Finance = financial decision making that allocates resources over time under conditions of uncertainty

Financial system = the set of financial institutions, markets and securities that manage financial contracting and the exchange of financial assets and risk

Financial institutions = principals

Financial markets → institutions act as agents

Functions of Financial System:

- Settle commercial transactions domestically and internationally
- Arrange the flow of funds (from surplus units to deficit units, can flow through via intermediaries or financial markets – overcome differences in preferences such as maturity and size mismatch)
- Transfer and manage risk
- Generate information to assist decision making
- Deal with incentive problems in contracting
- Pooling of funds

Participants in Financial System:

- Surplus units = supplier of funds (lenders, investors, depositors, shareholders)
- Deficit units = users of funds (borrowers, credit card users, companies/issuers)

Differences between surplus and deficit units: (return, length, risk, amount)

Surplus:

- High return/interest
- Flexible and short contract
- Risk varies but many are risk averse
- Usually small amount of funds

Deficit units:

- Low return
- Inflexible and long contract
- High risk
- Usually large amount of funds

Functions:

- Raises funds from deposits on which they pay interest (give surplus units low risk, low return, highly liquid investment, access to payment services)
- Uses these funds to make loans on which they earn interest (relatively low interest rates, long periods, large amounts; ADI earns interest rate spread and charges service fees)

Contracts = a promise or a set of promises that connect surplus and deficit units

Security = financial contract that can be traded in a financial market

- Asset involved: commodity (eg. gold), hard asset (eg. property), financial asset (eg. shares)
- Quantity and unit
- Price
- Date
- Payment/settlement terms

Transaction = arrangement between a buyer and a seller to exchange an asset or service for payment

Settlement is when value/purchasing power and title transfer (the exchange of value that completes the transaction)

Reserve Bank of Australia (RBA)

- promote financial system stability and efficiency
- supervises the payment system
- uses the system in its role of banker to the government
- assists/provides facilities for the settlement of payment obligations through:
  - queueing arrangements to help banks with their payment flow (instructions are placed in a queue and are tested for settlement and offsetting payments between banks)
  - intra-day repurchase agreements (repos) that provide banks with additional funds for part of the day (RBA purchases government securities from an ADI on the basis they will be repurchased at the same price later that day)

Differences between debt and equity:

Debt: - funds lent to the business

- Repaid with agreed interest rate (lower return required)
- Finite term
- Ranking ahead of equity (less risky for lenders as debt has first call over the firm's assets)
- Default risk and lower interest rates to surplus units
- Covenants and security

Equity: owners' funds

- Return varies (dividend + capital gain) (higher return required but rarely repaid)
- No terminal date
- Ranking behind creditors/debt holders (more risky)
- Residual claim → higher risk to surplus units
- Can appoint directors and involve in management (ownership)

Primary market – arranges for issue of new securities

Secondary market – subsequent trading in existing securities; assist primary markets

- Provide liquidity (investors are more likely to buy)
- Perform price discovery
- Develop the supply of investment funds