## Chapter Summary: Key Concepts

### Understanding the Financial System

**Understanding the financial system**
Households, businesses, government, financial institutions, and financial markets together form what is known as the financial system.

### Types of Securities

**Securities**
Also called financial instruments, securities represent obligations on the part of the issuers, businesses, and governments, to provide the purchasers with expected or stated returns on the funds invested or loaned.

**Money market instruments**
Short-term debt securities issued by corporations, financial institutions such as banks, and governments.

**Bonds**
By selling bonds, the seller obtains long-term debt capital. Bonds are sold by the U.S. Treasury, municipalities, and corporations.

**Quality ratings for bonds**
Standard & Poor’s and Moody’s rate corporate and municipal bonds with regard to risk. Higher risk bonds must pay higher interest to attract investors.

**Stock**
Corporations generate equity capital when they sell stock and when stockholders actually own a piece of the corporation. Corporations may issue, common stock, preferred stock, or convertible securities.

### Financial Markets

**The primary market**
Markets in which new issues of securities are sold to the public for the first time.

**The secondary market**
These markets include the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), NASDAQ, and regional and foreign stock exchanges. In these secondary markets, securities are traded between investors.
Understanding Stock Markets

The New York Stock Exchange
The NYSE or “Big Board” is the largest secondary market in the world. It is where most of the largest, best-known U.S. companies’ stocks are traded. Trading involves face-to-face bidding between seated traders at posts on the exchange floor.

The NASDAQ stock market
Also known as the National Association of Securities Dealers Automated Quotation system, it is a computerized communications network where buy and sell orders are executed electronically.

Other U.S. stock markets
AMEX and several regional exchanges trade in the stocks of smaller firms.

Foreign stock markets
All developed countries, and many developing countries, have stock exchanges.

ECNs and the future of stock markets
Electronic communications networks, sometimes called the fourth market, is where buyers and sellers meet in a virtual stock market and trade directly with one another.

Investor participation in the stock markets
Investors need to use the services of a brokerage firm to buy or sell stocks. Investors establish an account with the brokerage firm and then enter orders to trade stocks.

Financial Institutions

Financial institutions
Intermediary between savers and borrowers, collecting funds from savers and then lending the funds to individuals, businesses, and governments. Financial institutions greatly increase the efficiency and effectiveness of the transfer of funds from savers to users.

Commercial banks
Largest and probably the most important financial institutions in the United States and in most other countries. Services include a wide range of checking and savings deposit accounts, consumer loans, credit cards, home mortgage loans, business loans, and trust services.

Savings banks and credit unions
Savings banks offer many of the same services as commercial banks, including checking accounts, but they are not major lenders to businesses. Credit unions are cooperative financial institutions that are owned by their depositors, all of whom are members.

Nondepository financial
institutions
Nondepository financial institutions accept funds from businesses and households, much of which they then invest. Generally, these institutions do not offer checking accounts.

Mutual funds
Financial intermediaries that raise money from investors by selling shares. They then use the money to invest in securities that are consistent with the mutual fund’s objectives.

The Federal Reserve System
Organization of the Fed
The Federal Reserve System (The Fed) is a network of 12 regional banks controlled by a board of governors who each serve 14-year terms. The Federal Open Markets Committee (FOMC) of the Fed is responsible for setting most policies concerning monetary policy and interest rates.

Check clearing and the Fed
The Fed centralizes the process by which funds are transferred from the check writer to the recipient.

Monetary policy
The Fed’s most important function is controlling the money supply and credit. Using tools such as reserve requirements, the discount rate, federal funds rate targets, and open market operations, the Fed promotes economic growth and a stable dollar through monetary policy.

Regulation of the Financial System
Bank regulation
Banks are among the nation’s most heavily regulated businesses. The main purpose of bank regulation is to ensure public confidence in the safety and security of the banking system. All banks have either state or federal charters.

Government regulation of the financial markets
Regulation of U.S. financial markets is primarily a function of the federal government, although states also regulate them. U.S. Securities and Exchange Commission (SEC), created in 1934, is the principal federal regulatory overseer of the securities markets. The SEC’s mission is to administer securities laws and protect investors in public securities transactions.

Insider trading
The use of material nonpublic information about a company to make investment profits.

Industry self-regulation
Two examples of self-regulation are the rules of conduct established by the various professional organizations and
market surveillance techniques used by the major securities markets.

The Financial System: A Global Perspective

Global perspective

Virtually all nations have some sort of a central bank, similar to the U.S. Federal Reserve. Examples include the Banks of Canada, England, Japan and the European Central Bank. These central banks play roles much like that of the Fed, such as controlling the money supply and regulating banks.

Business Vocabulary

call provision investment-grade bond
common stock limit order
convertible securities market order
debenture money market instruments
Federal Deposit Insurance Corporation (FDIC) municipal bonds
Federal Open Markets Committee (FOMC) mutual fund
Federal Reserve System (Fed) open market operations
financial institution primary market
financial market secondary market
financial system securities
government bonds speculative (junk) bond
initial public offering (IPO) subprime mortgage
insider trading

Application of Vocabulary

Select the term from the list above that best completes the statements below. Write that term in the space provided.

1. ________________________ are short-term debt securities issued by governments, financial institutions, and corporations.

2. When a company offers stock for sale to the general public for the first time it is known as ________________________.

3. The ________________________ sets most policies concerning monetary policy and interest rates.
4. ___________________________ are markets in which securities are issued and traded.

5. The ___________________________ is the central bank of the United States.

6. ___________________________ are bonds with ratings of BBB and above.

7. ___________________________ is the basic form of corporate ownership.

8. U.S. Department of the Treasury sells these types of bonds: ___________________________.

9. A ___________________________ sets a price ceiling when buying or a price floor when selling.

10. ___________________________ gives the bondholder or preferred stockholder the right to exchange the bond or preferred stock for a fixed number of shares of common stock.

11. The collection of financial markets in which previously issued securities are traded among investors is called ___________________________.

12. System process by which money flows from savers to users is called the ___________________________.

13. ___________________________ are the financial market in which firms and governments issue securities and sell them initially to the general public.

14. Financial intermediaries that raise money from investors by selling shares are called ___________________________.

15. The federal agency that insures deposits at commercial and savings banks is called the ___________________________.

16. ___________________________ are bonds issued by state or local governments.

17. A ___________________________ allows the issuer to redeem the bond before its maturity at a specified price.

18. The use of material nonpublic information about a company to make investment profits is called ___________________________.

19. The ___________________________ is the intermediary between savers and borrowers, collecting funds from savers and then lending the funds to individuals, businesses, and governments.

20. Loans made to borrowers with poor credit ratings are called ___________________________.

21. The technique of controlling the money supply growth rate by buying or selling U.S. Treasury securities is called ___________________________.

22. A ___________________________ is an uninsured bond.
23. The market in which shares of stock are bought and sold by investors is called the ______________________.

24. ______________________ are financial instruments that represent obligations on the part of the issuers to provide the purchasers with expected stated returns on the funds invested or loaned.

25. A ______________________ instructs the broker to obtain the best possible price, the highest price when selling, and the lowest price when buying.

Analysis of Learning Objectives

Learning Objective 16.1: Outline the importance and structure of the financial system.

True of False

1. ____ The financial system is the process by which funds are transferred between those having excess funds (savers) and those needing additional funds (users).

2. ____ Users expect to earn a rate of return in exchange for the use of their funds.

3. ____ Financial markets, financial institutions, and financial instruments (securities) make up the financial system.

4. ____ Although direct transfers are possible, most funds flow from users to savers.

5. ____ Commercial banks are financial institutions.

6. ____ A well-functioning financial system is critical to the overall health of a nation’s economy.

7. ____ Generally, individuals are net users.

8. ____ Businesses and governments are net users.

Learning Objective 16.2: List the various types of securities.

Multiple Choice

1. The true owners of a corporation:
   a. are the common shareholders.  
   b. have voting rights.  
   c. have a residual claim to assets.  
   d. all of the above.

2. Preferred stockholders:
a. have a prior claim to assets.
b. usually have a vote.
c. are contributors of debt, not equity capital.
d. all of the above.

3. In the event of a firm’s dissolution, the first claim on its assets belongs to:
   a. bondholders.
   b. preferred stockholders.
   c. common stockholders.
   d. all investors have an equal claim to assets.

4. A person who prefers being a creditor to being an owner would invest in:
   a. common stock.
   b. preferred stock.
   c. bonds.
   d. an IPO.

5. Short-term debt securities sold by corporations and governments are:
   a. bonds.
   b. money market instruments.
   c. preferred securities.
   d. common stocks.

Learning Objective 16.3: Define financial markets and distinguish between the primary and secondary financial markets.

Multiple Choice

1. The initial issue of stock or bonds takes place in the:
   a. primary market.
   b. secondary market.
   d. all of the above.

2. When investors trade securities among themselves they do so by means of the:
   a. primary market.
   b. secondary market.
   c. Dow Jones Industrial Index.
   d. Standard & Poor’s rating services.

3. Each time securities are traded on the secondary market, the issuing corporation receives:
   a. 100% of the selling price.
   b. 50% of the selling price.
   c. 25% of the selling price.
   d. none of the selling price.

4. Rather than going directly to the public with a new issue of stock, most corporations use:
   a. investment bankers.
   b. the secondary market.
   c. the New York Stock Exchange.
   d. the American Stock Exchange.

Learning Objective 16.4: Discuss the characteristics of the major stock exchanges.

Multiple Choice
1. The largest exchange in the world is:
   a. NYSE.  
   b. NASDAQ.  
   d. London Exchange.

2. The oldest exchange is:
   a. NYSE.  
   b. NASDAQ.  
   d. London Exchange.

3. This exchange focuses on stocks of small firms.
   a. NYSE  
   b. NASDAQ  
   c. American Stock Exchange  
   d. London Exchange

4. This exchange is actually a computerized communications network that links member investment firms.
   a. NYSE  
   b. NASDAQ  
   c. American Stock Exchange  
   d. London Exchange

5. Which exchange is considered the most international?
   a. NYSE  
   b. NASDAQ  
   c. American Stock Exchange  
   d. London Exchange

Learning Objective 16.5: Discuss the organization and functioning of financial institutions.

Multiple Choice

1. A profit-making business that holds deposits for individuals and business firms and makes loans to individuals and business firms is a:
   a. commercial bank.  
   b. credit union.  
   c. commercial finance company.  
   d. consumer finance company.

2. A form of cooperative that acts as a depository and grants loans to its members is a(n):
   a. commercial bank.  
   b. commercial finance company.  
   c. insurance company.  
   d. credit union.

3. An institution that offers both saving and checking accounts and that has historically been the major source of home loans is called a:
   a. consumer finance company.  
   b. commercial bank.  
   c. savings bank.  
   d. credit union.

4. What type of financial institution offers short-term loans to businesses but not to individuals?
   a. credit unions  
   b. consumer finance companies  
   c. savings and loan associations  
   d. commercial banks  
   e. commercial finance companies
5. These types of institutions provide financial protection for their policyholders, make commercial and real estate mortgage loans, and purchase government bonds:
   a. mutual savings banks.  d. credit unions.
   b. insurance companies.  e. consumer finance companies.
   c. commercial banks.

6. All of the following are deposit institutions, EXCEPT:
   a. pension funds.  c. commercial banks.
   b. credit unions.  d. savings banks.

**Learning Objective 16.6:** Explain the functions of the Federal Reserve System and the tools it uses to control the money supply and credit.

**True or False**

1.____ The most essential function of the Federal Reserve System is to control the supply of money and credit in order to promote economic growth and a stable dollar.

2.____ An increase in the reserve requirement or the discount rate will increase the money supply.

3.____ The Fed is the U.S. Central Bank.

4.____ If the Fed buys government bonds on the open market, the money supply will increase.

5.____ The Federal Reserve System has no control over interest rates.

6.____ The Fed is designed to be politically dependent on the current administration and the Congressional appropriations process.

**Learning Objective 16.7:** Evaluate the major features of regulations and laws affecting the financial system.

**Fill in the blank**

1. The federal agency that regulates the securities markets is the__________________.

2. Before a new security can be issued, the issuer must prepare and submit a ________________.

3. The SEC tries to ensure__________________, that is, investors should have access to all relevant information so they can make informed investment decisions.

4. If a company’s officers, directors, lawyers, accountants, investment bankers, or even outside friends or reporters use material, nonpublic information about a company to make investment profits, they are engaged in ________________.
5. The SEC recently issued ____________________________ to ensure that no particular class of investor gets information about a company before it is available to everyone.

6. The securities industry uses market surveillance and adopts professional rules of conduct to ensure fair and orderly markets and to promote investor confidence. These activities are collectively known as ____________________________.

Learning Objective 16.8: Describe the global financial system.

True or False

1._____ Virtually all nations have a central bank.

2._____ American banks make up the majority of the global financial giants.

3._____ Transactions in international markets have no impact on the domestic money supply.

4._____ Foreign currencies and securities held by the Fed are counted as part of the U.S. banking system’s reserves.

Self Review

True or False

1._____ Financial control is the process that periodically checks actual revenues, costs, and expenses against a firm’s forecasts and plans.

2._____ Commercial paper is another name for long-term debt.

3._____ Having too much cash on hand can be costly.

4._____ Not having enough cash on hand can be costly.

5._____ The amount and timing of borrowing are important aspects of the financial plan.

6._____ Leverage is a technique of increasing the return on investment.

7._____ If the Federal Reserve Bank buys government bonds on the open market, the money supply with decline.

8._____ Commercial banks and savings banks both focus on business banking.

9._____ A demand deposit is another name for a checking account.

10._____ Commercial finance companies usually make long-term loans to businesses.
11.____ All national banks must belong to the Federal Reserve System.

12.____ If the Federal Reserve Bank increases the reserve requirements, member banks will have less funds available to make loans.

13.____ With a debit card, consumers’ purchases are deducted directly from their accounts.

14.____ In a secured loan, borrowers need not pledge collateral.

15.____ Loans repaid over one year or longer, bonds, and equity funds are all considered long-term sources of funds.

16.____ Commercial paper is more risky than T-Bills; thus it pays a higher rate of interest.

17.____ Banks examiners are trained representatives who inspect the financial records and management practices of financial institutions.

18.____ Equity capital is obtained through the sale of bonds.

19.____ Insurance companies are depository institutions.

Multiple Choice

1. Which of the following has no maturity date?
   a. debt
   b. equity
   c. both debt and equity mature
   d. neither has a maturity date

2. The largest and most common financial institutions in the United States are:
   a. commercial banks.
   b. commercial finance companies.
   c. savings banks.
   d. consumer finance companies.

3. Accounts similar to checking accounts that are offered by credit unions are called:
   a. time deposits.
   b. now accounts.
   c. share draft accounts.
   d. deposit accounts.

4. The clearinghouse for checks is the:
   a. Internet Banking System.
   b. Bank of America.
   c. Federal Reserve System.
   d. Federal Check Regulatory Commission.
   e. Internal Revenue Service.

5. Which of the following is NOT true of commercial paper?
   a. It is issued by major corporations to raise money.
   b. It is a secured short-term loan.
   c. It is a short-term promissory note.
16-12 Part VI Managing Financial Resources

d. It is backed by the reputation of the issuing company.
e. All of the above are true.

6. Corporate bonds are a form of:
   a. long-term debt financing.
   b. short-term debt financing.
   c. long-term equity financing.
   d. short-term equity financing.
   e. commercial paper.

7. Banks:
   a. raise money by accepting deposits.
   b. pool deposits and use them to make loans to consumers and businesses.
   c. make money by charging a higher rate on loans than they pay on deposits.
   d. make money on fees they charge to customers for services performed.
   e. all of the above.

8. Junk bonds:
   a. offer higher yields in return for taking greater risks.
   b. generally earn lower interest rates than AAA-rated bonds.
   c. are already in default.
   d. all of the above.

9. Sales charges levied on mutual funds are commonly called:
   a. loads.
   b. commissions.
   c. DRIPs.
   d. P/E ratios.

Application Exercises

1. Alice Brown is a recent widow who received $100,000 from her husband’s life insurance policy. She plans to use the money as a down payment for a new home in about a year and wants to put the money in a safe place until then. Her inclination is to put it in the bank, but she has also heard that sometimes banks fail. What can you tell her about the safety of her proposed deposit? What should she look for when selecting a bank? An investment vehicle?
Short Essay Questions

1. What are securities? What are the risks and rewards of investing in securities? What steps can an individual investor take to minimize risk?
2. What are primary markets? How do they differ from secondary markets?

3. What is the Federal Reserve System and What role does it play in modern finance? Name and discuss the major tools the Federal Reserve System has at its disposal.