION involved

Advantage:

- Cost of intermediation can be avoided
- ^ access range to diverse range of markets
- greater flexibility (range of securities that deficit units can issue for different financing needs

Disadvantage:

- matching of preference can be difficult(borrowers & lenders may have diff preference in terms, amount, security etc)
- Liquidity & marketability of a security is dependent upon the other party
- Search & transaction's costs may be high
- Assessment of risks especially default risk can be difficult

Indirect finance:

Involves the transfer of funds b/w ultimate *savers* & ultimate *borrowers* via financial institutions.

Involves the purchase of financial claim with one set of characteristics from deficit units & their **TRANSFORMATION** into financial claims with a different set of characteristics.

Why use it?

-better satisfy the needs & preference of both parties

-allows borrowers & savers to transfer funds without having to match the other party preferences

Benefits:

Asset Transformation

-Borrowers & savers are offered a range of products they can choose from without having to match the preferences of the other party.

Maturity Transformation

-is practice by financial institution of borrowing $$ on shorter timeframe than they lend out $$

Credit Risk Diversification

e.g. if you place your deposit with your bank as savings & the bank lends another client $$ to buy a home. Will not exposed to risk of borrower, bank will

Liquidity Transformation

Use of *short term* debts like deposits to finance *long term* investments like loans

Economies of scale

Using financial intermediary reduces the costs of lending and borrowing.

Risk and Return

- There are many types of risks which participants need to be aware of whether they are a surplus or deficit unit in the financial system. Some of the most important ones are:
- Credit risk- the risk of default on a debt that may arise from a borrower failing to make required payments;
- Interest risk- the risk that an investment's value will change due to a change interest rates/ **risk** that changes in **interest** rates may reduce (or increase) the market value of a bond you hold. **Interest** rate **risk**—also referred to as market **risk**—increases the longer you hold a bond.
- Liquidity risk- occurs when an individual investor, business or financial institution cannot meet short-term debt obligations// the risk that may arise from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss.
- Foreign exchange risk- typically affects businesses that export and/or import their products, services and supplies. It also affects investors making international investments. // chance that an investment's value will decrease due to changes in currency exchange rates.
- Political risk- The risk that an investment's returns could suffer as a result of political changes or instability in a country.
- Reputational risk- A threat or danger to the good name or standing of a business or entity. Reputational risk can occur through a number of ways: directly as the result of the actions of the company itself; indirectly due to the actions of an employee or employees; or tangentially through other peripheral parties, such as joint venture partners or suppliers
- Environmental risk- Actual/potential threat of adverse effects on living organisms an environment by effluents, emissions, waste, resources, depletion etc. arising out of an organisation activities.
- Operational risk- human risk; it is the risk of business operations failing due to human error.// (eg. employee errors, systems' failures, fraud, any disruption to business operations).