Sarah Whiteway

Explain what is meant by the term financial markets. How do financial markets bridge the gap between savers and borrowers?

The financial system comprises all financial markets, instruments and institutions. It is through this system that financial markets operate, playing a key role in allocating resources in the economy. Financial markets intermediate between those who have money and want to earn a profit on it (savings and investors) and those who need it (borrowers and entrepreneurs). In a small community, investors and borrowers could find one another just by asking around. But in an economy of hundreds of millions of people, each with a variety of saving and borrowing needs, putting every dollar of capital to efficient use is a vastly complex yet enormously important job. By issuing claims on themselves in the form of deposits (banks), commercial paper (finance companies), contracts (insurers), or shares (mutual funds), financial markets bridge the gap between countless borrowers and lenders. The more effectively they do this, the more efficiently capital will be allocated to its most productive uses, and the faster the economy will grow. The operations of financial markets provide a bridge between savers and borrowers, through the actions of financial intermediaries. These can broadly be divided into banks and non-bank financial institutions, finance companies, merchant banks, credit unions, building societies, mortgage originators, life insurance companies, superannuation funds and unit trusts. Within these financial institutions there is a variety of financial market products in the economy to meet the various needs of lenders and borrowers as according to risk, return and liquidity. The three main products are consumer credit, housing loans and business loans, which exist as a means of transferring financial resources between savers and borrowers. Finally, the three major functions of financial markets continue to further develop the economy at stake, as well as economies all around the world, not to mention in the future. These functions are commonly credit rating, mutual funds and providing vehicles for saving.

Financial intermediaries are firms that receive the accumulated funds of individuals or firms, as deposits, which can then be lent out to other firms or individuals who can make use of them. Fundamentally, financial intermediaries are the basis for the bridge between the savers and borrowers in our economy and the actions of these intermediaries has brought forth an indirect relationship between savers and borrowers, as their financial resources are transferred from one to another, with an aim to benefit all who are involved. Intermediaries exist because they can take advantage of economies of scale in obtaining and processing information. By knowing how to extend credit efficiently and with minimal losses, a bank typically can lend much more cheaply to a borrower than can any individual or group of individuals.

Banks continue to be the largest and most important part of the financial sector as they offer a vast range of financial services, in a safe environment. Services include accepting deposits (savings), making advances (loans), conducting the bank and credit card system, distributing travellers' cheques, arranging overseas accounts payable and accounts receivable, providing safe-deposit facilities and offering financial advice. The security of large banks such as the Commonwealth Bank has meant that the majority of the Australian population conduct their finance through a bank as they also provide benefits such as a return on investment (interest).

In addition to banks, there is a wide range of other financial institutions within the financial market that exist to bridge the gap between savers and borrowers. Some institutions specialise in certain services, such as mortgage originators ie. Aussie Home

Loans, who offer home loans to consumers at a rate which are highly competitive with banks. Mortgage originators accumulate these home loans and sell them as securities to investors. By presenting significantly lower interest rates than that of major banks, these funds have attained a significant share of the home loan mortgage market. Other financial institutions offer similar services to that of traditional banks, such as credit unions. This is an institution where it's members from a particular trade, industry, professions or area, can make regular deposits and borrow money on a short to medium term basis, for example Credit Union Australia.

Finance companies attain most of their funds by borrowing from the general public, by issuing debentures and unsecured notes, as well as issuing shares to gain capital. Finance companies, such as SME Venture Capital Brokers, provide mainly short to medium term loans to households and small businesses. In this way, they are similar to credit unions however they differ as finance companies aim for a profit while credit unions do not. Their relationship between borrowers and savers is however still clear: they both act as a bridge of the gap between borrowers and savers.

Merchant banks borrow on a short-term basis from companies with surplus funds, and lend these funds to other large corporations for business expansion purposes and government agencies. When comparing total assets, merchant banks encompass the largest segment of the non-bank financial intermediaries. An example of a merchant bank is Commercial IBT.
Permanent building societies bridge the gap between savers and borrowers by accepting deposits from the public (savers) and providing funds mainly for home loans (borrowers). Due to State law amendments, permanent building societies can now also offer other personal and business loans however they are still mainly involved in home loans.

Life insurance companies, such as Norwich Union, are part of the financial market as they acquire funds in the form of premiums from their policy holders who invest in life insurance. They then use this to buy income producing assets, for instance shares, debentures, government securities and real estate , as well as making loans to business firms and individuals. The profits are paid to policy holders as well as being used to purchase additional income producing assets.

Superannuation funds receive the contributions of employees and employers and invest them in different types of assets, including shares, debentures, government bonds and property, so as to provide a stable retirement income for the contributors. As a result of superannuation becoming compulsory in the early 1990s this sector has witnessed immense growth of customers and several new superannuation funds have joined the market, such as MLC Investments.
Unit trusts, which includes equity (share) trusts, property trusts and cash management trusts, raise money by selling portions (units) of the trust to the public. Resting on the type of trust, these funds can be used to purchase shares, property, government securities, as well as other assets on behalf of the unit holders. This service allows investors to spread their risk by investing in several items, and is a significant bridge between borrowers and investors as the state of these items is constantly changing. For example, the role of borrower and investor alters constantly when buying and/or selling shares.

The variety financial market products each reflect different levels of risk, return and liquidity. The option to choose which product a borrower or saver wants to be involved with gives the individual the opportunity for growth, stability and security. Consumer credit allows consumers to purchase consumer goods and services in advance of actual payment. This is most commonly in the form of the credit card which allows consumers to purchase goods and repay with an interest at a later date. They are offered by banks in union with credit car d companies such as Mastercard and Visa. Another form of consumer credit are personal loans offered by credit unions and banks, which have a higher rate of interest then housing loans. For example, currently Westpac is offering a personal loan at a fixed interest rate of 10.85%p.a, whilst it's fixed home loan rate is a low 6.57%p.a.

Housing loans are offered by banks, as well as mortgage originators such as Aussie Home loans and Rams. These are long term loans used to purchase property, entailing periodic repayments with interest. Housing loan rates are generally 1% to 2% higher than the cash rate. Housing loans, or mortgages, usually span between ten and thirty years.
Finally, business loans are the third main financial market product and is form of debt allowing business to begin or expand production of goods and services. A business can raise funds through either debt or equity. These loans are commonly taken out with an aim to increase market share by increasing production and the rates tend to be 1 -2% higher than household lending rates, as a higher risk is taken by an entrepreneurial business.
Whether through institutions or markets, the financial services industry is crucial to matching the hopes and dreams of the most inventive and opportunistic part icipants in our economy with those who have capital and want to put it to work. The importance of this matching function is perhaps best demonstrated by the failure of state -managed economies, in which governments rather than markets do the matching. No ce ntrally planned economy, such as former U.S.S.R, has come close to the efficiency that the financial marketplace achieves as a matter of course.

Through all three of it's major functions, finance connects Australians with each other and the world. Firstly, by rating a person's credit and providing a quick and reliable payments mechanism, the company issuing his credit card allows him to make purchases by telephone from companies that know nothing about him and are located thousands of miles away. Mutual fu nds give each Australian the ability to invest in products and services being provided by millions of diverse economic agents without actually requiring any two of those agents to even converse with one another. And lastly, by providing vehicles for saving, markets and intermediaries allow each generation to bequeath a wealthier future to its children.

Financial markets bridge the gap between savers and borrowers by providing a marketplace where debt and equity can be transferred, providing a return for t hose who have excess funds or savings, while making loan funds available to those who need additional money.
In short, the financial services industry and hence financial markets, connects Australians to each other not only today but across decades.