**Flow of Funds:**

* Financial system provides a transmission mechanism between saver-lenders and borrower-spenders.
	+ Savers benefit—earn \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
	+ Investors benefit—access to money otherwise not available
	+ Economy benefits—efficient means of bringing savers and borrowers together
* Funds flow \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ from ultimate lenders [households] through financial intermediaries [banks or insurance companies] or \_\_\_\_\_\_\_\_\_\_\_\_\_ through financial markets [stock exchange/bond markets] to ultimate borrowers [business firms, government, or other households]

 In order for financial system to function smoothly, must be adequate information about the markets and their operation

**Financial Instruments and Markets:**

* Primary Markets
	+ Market for issuing a new security and distributing to saver-lenders.
	+ Investment Banks—Information and marketing specialists for newly issued securities.
* Secondary Markets
	+ Market where existing securities can be exchanged
		- New York Stock Exchange
		- American Stock Exchange
		- Over-the-counter (OTC) markets
* Bonds Represent Borrowing
	+ Agreement by issuer to pay interest on specified dates and redeem the bond upon maturity.
	+ Consoles—Bond with no \_\_\_\_\_\_\_\_\_\_\_\_\_\_ date, pay interest forever
	+ Coupon Securities—Attached to bond and sent in to collect interest [generally semi-annually]
	+ Zero-coupon—Sold at price well below face value. Collect interest when the bond matures.
	+ Tax Exempt—Interest earned is not taxed (issued by state, local, or municipal governments).
* Stocks Represent Ownership
	+ Stockholder owns part of the corporation and receives dividends from the issuer.
	+ No government stock—individuals \_\_\_\_\_\_\_\_\_\_\_\_\_\_ “own” part of the government
	+ Types of Corporate stocks
		- Preferred Stock—Fixed dividends, priority over common stock
		- Common Stock—Variable dividends, based on company’s profits.
		- Convertible—Convert preferred into common at a stated price
	+ Like bonds, existing stock may be exchanged through secondary markets.
	+ Capital Gains—Difference between price initially paid and amount \_\_\_\_\_\_\_\_\_\_\_\_ when stock is sold.
	+ Measures of trends in overall common stock prices
		- Standard & Poor’s 500 Stock Index—based on prices of 500 individual stocks
		- NASDAQ Composite Index—based on all stocks listed in \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
		- Dow Jones Industrial Average—based on price of 30 “blue-chip” stocks
* Both stocks and bonds [securities] represent a claim to a stream of payments [cash flows] in the future
	+ Bonds—Interest payment and face value at maturity
	+ Stocks—Dividends and sales price when sold
* Mortgages Involve Real Estate
	+ Debt incurred in order to buy land or building
	+ Amortized—principal and interest is gradually repaid over the life of loan
	+ Fixed Rate—Rate of interest is \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
	+ Variable-Rate—Rate of interest varies depending on financial environment
	+ Cash flow for lender is uncertain
		- Interest payments may vary [variable rate mortgages]
		- Home owner may prepay
		- Refinance a fixed mortgage if interest rates decline
* Securitization—Individual mortgages may be “pooled” and sold as a unit to reduce uncertainty.
* Mortgages may be insured by government agencies—Federal Housing Authority (FHA) or Veterans Administration (VA)
* Derivatives: Options and Futures Contracts
	+ Contractual agreement between two parties to exchange a third asset in the future at a stated price
	+ Often called derivative financial instruments because they derive value from underlying assets
	+ Long—\_\_\_\_\_\_\_\_\_\_\_ of the contract, receive commodity in the future
	+ Short—\_\_\_\_\_\_\_\_\_\_\_ of the contract, provide commodity in the future
	+ Speculators gamble on price fluctuations and hope to profit
	+ Eliminate the risk of price fluctuations
* **The Capital Market**
	+ Exchange of long-term securities—in excess of one year
	+ Generally used to secure long-term financing for capital
		- Stock market—Largest part of capital market and held by private and institutional investors
		- Residential and commercial mortgages—Held by commercial banks and life insurance companies
		- Corporate bond market—Held by insurance companies, pension and retirement funds
		- Local and state government bonds—Primarily held for tax-\_\_\_\_\_\_\_\_\_\_ feature
		- Government securities—Held by commercial banks, the Fed, individual Americans/foreigners, and dealers
* The Money Market
	+ Exchange of short-term instruments—less than one year
	+ Highly liquid, minimal risk
	+ Use of a temporary surplus of funds by banks or businesses
	+ Commercial paper—short-term liabilities of prime business firms and finance companies
		- Bank Certificates of Deposits—liabilities of issuing bank, interest bearing to corporations that hold them
		- U.S. Treasury bills—\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_-term debts of US government

**Financial Intermediaries: Purposes and Profile:**

* Role Financial Intermediaries
	+ Act as agents in transferring funds from savers-lenders to borrowers-spenders.
	+ Acquire funds by issuing their liabilities to public and use money to purchase financial assets
		- Earn \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ on difference between interest paid and earned
		- Diversify portfolios and minimize risk
		- Lower transaction costs
		- Competition lowers interest rates—beneficial to economic growth

**Financial Intermediaries: Purposes and Profile**

* Financial Institutions in Profile—focus on composition of liabilities and assets
	+ Commercial Banks
		- Most \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
		- Range in size from huge (BankAmerica) to small (local banks)
		- Major source of funds used to be demand deposits of public, but now rely more on “other liabilities”
		- Also accept savings and time deposits—interest earning
		- Purchase wide variety of assets
			* short-term government securities
			* long-term business loans
			* home mortgages
	+ Life Insurance Companies
		- Insure against \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
		- Receive funds in form of premiums
		- Use of funds is based on mortality statistics—predict when funds will be needed
		- Invest in long-term securities—high \_\_\_\_\_\_\_\_\_\_\_\_\_\_
			* Long-term corporate bonds
			* Long-term commercial mortgages
* Financial Institutions in Profile (Cont.)
	+ Pension and Retirement Funds
		- Concerned with long run
		- Receive funds from working individuals building “\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_”
		- Accurate prediction of future use of funds
		- Invest mainly in long-term corporate bonds and high-grade stock
	+ Mutual Funds
		- Stock or bond market related institutions
		- Pool funds from many people
		- Invest in wide variety of securities—\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ risk
	+ Money Market Mutual Funds
		- Individuals purchase shares in the fund
		- Fund invests in highly liquid short-term money market instruments
			* large-size negotiable CD’s
			* Treasury bills
			* high-grade commercial paper
	+ Savings and Loan Associations [S&L’s]
		- Traditionally acquired funds through savings deposits
		- Used funds to make home mortgage loans
		- Now perform same functions as commercial banks
			* issue checking accounts
			* make consumer and business loans
	+ Commercial and Consumer Finance Companies
		- Acquire funds primarily by selling \_\_\_\_\_\_\_\_ term loans (commercial paper)
		- Lend money for consumer purchases or business firms to finance inventories
	+ Property and Casualty Insurance Companies
		- Insure homeowners and businesses against losses
		- Receive \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
		- Need to be fairly liquid due to uncertainty of claims
		- Purchase a variety of securities
			* high-grade stocks and bonds
			* short-term money market instruments for liquidity
	+ Credit Unions
		- Organized as cooperatives for people with common interest
		- Members buy shares [\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_] and can borrow
		- Changes in the law in early 1980’s broadened their powers
			* checking [share] accounts
			* make long-term mortgage loans