**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