FOUNDATIONS OF FINANCE 101

Chapter 1: Introduction to the Financial System

Finance rests on three big ideas: the **time value of money**, **diversification**, and **arbitrage**. Every chapter in this course builds toward one of those three. Before we get there, though, we need the setting where all of finance happens: the **financial system** — the markets, institutions, and instruments that move money from people who have it to people who need it.

> **REMEMBER IT — THE THREE BIG IDEAS**
>
> **T-D-A:** "*Time, Diversify, Arbitrage*"
> - Time value of money (a dollar today beats a dollar tomorrow)
> - Diversification (don't put all your eggs in one basket)
> - Arbitrage (identical things must have identical prices).
>
> If an exam question feels abstract, ask yourself which of the three ideas it is really testing.

1.1 What Is a Financial System?

At any point in time, some people and businesses have **more money than they currently need** (savers, or *surplus units*), while others have **less money than they currently need** (borrowers, or *deficit units*). The financial system exists to connect the two, moving funds from surplus to deficit units so that money that would otherwise sit idle gets put to productive use.

This transfer happens through two channels:

- **Direct finance:** borrowers raise funds directly from savers by issuing securities — for example, a company selling shares or bonds to investors.
- **Indirect finance:** funds flow through a financial intermediary — most commonly a bank — which takes deposits from savers and lends them to borrowers.

© Vectis Learning. All rights reserved.

KEY DEFINITIONS

Financial system: the network of markets, institutions, and instruments that channels funds from surplus units (savers) to deficit units (borrowers).

Financial intermediary: an institution (e.g. a bank) that stands between savers and borrowers, transforming deposits into loans.

Security: a tradeable financial instrument representing a claim — e.g. a share (claim on ownership) or a bond (claim on repayment).

Why do intermediaries exist at all, when savers could just lend directly? Because intermediaries solve three practical problems more cheaply than individuals can: they **pool** many small deposits into large loans, they **assess and monitor** borrowers (reducing information costs), and they **transform maturity** — funding long-term loans with short-term deposits while keeping deposits accessible.

1.2 Money Markets vs. Capital Markets

Financial markets are classified by the **maturity** of the instruments traded in them.

Money markets — short-term (under 12 months)

Money markets trade short-term, low-risk debt used mainly for liquidity management — parking cash safely or covering short-term funding gaps. Typical instruments include:

- **Treasury notes:** short-term government debt, issued at a discount and repaid at face value.
- **Bank bills / bank-accepted bills:** short-term corporate borrowing guaranteed (accepted) by a bank.
- **Commercial paper:** short-term unsecured IOUs issued by large, creditworthy companies.

Capital markets — long-term (over 12 months)

Capital markets fund long-term investment — the factories, infrastructure, and business expansion that take years to pay off. The two main segments are the **bond market** (long-term debt) and the **equity market** (shares). Chapter 3 focuses on how to value both.

© Vectis Learning. All rights reserved.

1.3 Stock Markets: Primary vs. Secondary

The equity (stock) market is where ownership stakes in companies — **shares** — are issued and traded. It operates in two layers, and exam questions love testing whether you can tell them apart.

- **Primary market:** where securities are created and sold for the first time. When a company lists via an Initial Public Offering (IPO) or issues new shares, money flows from investors *to the company*.
- **Secondary market:** where existing securities trade between investors — e.g. everyday trading on the ASX. The company receives *no money* from these trades; investors simply exchange with each other.

The secondary market still matters enormously to companies: it provides **liquidity** (investors will only buy new shares in the primary market if they know they can sell them later) and continuous **price discovery** (a live market price for the firm's equity).

> **KEY DEFINITIONS**
>
> **IPO (Initial Public Offering):** the first sale of a company's shares to the public, moving it from private to publicly listed.
>
> **Liquidity:** how quickly and cheaply an asset can be converted to cash without moving its price.
>
> **Price discovery:** the process by which trading activity reveals what an asset is currently worth.

> **REMEMBER IT — NEW VS. USED**
>
> Think of a car dealership: the **Primary market sells new cars** (money goes to the manufacturer — the company), while the **Secondary market is the used-car lot** (money passes between owners; the manufacturer gets nothing). “Second-hand trading = Secondary market.”

1.4 Foreign Exchange Markets

The foreign exchange (FX) market is where currencies are traded — and it is the largest financial market in the world by daily turnover. Every cross-border transaction ultimately touches it: an Australian importer paying a US supplier must sell AUD and buy USD.

The key price is the **exchange rate** — the price of one currency expressed in another. A quote of AUD/USD = 0.65 means one Australian dollar buys 65 US cents. Two terms describe movements:

- **Appreciation:** a currency strengthens (AUD/USD rises from 0.65 to 0.70 — each AUD now buys more USD).

© Vectis Learning. All rights reserved.

- **Depreciation:** a currency weakens (AUD/USD falls from 0.65 to 0.60).

For now, you only need the **spot market** — trades settled essentially immediately at today's rate. Forward FX contracts (locking in a rate for a future date) are derivatives, and will be covered in later chapters.

> **DEFINITION**
> **Spot exchange rate:** the rate for a currency trade settled now (in practice, within two business days), as opposed to a forward rate agreed today for settlement at a future date.

1.5 Derivative Markets — A First Look

A **derivative** is a contract whose value *derives* from the price of something else — the **underlying asset** (a share, a currency, a commodity, an interest rate). The name literally tells you what it is, which makes this the easiest definition in the course to remember.

The three families are:

- **Forwards:** a private agreement to buy or sell the underlying at a fixed price on a future date.
- **Futures:** the same idea, but standardised and traded on an exchange.
- **Options:** the *right, but not the obligation*, to buy (call) or sell (put) the underlying at a fixed price.

Why do derivatives exist? Primarily for **risk management (hedging)**: a wheat farmer can lock in today's price for next season's harvest; an importer can fix the exchange rate on a payment due in six months. Derivatives transfer risk from those who don't want it to those willing to bear it — that is their economic function.

> **REMEMBER IT — DERIVATIVES**
> **"Derivatives DERIVE."** Their value is never standalone — it always comes from an underlying asset. In any derivatives question, your first move is to **identify the underlying asset.**

© Vectis Learning. All rights reserved.

1.6 Key Institutions in the Australian System

Four institutions frame the Australian financial system, and FINM1001 expects you to know who does what:

- **RBA (Reserve Bank of Australia):** the central bank — sets the cash rate (monetary policy), issues currency, and oversees payments-system stability.
- **APRA (Australian Prudential Regulation Authority):** supervises the safety and soundness of banks, insurers, and super funds — making sure institutions can honour their promises.
- **ASIC (Australian Securities and Investments Commission):** regulates market conduct and consumer protection — licensing, disclosure, and policing misconduct.
- **ASX (Australian Securities Exchange):** the main marketplace itself — where shares and other securities are listed and traded.

APRA and ASIC together form Australia's **"twin peaks"** model of regulation: one peak watches *prudence* (institutional safety), the other watches *conduct* (market behaviour).

> **REMEMBER IT — TWIN PEAKS**
>
> **APRA = Prudence, ASIC = Conduct.** Think of ASIC as the market's police — if a company does something *sick*, ASIC comes knocking. The RBA sits above both as the central bank, not a regulator of individual firms.

1.7 A First Word on Market Efficiency

If markets do their job well, prices should reflect available information — new information moves prices quickly, leaving few easy profits lying around. This idea, **market efficiency**, underpins the arbitrage logic you will meet in Chapter 6: in an efficient market, two identical assets cannot trade at different prices for long, because traders will exploit the gap until it closes.

You do not need the formal Efficient Markets Hypothesis at this stage — just the intuition: ***in liquid, well-functioning markets, free lunches are rare and disappear fast.***

> **DEFINITION**
>
> **Market efficiency (working definition):** the degree to which market prices reflect available information. The more efficient the market, the faster prices adjust and the harder it is to earn abnormal profits.

© Vectis Learning. All rights reserved.

1.8 Chapter Summary

- The financial system channels funds from **surplus units to deficit units**, either directly (securities) or indirectly (intermediaries such as banks).
- **Money markets** trade short-term instruments (< 1 year); **capital markets** fund the long term (bonds and shares). “Months vs. Careers.”
- **Primary market** = new securities, money to the company. **Secondary market** = existing securities, money between investors. “New vs. used cars.”
- The **FX market** prices currencies; know spot rates, appreciation, and depreciation.
- **Derivatives derive** their value from an underlying asset; their core economic purpose is transferring risk (hedging).
- **Twin peaks:** APRA supervises prudence, ASIC polices conduct, the RBA runs monetary policy, and the ASX is the marketplace.
- Efficient markets leave few free lunches — the intuition behind **arbitrage**, one of the three big ideas of this course.

Next — Chapter 2: Time Value of Money

© Vectis Learning. All rights reserved.