

Topic1- A modern financial system: an overview

What is a Financial System?

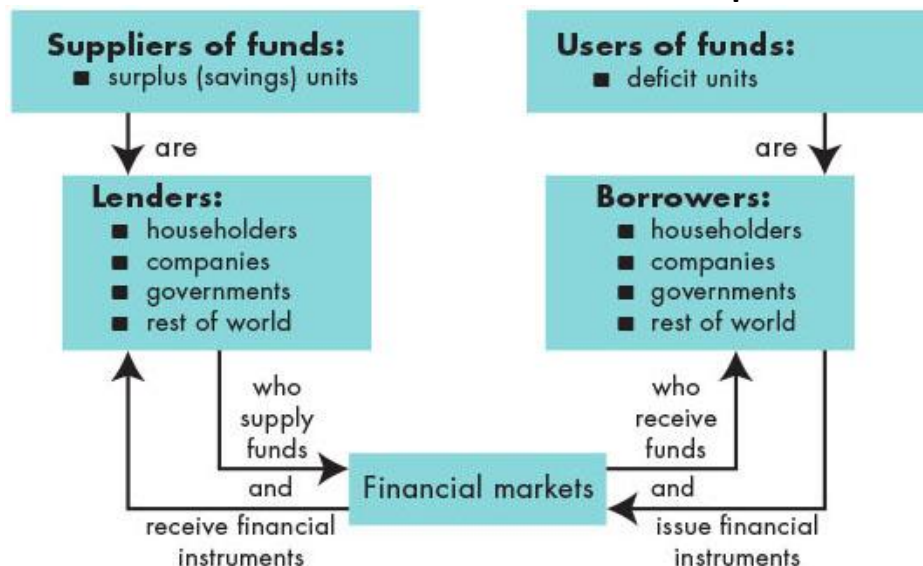
A financial system comprises three principal elements:

- financial institutions
- financial markets
- financial instruments

What Does It Do?

- A financial system facilitates financial transactions through the
 - Creation
 - Sale, and
 - Transfer of financial assets

Financial markets and flow of funds relationship



Financial Assets Are...

- Currency
- Financial instruments, which represents a claim to future cash flows
 - egs.
 - ordinary shares issued by a company
 - Govt. treasury bonds
 - bank term deposits

The financial system allows both lenders and borrowers to trade-off between different attributes of financial assets in order to achieve their desired portfolio structure needs

Attributes -

- ☐ Return
- ☐ Risk

- ☐ Liquidity
- ☐ Time-pattern of cash flows

Types of Financial Institutions

Category 1: Depository Institutions (e.g. Banks)

Commercial Banks
Building Societies
Credit Unions

Category 2: Non-Depository Financial Institutions

Contractual savings institutions
Life and general insurance companies
Pension Funds (superannuation)
Investment Intermediaries
Finance companies and general financiers
Unit trusts and managed funds
Investment and merchant banks

Authorised Depository Institutions (ADIs)

- Attract savings from depositors and investors to provide loan facilities to borrowers

Contractual Savings Institutions

- liabilities (source of funds) are contracts that generate periodic cash flows, such as insurance contract instalments or superannuation savings
- accumulated funds are used to purchase both real and financial assets
- Superannuation: fastest growing sector

Finance Companies

- liabilities (funds) generated from the issue of financial securities direct into the money markets and capital markets – 1.9% of FS assets
- assets (use of funds) are mainly loans to retail customers (individuals and small business)

Investment banks and merchant banks

- Also known as money market corporations - 0.6%
- Generally raise short-term funds in the wholesale money markets
- Provide short-to-medium-term loans to corporate clients
- Specialise in off-balance sheet financial services to corporate clients and government

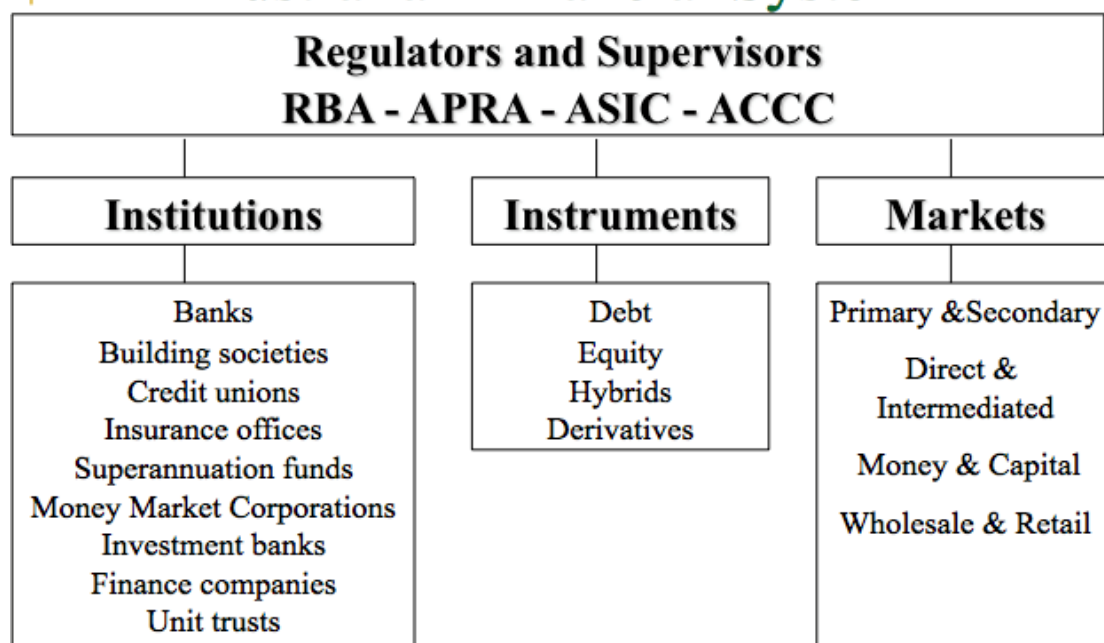
Unit trusts and managed funds

- investors purchase units in a trust - 5.1%
- trustee (using funds managers) invests accumulated funds in a specified range of investment types
- Include cash management trusts, equity trusts and mortgage trusts

Regulatory environment – legislation & prudential supervision

- 4 components of regulatory framework
 - Reserve Bank of Australia (RBA)
 - Australian Prudential Regulation Authority (APRA)
 - Australian Securities and Investments Commission (ASIC)
 - Australian Competition and Consumer Commission (ACCC)

Australian Financial System



Financial Instruments

1. Equity

- *ordinary shares* issued by a company which represent an ownership position for the shareholder
- shareholder has an entitlement to receive a share of any distribution of profits of the company – dividends

2. Debt

Contractual claim to:

- periodic interest payments
- repayment of principal.

Ranks ahead of equity

Can be:

- short term (money market instrument) or medium to long term (capital market instrument)
- secured or unsecured
- negotiable (ownership transferable; e.g. commercial bills and promissory notes) or non-negotiable (e.g. term loan obtained from a bank).

- corporate and government debt

3. Hybrids

- combine the elements or characteristics of both debt and equity
- example - an instrument issued which makes periodic interest payments, but offers a future ownership entitlement (example: convertible notes and preference shares)

4. Derivatives

- a product whose pricing is *derived* from an existing product (e.g. gold)
- not instruments issued for raising funds