Lecture 1- Intro to Australia's financial system

Financial system consists of financial institutions, markets and instruments that together provide financial services for the economy

- Developed financial systems perform 5 financial functions
- **3** of these are used to organise our study of the financial system

Functions of the financial system

- Major functions of the financial system are:
  - **Settlement of transactions**
  - **The flow-of-funds**
  - **Risk management**
  - To be efficient
  - To be stable

The settlement functions

- =the provision and processing of payment instruments for the settlement of commercial transactions
- Transaction=an agreement between a buyer and seller to exchange an item (or service) for payment
- Settlement occurs when a buyer exchanges money for a purchased item (money includes cash and payment instructions)

The payment system

- Performs the settlement function
- Comprises the banking system, financial market clearing arrangements, the central bank (RBA and its Payments System Board)

The retail payments system

- The settlement arrangements for retail transactions
  - Includes transactions between households, households and businesses and between businesses
  - The retail payment system settles many more transactions than the wholesale payment system

Retail payment orders

- =instructions, most are to the payer's bank, to pay the stated amount to the nominated party
- Main retail payment orders are:
  1. Direct debits and credits-→direct debit is a pre authorised payment from a bank account. Direct credits is a pre authorised payment into a bank loan (e.g. a salary payment)
  2. Cheques
  3. Debit and credit cards
  4. Online payment instruments e.g.BPAY

Processing retail payment orders

- Retail transaction is settled when the seller/recipient accepts currency or a payment order
- Currency immediately settles the transaction and same-bank payment orders avoid the inter-bank settlement system
- If drawer and recipient of a payment order use different banks, the order is settled by the inter-bank settlement system
    - These payment orders are settled by the transfer of funds between each bank's exchange settlement account (ESA) at the central bank

The new payments platform

- In 2018 a new payment platform (NPP) was introduced that enable retail payment orders to be settled on a same day basis
- **Clearing**=the ESA holders agree on their payment obligations to each other and so ask the RBA to make the ESA transfer
- **Settlement**=the actual transfer of exchange settlement (ES) funds from the paying to the receiving ESA holder

Wholesale payments system

- Arranges the settlement of financial market trades
    - Trades in foreign exchange, bond and money markets represent most of these payments
- Trade is an agreement between the buyer and seller on the price and quantity of the traded asset
- Settlement occurs when payment is made (at a specific date) and ownership of the asset is transferred
- Payments are made with ES funds on the advice of each market's clearinghouse, when then transfers ownership of the traded asset

The RBA's settlement system

- Has 3 main components
    1. RITS→info transfer system for handling all payment order to and from the RBA
    2. RTGS→its system for instantly arranging the settlement of payment orders
    3. ESAs which hold funds for banks and other institutions that provide payment services to their customers
- Settlement occurs when funds are transferred by the RBA from the ESA of the paying institutions to the ESA of the receiving institution

Exchange settlement accounts

- ESAs=accounts financial institutions have with the central bank, the funds in which are used to settle the payments they make to each other and with the RBA

Advantages	Disadvantages
RBA transfer funds into and out of them as required by the ESA holders, enabling them to provide payment services to their customers	Account can't be overdrawn
Funds in ESAs are safe	
RBA pays interest on the end-of-day balance	

Exchange settlement funds and the cash rate

- Funds in ESAs are known as cash because they can be used to immediately settle transactions
- The RBA pays interest on the end-of-day balance in the ESAs at the cash rate minus 25 basis points
- The cash rate is the RBAs target rate used mainly for setting its monetary policy
- Current cash rate is 0.75%--->each bank end-of-day ESA balance times (0.0075-0.0025)/365

Exchange settlement funds and the overnight market

- Banks lend to each other on an overnight basis
    - Banks supply funds to this market via 24-hour loans
    - These are reserves of ES funds because the RBA can move funds instantly between this market and ESAs
    - The RBA can influence the supply of funds in their market through its transactions with the banking system enabling it to enforce its target for the cash rate
- Cash rate is the interest rate in the overnight market

Flow of funds function

- Financial system arranges the supply of funds and allocated them among users depending on the returns they pay and the risks the pose to suppliers
- Funds are supplied by surplus units mostly as bank deposits and superannuation contributions
    - Require compensation for forgoing the immediate use of the funds and for the risk the funds will not be compensated as agreed
- The deficit units that require funds include householder, businesses and the government
- Funds are supplied either:
    - Directly
        - Deficit units raise funds directly from surplus units through the issue of securities in the financial markets
        - Securities are contracts issued by deficit units to raise funds→they specify their promised payments and can be traded in the financial markets
    - Indirectly
        - Where funds are supplied as deposits to financial institutions, which in turn supply funds as loans to deficit units
- In Australia, indirect financing makes up the largest component of the flow of funds, with the majority of these funds being used to purchase residential property

- Direct financing also contributes to wealthy creating through the ownership of financial assets, the success of these investments is reflected through share price indices

Risk transfer function

- Investors, businesses and financial institutions need ways to manage risks that arise in the financial system
- Risk transfer contracts (known as derivatives) are provided by both financial institutions and markets
- Main risks:

- Default risk → chance that financial obligations will not be met, such as loan payment defaults
- Market risk → the possibility of loss arising from unexpected changes in market variables (such as interest rates, exchange rates or share prices)

Promoting the efficiency of the financial system

- 3 determinants of financial system efficiency
    1. Decision making that is mutually beneficial to the parties involves, and which is not impeded by: **info asymmetry** and **incentive problems**
    2. The **pooling of funds** from individual suppliers
    3. The emergence of new and reliable financial instruments, services and operating systems

Impediments to mutually beneficial decisions

Info asymmetry

- Arises when 1 party to a potential contract has an info advantage over the other party
- E.g. a potential borrower knows more about their capacity to repay than the lender does
- Problem arises when contracts are entered that wouldn't have been if both parties had equal info

Incentive problems

- Financial contracting is influenced by the incentives faced by the parties involved
- Can be a problem if incentives motivate bad behaviour such as:
    - Remuneration arrangements that reward short term profits without regard to long run consequences
    - A financial advisor who received commissions from suppliers of investment products and directs clients to products which pay the advisor the highest commission

Moral hazard

- The system needs to ensure these incentives are removed or overcome
    - One approach is where financial institutions have a fiduciary duty to their customers
    - Another is the practice of professional bodies that require members to adhere to a code of ethics

Royal Commission into misconduct in the banking, superannuation and financial services industry

- The commission was established in Dec 2017 to investigate malpractices within Australia's financial institutions
- It revealed a culture that fails to deal with moral hazards and info asymmetry, and that has eroded the trust of the public

Pooling of funds

- Usually deficit units are seeking large amounts that will take a long period to repay
- Surplus units normally want to supply small amounts for short periods
- Surplus and deficit units have incompatible wants
- Can be overcome by pooling of funds:
    - Bank accepts small deposits and makes large value loans

    - Deficit unit who issues many securities to many investors to raise a very large amount of funds

Financial system stability

- Unstable financial systems experience crises that disrupt the flow of funds and activity in the economy, resulting in greater unemployment and a loss of wealth
- Central bank assist with system stability by being 'lender-of-last-resort' to solvent but illiquid banks
- There are international banking supervision guidelines, which aim to establish internationally consistent supervision arrangements, and that are implemented by APRA

Structure of a financial system

Main components of a financial system include:

- **Financial institutions**. Main types:
    - Deposit-taking institutions, that make loans
    - Investment banks, that assist their large company clients assess funds from the financial markets
    - Fund managers that manage investors funds
- **Financial markets**→arrange trading in securities, foreign exchange and derivative contracts
- **Regulators** that oversee the institutions and markets

Australia's financial institutions

- Banks and fund manager dominate in terms of their assets

Banks

- Banks are financial institutions that are authorising by APRA to undertake banking business (i.e. to accept deposits, make loans and provide other financial services)
- They include
    - The 4 major banks (ANZ, CBA, NAB, Westpac) that provide a full range of banking services
    - Credit unions and building societies that mainly service households
    - Institutions that provide investment banking services to large businesses

Shadow banks

- Non-bank financial institutions that compete with banks
- **Merchant banks**=provide financing service of wholesale customer→their role has been largely taken over by banks
- **Finance companies**=mainly provide lease financing for motor vehicles and business equipment
- **Mortgage originators**= lenders who fund loans from the proceeds of mortgage backed→their activities were curtailed by the GFC

Fund managers

- =provide investment management services for their clients in return for fees
- **Superannuation funds=**long term investment schemes for the purpose of generating income in retirement
- **Public unit trusts=** voluntary investment vehicles that sell 'units' in their trust and then invest the funds

- **Insurance companies=** manage funds as part of their operations and some of their policies have an investment purpose

Australia's financial markets

Markets that arrange direct financing

- **Money market** trades ST debt securities that pay a single amount at maturity and are known as 'discount securities'
- **Bond market** trades LT debt securities that make regular interest payments and then repay their face value
- **Share market** arranges trading in shares, which are perpetual equity securities that commonly pay dividends
- **Foreign exchange market** enables transactions to be made in different currencies because it arranges trading in foreign currencies
- Markets for **derivative contracts (**such as futures and options) trade contracts that can be used to manage forms of financial risk and for speculation

The financial regulators

- RBA=Reserve Bank of Australia
- ASIC= Australian Securities and Investments Commissions
- APRA= Australian Prudential Regulation Authority
- These bodies (along with The Treasury which represents the government) form **the Council of Financial Regulators**

RBA

- Australia's central bank that has 6 main functions
    1. **Implement monetary policy**--->RBA influences ST interest rates to contribute to its objectives for inflation, unemployment and economic wellbeing
    2. **Issuing banks notes and coins**
    3. **Acting as a banker to the Commonwealth Government**
    4. **Monitoring the stability of the financial system**→RBA works with other regulators and global agencies to avoid financial crisis, and monitors data to help identify threats to stability
    5. **Regulating the payment system**→through its Payments System Board the RBA is responsible for ensuring the payment system is safe and efficient
    6. **Managing Australia's reserves of foreign exchange**

Other regulatory bodies

- **APRA** is the prudential regulator of banks, insurance companies and superannuation fund trustees
    - Seek to ensure an institution is able to meet its obligations to its customers
    - Apply the recommendations of the Basel Committee on Banking Supervision (BCBS)
- **ASIC** enforces company and financial services laws to protect consumers, investors and creditors
- The **Australian Treasury** is not a regulator but represents the government on issues of financial regulation