**FIN 440 LECTURE 2**

**REVIEW OF BASIC CONCEPTS contd…**

**CHAPTER REFERENCE – CHP 1**

Every corporation has an ongoing need for funds – which they can obtain externally from three sources –

* PRIVATE PLACEMENT
* FINANCIAL INSTITUTIONS
* FINANCIAL MARKETS

A financial institution accepts savings and transfers them to those that need funds. They serve as

intermediaries by channeling the savings of individuals, businesses, and governments into loans or

investments. Additionally, they pay savers interest on deposited funds, and provide services

(with/without fees).

FINANCIAL INSTITUTIONS

Financial institutions take funds from individuals, businesses and governments, combine them and

make loans available to individuals and businesses.

**What is the most common financial institution?**

**What are some of the other types of financial institutions?**

* Credit unions
* Savings banks
* Insurance companies
* Pension funds
* Etc.

**KEY CUSTOMERS OF FINANCIAL INSTITUTIONS**

**Key Supplier** – those who save more money than they borrow from financial institutions.

WHO are the net/key suppliers of financial institutions?

**Key Demanders** – those who borrow more money than they save

WHO are the net/key demanders of financial institutions?

**FINANCIAL MARKET**

* Is where the net suppliers of funds and the net demanders can transact business DIRECTLY.
* Suppliers in the financial market know where their money is being invested.
* To raise funds in the financial market, firms can use either private placements or public offerings.

PRIVATE PLACEMENTS – sale of NEW company stock directly to a select group of

investors.

PUBLIC OFFERINGS – sale of securities/stocks/bonds to the general public.

PRIMARY MARKET – is the ONLY place where YOU are directly involved in the transaction

and receive direct benefit from the issue. The market in which securities/stocks are initially

issued.

SECONDARY MARKET – Is where pre-owned shares are sold/bought.

***Q. Is there a relationship between financial institutions and financial markets?***

A. Financial institutions actively participate in the financial market and both suppliers and demanders of

funds. Financial institutions are an integral part of financial markets.

**MONEY MARKET**

-The money market deals with **SHORT TERM** funds.

- It creates a relationship between the suppliers and demanders of short term funds.

- It exists because some individuals, businesses, governments and financial institutions have temporarily

idle funds that they wish to put to some interest-earning use. At the same time, other individuals,

businesses, governments and financial institutions find themselves in need of short term funds (cash flow).

The money market brings these two groups together

Money market transactions are done through **MARKETABLE SECURITIES**

Treasury bills

Certificates of deposit issued by governments, businesses, and financial institutions

**How does the system of marketable securities work?**

In the money market, businesses and governments – those who need short term funds, issue a MONEY

**MARKET INSTRUMENT** i.e. a **MARKETABLE SECURITY**. Those who supply short term funds

PURCHASE (invest) these securities. After a pre-determined amount of time (differs from security to

security) the security MATURES, and can be redeemed for a higher than purchase value from the issuer.

Where is the money market?

- To issue or purchase a money market instrument, the buyer/issuer and seller MUST directly go to one

another or use an intermediary, such as a financial institution to make the transaction.

- Typically money market securities are sold through government securities dealers. Stock brokerage firms

also sell money market instruments. Most commonly, financial institutions will sell money market securities

to provide their customers attractive returns on their savings.

*What are FEDERAL FUNDS?*

*Loan transactions between commercial banks in which the Federal Reserve banks become involved.*

**THE EUROCURRENCY MARKET**

- Is the international equivalent to the domestic money market. It is a market for short term banks deposits

denominated in US Dollars or other easily convertible currencies.

- Eurocurrency deposits arise when a corporation or individual makes a bank deposit in a currency other

than the local currency of the country where the bank is located

- E.g. a multinational corporation deposits US dollars in a London Bank. This would create a Eurodollar

deposit. Also **all Eurodollar deposits are time deposits** i.e. the bank would promise to repay the deposit,

with interest at a fixed data in the future, e.g. 6 months. During this time the bank is free to invest the

money/lend it to whoever it wants. It can even lend the money to another bank – the interest rate charged on

Eurocurrency loans between banks is called the **LIBOR – London Inter-bank Offered Rate** – usually it is

the base rate that is used to price all Eurocurrency loans.

**Why is the Eurocurrency Market important?**

- It fills the needs of borrowers and lenders globally. IT IS A GLOBAL MARKET

- Investors with excess cash are able to make short term, large, and safe deposits at attractive interest rates.

- Borrowers are able to arrange large loans, quickly and confidentially, at attractive rates.

**CAPITAL MARKET**

is the market that enables suppliers and demanders of LONG TERM FUNDS to make

transactions. The capital market is formed by the various SECURITIES EXCHANGES that provide a forum

for bond and stock transactions.

KEY SECURITIES TRADED IN THE CAPITAL MARKET

* BONDS
* STOCK

BONDS – are LONG TERM debt instruments used by business and governments to raise large sums of

money, from a diverse group of lenders.

- CORPORATE BONDS – Typically pay interest SEMIANNUALLY (every 6 months) at a stated **coupon interest rate**. They have an initial maturity from 10 – 30 years, and a **par** or **face value** of $1000 that must be repaid at maturity.

STOCKS – units of ownership or EQUITY in a corporation.

COMMON STOCK – common stockholders earn a return by receiving dividends – periodic

distribution of earnings – or by realizing increases in share price.

PREFERRED STOCK – preferred stockholders are PROMISED a FIXED PERIOD DIVIDEND that

MUST be paid prior to payment of any dividends to common stockholders.

**SECURITIES EXCHANGES**

Q. WHAT ARE SECURITIES EXCHANGES ?

A. The marketplace in which firms/corporations can raise funds through the sale of new securities and the

purchasers of securities can resell them when necessary. Securities exchanges are commonly referred to as

the “STOCK MARKET”. IS THIS DEFINITION ACCURATE ?

- ORGANIZED SECURITIES EXCHANGE

- OVER THE COUNTER SECURITIES EXCHANGE

ORGANIZED SECURITIES EXCHANGES

Are tangible organizations that act as secondary markets where securities are sold and resold. They

account for about 46% of the total dollar volume of domestic shares traded. The two best known stock

exchanges are –NYSE – New York Stock Exchange – MOST EXCHANGES ARE MODELED AFTER THE

NYSE;AMEX – American Stock Exchange