MAF202 – Money and Capital Markets

Topic 1 (Financial System Overview)

A financial system comprises 3 principle elements

- Financial institutions
- Financial markets
- Financial instruments

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
  - Banks - **57%** of total financial system assets
  - Non-banking depository institutions
    - Building societies - **0.4%**
    - Credit Unions - **0.7%**

Contractual Savings Institutions

- Liabilities (source of funds) are contracts that generate 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
  - 1990 made up **10.8%** of total assets
  - 2015 makes up **22.8%**
  - As of September 2015 superannuation sector had $2 trillion funds under management

Finance Companies

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

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 and prudential supervision

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

Financial Instruments

-Can be divided into 4 categories

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)
   - Hybrid security – a financial instrument that incorporates the characteristics of both debt and equity (e.g. preference shares)
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 (debt instrument that provides the lender with a claim over specified assets if the borrower defaults)
  - Negotiable (ownership transferable; e.g. commercial bills and promissory notes) or non-negotiable (e.g. term loan obtained from a bank) (can be sold by the original lender through a financial market)
- 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