#### CHAPTER 16: The Financial System

**Chapter Overview**

We begin by describing the financial system and its components in more detail. Then, the major types of financial instruments, such as stocks and bonds, are outlined. Next we discuss financial markets, where financial instruments are bought and sold. We then describe the world’s major stock markets, such as the New York Stock Exchange.

Next, banks and other financial institutions are described in depth. The structure and responsibilities of the U.S. Federal Reserve System, along with the tools the Fed uses to control the supply of money and credit, are detailed. The chapter concludes with an overview of the major laws and regulations affecting the financial system and a discussion of today’s global financial system.

**Glossary of Key Terms**

**Common stock:** basic form of corporate ownership

**Federal Deposit Insurance Corporation (FDIC):** federal agency that insures deposits at commercial and savings banks

**Federal Reserve System (Fed):** central bank of the United States

**Financial institutions:** intermediary between savers and borrowers, collecting funds from savers and then lending the funds to individuals, businesses, and governments

**Financial market:** market in which securities are issued and traded

**Financial system:** process by which money flows from savers to users

**Insider trading:** use of material nonpublic information about a company to make investment profits

**Primary market:** financial market in which firms and governments issue securities and sell them initially to the general public

**Secondary market:** collection of financial markets in which previously issued securities are traded among investors

**Securities:** 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

**Stock markets (exchanges):** market in which shares of stock are bought and sold by investors

**Learning Objective 1: Understand the financial system.**

*The financial system is the process by which funds are transferred between those having excess funds (savers) and those needing additional funds (users). Savers and users are individuals, businesses, and governments. Savers expect to earn a rate of return in exchange for the use of their funds. Financial markets, financial institutions, and financial instruments (securities) make up the financial system. Although direct transfers are possible, most funds flow from savers to users through the financial markets or financial institutions, such as commercial banks. A well-functioning financial system is critical to the overall health of a nation’s economy.*

**Annotated Lecture Outline**

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| **Opening Vignette:**  **Community Banks Team Up to Fight the Megabanks**  Here’s what one customer recently had to say about her relationship with a major U.S. bank: “I’m sick of their fees. I’m sick of not knowing where my money goes.”  Does that sound familiar? Millions of bank customers who feel the same are finding smaller community banks and credit unions more appealing alternatives than megabanks, with their multiplying fees and impersonal service. But smaller institutions have been woefully lacking in competitive clout and product offerings compared to major banks like Bank of America and Citibank—until now.  Almost 130 banks and credit unions in 35 states have joined forces under a new national brand called Kasasa, pooling their resources to offer banking products that compete with the big names. BancVue is the parent company of Kasasa; it provides staff training to member institutions and does their marketing and promotion. Member banks pay Kasasa a fee based on their size and contribute some marketing funds. In return they’re reporting increases in checking and savings deposits between 15 percent and 25 percent.  Customers benefit from the alliance’s scope. They still bank locally with no minimum-balance requirement, and they can sign up for online banking, higher-yield accounts, and refunds of ATM fees. They can also make automatic charitable donations, automatically deposit interest into savings accounts, and earn free iTunes downloads. Requirements are few and include using a debit card for 10 transactions in any amount per month.  The more banks that join Kasasa, the more it can do. With seven Ohio banks on board, for instance, Kasasa achieved a powerful marketing milestone none could achieve alone by winning sponsorship of the Cleveland Cavaliers NBA basketball team. The small-bank alliance expects to double its membership soon, raise its advertising budget to $13.5 million, and reach 1,000 members within a few years.  Some current members are doing their part to help Kasasa achieve that goal, including the veteran CEO of one Minnesota bank who persuaded two neighboring banks to join. “Over the past couple years,” he said, “I’ve realized that other banks like us that serve their communities shouldn’t be the ones we’re competing with.” Another CEO in Missouri who reached out to rivals said they were skeptical about Kasasa at first, but “once they see the results we’ve had, I think they’ll be coming back around.”1 |  |
| **UNDERSTANDING THE FINANCIAL SYSTEM** | PowerPoint Slide 3 |
| 1. The *financial system* is the process by which money flows from savers to users. | *Lecture Enhancer: How are savers served by the*  *components of the financial system? How do users benefit?* |

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| 2. Households, businesses, government, financial institutions, and financial markets together form what is known as the financial system. | PowerPoint Slide 4  Figure 16.1 Overview of the Financial System and Its Components |
| * 1. Savers are those with excess funds who choose not to spend all of their current income, so they have a surplus of funds. |  |
| * 1. Users are the opposite of savers; their spending needs exceed their current income, so they have a deficit and need to obtain additional funds to make up the difference. |  |
| * 1. In the United States, households are net savers while businesses and governments are net users. |  |
| * + 1. Even though the savings rate of American households is low compared with those of other countries, American households still save hundreds of billions of dollars each year. |  |
| 3. How much an individual saves is a function of many variables. |  |
| * 1. People often transition from net borrowers to net savers as they get older. | *Class Activity:*  *Ask students why it is difficult for them to save money as compared to older people.* |
| * + 1. In the early years your net worth—the difference between what you own and what you owe—is very low and may even be negative. |  |
| * + 1. As your career progresses and your income rises, you build a financial nest egg to fund retirement, and your net worth increases. | *Lecture Enhancer:*  *What expenses typically decrease as you get older? Which ones might rise?* |
| 4. Funds can be transferred between savers and users in two ways: directly and indirectly. |  |
| * 1. A direct transfer means that the user raises the needed funds directly from savers. |  |
| * 1. Funds can be transferred indirectly through either financial markets or financial institutions. | Going Green:  Green Banking at New Resource Bank |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**Going Green**

Green Banking at New Resource Bank

**Summary**

Would you drive 25 miles to move your money to a “green” bank? One couple in Illinois recently did. The trend toward small banks with personalized service and Earth-friendly profiles has gained steam in the wake of recent protests and gaffes like Bank of America’s quickly withdrawn debit card fee.

New Resource Bank is a popular green-bank alternative for many San Francisco customers. “Our business has tripled this month,” its CEO said recently after New Resource gained $1.5 million in deposits from 150 new accounts. “We have had nonstop, all day long, people moving their money.”

New Resource earns part of its appeal from its sustainability focus. It is a Certified B Corporation and San Francisco-certified Green Business, its headquarters are LEED Gold certified, and it won a regional Outstanding Achievement award from the U.S. Environmental Protection Agency. The bank reuses and recycles to keep 95 percent of its waste from entering local landfills, it purchases Green-e certified wind power certificates to offset electricity use, and it uses remanufactured toner cartridges and recycled paper. It is also a leading local lender to communities and businesses installing solar panels in California. The loans are funded by certificate of deposit (CD) accounts dedicated exclusively to financing solar panels.

**Questions for Critical Thinking**

**1. One bank’s COO calls the popularity of green banks “a broader cultural shift in what people expect from their bank.” Do you agree? Why or why not?**

*I agree. In the wake of recent protests and gaffes (like Bank of America’s quickly withdrawn debit card fee), people are moving their money to banks with personalized service and Earth-friendly profiles.*

**2.****How important to bank customers is community involvement like New Resource’s solar lending program and dedicated solar CDs?**

***It is very important to customers that banks are involved with their community. Not only does it show that the bank wants to cut back on its own electricity use, but it wants to help the community reap the same benefits****.*

Assessment Check Answers

**1.1 What is the financial system?**

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

**1.2 In the financial system, who are the borrowers and who are the savers?**

*Savers and borrowers are individuals, businesses, and governments. Generally, individuals are net savers, meaning they spend less than they make, whereas businesses and governments are net borrowers.*

**1.3 List the two most common ways in which funds are transferred between borrowers and savers.**

*The two most common ways funds are transferred are through the financial markets and through financial institutions.*

**Learning Objective 2: List the various types of securities.**

*Securities, also called* financial instruments, *represent obligations on the part of issuers—businesses and governments—to provide purchasers with expected or stated returns on the funds invested or loaned. Securities can be classified into three categories: money market instruments, bonds, and stock. Money market instruments and bonds are debt instruments. Money market instruments are short-term debt securities and tend to be low-risk securities. Bonds are longer-term debt securities and pay a fixed amount of interest each year. Bonds are sold by the U.S. Department of the Treasury (government bonds), state and local governments (municipal bonds), and corporations. Mortgage pass-through securities are bonds backed by a pool of mortgage loans. Most municipal and corporate bonds have risk ratings. Common stock represents ownership in corporations. Common stockholders have voting rights and a residual claim on the firm’s assets.*

**Annotated Lecture Outline**

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| **TYPES OF SECURITIES** | PowerPoint Slide 5 |
| 1. *Securities*, also called financial instruments, 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. |  |
| b. Securities can be grouped into three categories: money market instruments, bonds, and stock. |  |
| **1. Money Market Instruments** | PowerPoint Slide 6 |
| 1. *Money market instruments* are short-term debt securities issued by governments, financial institutions, and corporations. |  |
| 1. They are low-risk securities that mature in one year. | *Lecture Enhancer:*  *What type of person would be more likely to invest in low-risk securities?* |
| 1. Investors are paid interest for the use of their funds. |  |
| i. Treasury bills are short-term securities issued by the U.S. Treasury and backed by the government. |  |
| ii. Commercial paper, securities sold by corporations, matures within 270 days. |  |
| iii. A certificate of deposit (CD) is a time deposit at a financial institution. |  |
| **2. Bonds** | PowerPoint Slide 7 |
| a. Bondholders are creditors of a corporation or government body. |  |
| **b. Types of Bonds:** | PowerPoint Slide 8  Table 16.1 Types of Bonds  *Lecture Enhancer: Compare the risks and features of each type of bond. Why would a firm choose a certain type as an investment?* |
| * + 1. *Government bonds* are sold by the U.S. Treasury and are considered the least risky of all bonds. |  |
| ii. *Municipal bonds* are issued by state and local governments; interest payments are exempt from federal income tax. |  |
| iii. A revenue bond is a bond issue whose proceeds will be used to pay for a project that will produce revenue, such as a toll road or bridge. |  |
| iv. A general obligation bond is a bond sold by government units with the power to levy taxes whose proceeds are to be used to pay for a project that will not produce any revenue. |  |
| v. A secured bond is backed by a specific pledge of company assets. |  |
| vi. Many firms also issue unsecured bonds, called *debentures.* | *Lecture Enhancer:*  *Do you think unsecured bonds would pay higher or lower interest? Why?* |
| vii. A mortgage pass-through security is backed by a pool of mortgage loans purchased from lenders. |  |
| viii. *Subprime mortgages* are loans made to borrowers with poor credit ratings. | *Lecture Enhancer: How did subprime mortgage loans lead to the $700 billion government bailout?* |
| ix. Many of these securities turned out to be quite risky and, in part, triggered what became known as the credit crisis. |  |
| **c. Quality Ratings for Bonds** | PowerPoint Slide 9 |
| * + 1. Two factors determine the price of a bond—its risk and its interest rate. |  |
| * + 1. *Bond rating* is a rating of a bond’s level of risk. | PowerPoint Slide 10  Table 16.2 Standard & Poor’s Bond Ratings |
| * + 1. Ratings of AAA are considered the least risky. |  |

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| * + 1. Bonds rated BBB and above are called *investment-grade bonds.* |  |
| * + 1. Bonds rated BB and below, are *speculative-grade bonds,* also called *junk bonds*; they are speculative, pay a higher interest, and carry a greater risk. |  |
| * + 1. Higher interest rates bring higher bond prices. |  |
| * + 1. *Market interest rates* also influence bond prices. |  |
| viii. A *call provision* allows the issuer to redeem the bond before its maturity at a determined price. |  |
| ix. Issuers tend to “call” bonds when market interest rates decline. |  |
| **3. Stock** | PowerPoint Slide 11 |
| * 1. The basis of corporate ownership is embodied in *common stock* since purchasers are true owners of the firm. |  |
| * + 1. Stockholders can vote on major decisions, and they expect some sort of return on the money they invest. |  |
| * + 1. The return may be in the form of cash dividend payments and/or price appreciation. |  |
| * + 1. Dividends vary widely, and fast-growing firms often pay less in dividends because they need the money to finance growth. | *Lecture Enhancer: How might a fast-growing company need and use more money than a slower growing company?* |

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| * + 1. Common stockholders benefit from company success and risk the loss of their investments if the company fails. | *Class Activity: Discuss the BP oil spill and how damage estimates might be developed for such an incident.* |
| * + 1. A stock’s market value is the price at which the stock is currently selling. |  |
| * 1. **Preferred Stock** |  |
| * + 1. Preferred stock holders have priority over common stockholders in the payment of dividends but have no voting rights. | *Lecture Enhancer:*  *In a corporate bankruptcy, would you rather hold preferred stock or common stock? Why?* |
| ii. Preferred stock pays fixed dividend regardless of company performance. |  |
| iii. Many investors consider it more like a bond than a common stock. |  |
| **c. Convertible Securities** | PowerPoint Slide 12 |
| * + 1. A convertible security is a bond or preferred stock that gives the holder the right to exchange the bond or preferred stock for a fixed number of shares of common stock. |  |
| * + 1. Convertible bonds pay a lower interest rate but offer the potential of additional gain if the firm’s stock rises. |  |

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Assessment Check Answers

**2.1 What are the major types of securities?**

*The major types of securities are money market instruments, bonds, and stock.*

**2.2 What is a government bond? A municipal bond?**

*A government bond is one issued by the U.S. Treasury. Municipal bonds are issued by state and local governments.*

**2.3 Why do investors purchase common stock?**

*There are two primary motives for purchasing common stock. One is to receive dividends, cash payments to shareholders by the firm. The other is the potential price appreciation of the shares.***Learning Objective 3: Discuss *financial markets*.**

*A financial market is a market where securities are bought and sold. The primary market for securities serves businesses and governments that want to sell new security issues to raise funds. Securities are sold in the primary market either through an open auction or via a process called* underwriting. *The secondary market handles transactions of previously issued securities between investors. The New York Stock Exchange is a secondary market. The business or government that issued the security is not directly involved in secondary market transactions. In terms of the dollar value of trading volume, the secondary market is about four to five times larger than the primary market.*

**Annotated Lecture Outline**

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| **FINANCIAL MARKETS** | PowerPoint Slide 13 |
| 1. Securities are issued and traded in *financial markets.* |  |
| a. While there are many different types of financial markets, one of the most important distinctions is between primary and secondary markets. |  |
| b. In the *primary market,* firms and governments issue securities and sell them initially to the general public. |  |
| * + 1. A stock offering lets investors purchase ownership shares in a firm and participate in its growth, in exchange for providing capital. |  |
| * + 1. An *initial public offering (IPO)* is the first sale of a company’s stock to the general public. | Hit & Miss:  Facebook at the IPO Crossroads |
| * + 1. Both firms and government agencies rely on primary markets to raise funds by issuing bonds. | *Class Activity: Review the academic courses that an investment banker might take.* |
| * + 1. Announcements of new stock and bond offerings appear in publications such as the *Wall Street Journal* and are called *tombstones.* |  |
| c. Securities are sold in open auctions and through investment bankers. |  |
| * + 1. Almost all securities sold through open auctions consist of U.S. treasury securities. |  |
| * + 1. Underwriting is the process of purchasing an issue from a firm or government and then reselling the issue to investors. | *Lecture Enhancer: Do you think investment banking would be an interesting career opportunity?* |
| * + 1. Financial institutions underwrite stock and bond issues at a discount, which is compensation for their services. |  |
| * + 1. In addition to locating buyers for the issue, the underwriter advises the issuer on the general characteristics of the issue, its pricing, and the timing of the offering. |  |
| 2. The Secondary Market |  |
| 1. The *secondary market* is the market in which existing security issues are bought and sold by investors (e.g., New York Stock Exchange,NASDAQ). |  |
| 1. The corporations and governments that issued the securities being traded are not directly involved. |  |

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| 1. They do not make payments when securities are sold and do not receive proceeds when they’re purchased. |  |
| * 1. The secondary market is four to five times larger than the primary market. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

**Hit or Miss**

Facebook at the IPO Crossroads

**Summary**

Because privately held companies with assets over $10 million and 500 shareholders must file financial statements with the Securities and Exchange Commission (SEC), Facebook, valued at $75 to $100 billion, recently announced its IPO, seeking $5 billion in funding. The eagerly awaited stock offering could disappoint investors, however, since trades among company insiders may have generated all the early profits possible from shares.

But the IPO nevertheless represents a crossroads. Despite having 850 million members worldwide, Facebook earns only $4.39 a year from each active user. Once it goes public, it must find new ways to capitalize on its biggest asset—an unmatched store of members’ personal data—or stop growing. Some believe Facebook’s targeted ads, which bring 84 percent of its revenues, are an outmoded model that “doesn’t work very well.” Making deeper use of members’ data, such as to further fine-tune ads without running afoul of privacy laws worldwide—or raising users’ ire—will be a difficult challenge.

To battle Google, Amazon, Apple, and Microsoft, tech giants “competing to become the operating systems of our lives,” Facebook must make savvy use of its new store of IPO cash.

Questions for Critical Thinking

1. What impact on Facebook’s mission do you think the IPO will have?

*Facebook will have to find new ways to make money without running afoul of privacy laws. Its largest cash cow, targeting advertising, is becoming less effective, so it will need to search for new ways to make money.*

1. Would you invest in Facebook stock? Why or why not?

*I would invest in facebook stock because it is one of the largest companies globally to make an impact over the past few years. It is so engrained as a part of our society that it isn’t going to fade away anytime soon.*

Assessment Check Answers

**3.1 What is a financial market?**

*A financial market is a market in which securities are bought and sold.*

**3.2 Distinguish between a primary and a secondary financial market.**

*The primary market for securities serves businesses and governments that want to sell new security issues to raise funds. The secondary market handles transactions of previously issued securities between investors.*

**3.3 Briefly explain the role of financial institutions in the sale of securities.**

*Financial institutions purchase new securities issues from corporations or state and local governments and then resell the securities to investors. The institutions charge a fee for their services.*

**Learning Objective 4: Understand the stock markets.**

*The best-known financial markets are the stock exchanges. They exist throughout the world. The two largest—the New York Stock Exchange andNASDAQ—are located in the United States. The NYSE is bigger, measured in terms of the total value of stock traded. Larger and better-known companies dominate the NYSE. Buy and sell orders are transmitted to the trading floor for execution. The NASDAQ stock market is an electronic market in which buy and sell orders are entered into a computerized communication system for execution. Most of the world’s major stock markets today use similar electronic trading systems.*

**Annotated Lecture Outline**

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| **UNDERSTANDING STOCK MARKETS** | PowerPoint Slide 14 |
| * 1. *Stock markets* or *exchanges* are the best known of the world’s financial markets because shares of stock are bought and sold by investors. | PowerPoint Slide 15 |
| 1. **The New York Stock Exchange** |  |
| * 1. The New York Stock Exchange is the world’s oldest (1792), largest, and most famous stock market. |  |
| * 1. The NYSE lists about 2,300 common and preferred stocks with a market value of more than $12 trillion. |  |
| * 1. Trading takes place face-to-face on trade floor, where only members are allowed to trade. |  |
| * 1. Each NYSE stock is assigned to a specialist firm. |  |
| 1. **The NASDAQ Stock Market** |  |
| * 1. The NASDAQ stock market is the world’s second-largest stock exchange, and very different from the NYSE. |  |
| * 1. NASDAQ (National Association of Securities Dealers Automated Quotations) is a computerized network that links member investment firms. |  |
| * 1. All trading takes place electronically. |  |
| * 1. All NASDAQ-listed stocks have two or more market makers—firms that perform the same functions as NYSE specialists. |  |
| 1. **Other U.S. Stock Markets** |  |
| * 1. The American Stock Exchange (AMEX) focuses on smaller firms; daily trading volume is less than 100 million shares. |  |
| * 1. U.S. regional stock exchanges include the Chicago, Pacific (San Francisco), Boston, Cincinnati, and Philadelphia stock exchanges. |  |
| * + 1. Originally established to trade the shares of small, regional companies, the regional exchanges now list securities of many large corporations as well. |  |
| * + 1. More than half of the companies listed on the NYSE are also listed on one or more regional exchanges. |  |
| 1. **Foreign Stock Markets** |  |
| a. Virtually all developed countries and many developing countries have stock exchanges. | Hit & Miss:  **How News Lifts—or Sinks—World Stocks** |
| * 1. One of the largest stock exchanges outside of the United States is the London Stock Exchange. |  |

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| 1. **ECNs and the Future of Stock Markets** | PowerPoint Slide 16 |
| * 1. The *fourth market* is the direct trading of exchange-listed stocks off the floor of the exchange or outside the network or the NYSE andNASDAQ. |  |
| * 1. The fourth market has begun to open up to smaller, individual investors through markets called electronic communications networks (ECNs). |  |
| i. In ECNs, buyers and sellers meet and trade directly with one another in a virtual stock market. |  |
| ii. No specialist or market maker is involved. |  |
| iii. INET and Archipelago are the two largest ECNs. |  |
| **6. Investor Participation in the Stock Markets** | PowerPoint Slide 17 |
| * 1. Most investors aren’t members of the NYSE, or any other stock market, so they need to use the services of a brokerage firm to buy or sell stocks. |  |
| b. Brokerage firms are financial intermediaries that buy and sell securities for individual and institutional investors. | *Lecture Enhancer: How might you find a broker if you wanted to begin investing?* |
| i. A *market order* is the most common type of order. |  |
| ii. A market order instructs the brokerage firm to obtain the highest price possible, if the investor is selling, or the lowest price possible, if the investor is buying. |  |
| iii. A *limit order* sets a price ceiling when buying or a price floor when selling. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Hit & Miss:

How News Lifts—or Sinks—World Stocks

**Summary**

The growth of computerized trading has closely connected all the developed nations and many of the developing nations. Events in one country influence stock markets everywhere. In the spring of 2010, Americans grew hopeful that the country was starting to climb out of the worst financial crisis since the Great Depression. The credit crisis then struck Greece, Spain, and Portugal.

**Questions for Critical Thinking**

**1. Why would a financial crisis on the other side of the world affect the U.S. economy?**

*Most countries today are highly interconnected in economic transactions and through buying and selling each other’s debt instruments. If Greece, Spain, and Portugal cut their public spending in order to lower their deficits, this means those countries and their citizens are much less likely to buy goods and services from the United States. This in turn lowers the expectations of sales and profits for U.S. companies, possibly requiring them to downsize and cut their own expenses in reaction.*

**2. Greece continues to struggle with its debt crisis. In what ways do its investors share the cost?**

*The Greek government implemented an austerity program to reduce government spending. Even with a bailout from the EU and the IMF, economists believe that Greece will need to restructure its debt through bond buybacks and other methods in order to get its economy back on its feet.*

Assessment Check Answers

**4.1 What are the world’s two largest stock markets?**

*The world’s two largest stock markets are the New York Stock Exchange and the NASDAQ Stock Market.*

**4.2 Why is the London Stock Exchange unique?**

*The London Stock Exchange is probably the most international of the world’s stock markets because a large percentage of the shares traded are not those of British firms.*

**4.3 Explain the difference between a market order and a limit order.**

*A market order instructs the investor’s broker to obtain the best possible price when buying or selling securities. A limit order sets a maximum price (if the investor wants to buy) or a minimum price (if the investor wants to sell).*

**Learning Objective 5: Evaluate financial institutions.**

*Financial institutions act as intermediaries between savers and users of funds. Depository institutions—commercial banks, savings banks, and credit unions—accept deposits from customers that can be redeemed on demand. Commercial banks are the largest and most important of the depository institutions and offer the widest range of services. Savings banks are a major source of home mortgage loans. Credit unions are not-for-profit institutions, offering financial services to consumers. Government agencies, most notably the Federal Deposit Insurance Corporation, insure deposits at these institutions. Nondepository institutions include pension funds and insurance companies. Nondepository institutions invest a large portion of their funds in stocks, bonds, and real estate. Mutual funds are another important financial institution. These companies sell shares to investors and, in turn, invest the proceeds in securities. Many individuals today invest a large portion of their retirement savings in mutual fund shares.*

**Annotated Lecture Outline**

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| **FINANCIAL INSTITUTIONS** | PowerPoint Slide 18 |
| 1. A *financial institution* is an intermediary between savers and borrowers, collecting funds from savers and then lending the funds to individuals, businesses, and governments. |  |
| i. Financial institutions greatly increase the efficiency and effectiveness of the transfer of funds between savers and users. |  |
| ii. Because of financial institutions, savers earn more, and users pay less. |  |

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| 1. Financial institutions are classified into depository institutions and nondepository institutions. | Figure 16.2 Assets of Major Financial Institutions  *Lecture Enhancer: Which type of institution has the largest assets? The second largest?* |
| 1. Depository institutions accept deposits that customers can withdraw on demand (commercial banks, savings banks, credit unions). | PowerPoint Slide 19 |
| 1. Nondepository institutions include life insurance companies, pension funds, and mutual funds. |  |
| 1. **Commercial Banks** |  |
| * 1. Commercial banks are the largest and most important financial institutions in the United States and most nations. |  |
| * + 1. About 6,300 commercial banks now operate in the United States with almost $12 trillion in assets. |  |
| * + 1. Large banks have bought up smaller ones; banks in existence are five times larger than they were a decade ago. |  |
| iii. A countertrend has emerged as more community banks start up, serving a single city or county. |  |

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| * 1. **How Banks Operate** |  |
| * + 1. Banks raise funds by offering checking and savings deposits to customers. |  |
| ii. They pool these funds and offer consumer and business loans. | Business Etiquette:  What to Do When Your Credit Gets Pulled |
| iii. Banks lend money to both households and businesses. | Figure 16.3 Distribution of Outstanding Commercial Bank Loans |
| iv. Commercial banks are an important source of funds for small businesses. |  |
| v. Banks make money because the rate they charge borrowers is higher than the rate of interest they pay depositors. |  |
| * 1. **Electronic Banking** | PowerPoint Slide 20 |
| * + 1. Electronic funds transfer systems (EFTSs) are computerized systems for conducting financial transactions over electronic links. |  |

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| * + 1. *Check cards,* or debit cards, allow consumers to make purchases directly from their checking or savings accounts. | *Lecture Enhancer: Does having a debit card increase the likelihood that you will spend more?* |
| * 1. **Online Banking** |  |
| * + 1. According to surveys, 62 percent of consumers prefer online banking. |  |
| * + 1. Two types: Internet-only banks, and traditional banks with Web sites. |  |
| * + 1. Online banking allows customers to make transactions at any hour on any day. |  |
| * 1. **Federal Deposit Insurance** | PowerPoint Slide 21 |
| * + 1. The *Federal Deposit Insurance Corporation (FDIC)*, a federal agency, insures most commercial bank deposits. |  |
| * + 1. Deposit insurance means that, in the event the bank fails, insured depositors are paid in full by the FDIC, up to $250,000. |  |
| * + 1. Before deposit insurance, so-called *runs* were common as people rushed to withdraw their money from a bank. |  |
| * + 1. Federal deposit insurance was enacted by the Banking Act of 1933 as one of the measures designed to restore public confidence in the banking system. |  |
| 1. **Savings Banks and Credit Unions** | PowerPoint Slide 22 |
| * 1. Savings banks and credit unions offer many of the same services as commercial banks. |  |
| * 1. Savings banks used to be called savings and loan associations or thrift institutions. |  |
| * + 1. There are nearly 1,070 savings banks with total assets of about $1.24 trillion. |  |
| * + 1. About 78 percent of their loans are for real estate. |  |
| * 1. Credit unions are cooperative financial institutions owned by their members. |  |
| * + 1. 92 million Americans belong to one of the nation’s approximately 7,100 credit unions. |  |
| * + 1. Laws require that members share similar occupations or other traits to keep their sizes small. |  |
| * + 1. Credit unions have more than $962 billion in assets. |  |
| * + 1. Credit unions pay higher interest, charge lower rates on loans, and have fewer fees. |  |
| 1. **Nondepository Financial Institutions** | PowerPoint Slide 23 |
| * 1. Nondepository financial institutions accept funds from businesses and households, much of which they then invest. |  |

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| * 1. **Insurance Companies** |  |
| * + 1. Households and businesses buy insurance to transfer risk from themselves to insurance company. |  |
| * + 1. The insurance company accepts the risk in return for a series of payments, called premiums. | *Lecture Enhancer: What types of insurance premiums do you pay each year?* |
| * + 1. Underwriting is the process insurance companies use to decide who to insure and what to charge. |  |
| * + 1. Insurance companies collect more in premiums than they pay in claims. After paying their expenses, they invest the difference. |  |
| * 1. **Pension Funds** | *Class Activity: Discuss with students the difference between institutional investors and individual investors.* |
| * + 1. Pension funds provide retirement benefits to workers and their families. |  |
| * + 1. They are set up by employers and funded by contributions from employers and employees. |  |
| * + 1. They invest heavily in common stocks and real estate. |  |
| iv. Pension funds have more than $6.1 trillion in assets. |  |
| * 1. **Finance Companies** |  |
| * + 1. Finance companies offer short-term loans to borrowers in exchange for collateral. |  |
| * + 1. A commercial finance company gives short-term loans to businesses; a consumer finance company gives loans to individuals. |  |
| * + 1. Many finance companies are subsidiaries of large manufacturers. |  |
| 1. **Mutual Funds** |  |
| * 1. *Mutual funds* are financial intermediaries that raise money from investors by selling shares. |  |
| * 1. They use the money by investing in securities that are consistent with the mutual fund’s objectives. | *Lecture Enhancer: What are the advantages and disadvantages of a mutual fund to an investor?* |
| * 1. Mutual fund investors are indirect owners of a portfolio of securities. |  |
| * 1. The United States’ nearly 7,600 mutual funds have about $12 trillion in assets and more than 292 million shareholder accounts. | *Class Activity:*  *Ask students why an individual might invest in a mutual fund rather than investing his or her money in individually selected stocks.* |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Assessment Check Answers

**5.1 What are the two main types of financial institutions?**

*The two major types of financial institutions are depository institutions (those that accept checking and similar accounts) and nondepository institutions.*

**5.2 What are the primary differences between commercial banks and savings banks?**

*Today commercial and savings banks offer many of the same services. However, commercial banks lend money to businesses as well as to individuals. Savings banks lend money primarily to individuals, principally in the form of home mortgage loans.*

**5.3 What is a mutual fund?**

*A mutual fund is an intermediary that raises money by selling shares to investors. It then pools investor funds and purchases securities that are consistent with the fund’s objectives.*

**Learning Objective 6: Explain the role of the Federal Reserve System.**

*The Federal Reserve System is the central bank of the United States. The Federal Reserve regulates banks, performs banking functions for the U.S. Department of the Treasury, and acts as the bankers’ bank (clearing checks, lending money to banks, and replacing worn-out currency). It controls the supply of credit and money in the economy to promote growth and control inflation. The Federal Reserve’s tools include reserve requirements, the discount rate, and open market operations. Selective credit controls and purchases and sales of foreign currencies also help the Federal Reserve manage the economy.*

**Annotated Lecture Outline**

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| **THE ROLE OF THE FEDERAL RESERVE SYSTEM** | PowerPoint Slide 24 |
| * 1. The *Federal Reserve System*, or *Fed,* is the nation’s central bank and an important part of the nation’s financial system. |  |
| * 1. The Fed’s four basic responsibilities: |  |
| * + 1. regulating commercial banks |  |
| * + 1. performing banking-related activities for the U.S. Treasury |  |
| * + 1. providing services for banks |  |
| * + 1. setting monetary policy |  |
| * 1. Not all banks are members of the Federal Reserve, though federally chartered banks must belong. |  |
| * 1. Because the largest banks in America are federally chartered, most of the banking assets are controlled by Fed members. |  |

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| 1. **Organization of the Federal Reserve System** | PowerPoint Slide 25 |
| * 1. The nation is divided into 12 federal reserve districts, each with its own federal reserve bank. |  |
| * + 1. Each district bank supplies banks within its district with currency and facilitates the clearing of checks. |  |
| * 1. The Fed is governed by a board of directors. |  |
| * 1. The Fed is designed to be politically independent, with its own revenue sources and no dependence on Congressional appropriations. |  |
| * 1. An important part of the Fed is the *Federal Open Markets Committee (FOMC),* whichsets most policies concerning monetary policy and interest rates. |  |
| 1. **Check Clearing and the Fed** | PowerPoint Slide 26 |
| * 1. One of the Fed’s responsibilities is to help facilitate the clearing of checks. |  |
| * 1. The clearing of a check is the process by which funds are transferred from the check writer to the recipient. |  |
| * 1. When the writer’s account is at one bank and the recipient’s is at another, the check goes through a local check clearinghouse. |  |
| * 1. If the writer and recipient are in separate states, the check is cleared through the Federal Reserve System. |  |

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| * 1. The Check Clearing for the 21st Century Act allows banks and the Fed to use electronic images of checks—rather than the paper itself—during the clearing process. |  |
| 1. **Monetary Policy** | PowerPoint Slide 27 |
| * 1. The Fed’s most important function is controlling the supply of money and credit, or monetary policy. |  |
| * 1. The Fed’s job is to make sure that the money supply grows at an appropriate rate, allowing the economy to expand and inflation to remain in check. |  |
| * + 1. If the money supply grows too slowly, unemployment will increase. |  |
| * + 1. If the money supply grows too quickly, inflationary pressures will build. |  |
| * 1. The Fed uses its policy tools to push interest rates up or down. |  |
| * + 1. If the Fed pushes interest rates up, the growth rate in the money supply will slow, economic growth will slow, and inflationary pressures will ease. | *Lecture Enhancer: How do higher interest rates affect consumer spending?* |
| * + 1. If the Fed pushes interest rates down, the growth rate in the money supply will increase, economic growth will pick up, and unemployment will fall. |  |
| * 1. The two common measures of the money supply are called M1 and M2. | PowerPoint Slide 28  Figure 16.4 Breakdown of M1 and M2 |
| i. M1 consists of currency in circulation and balances in bank checking accounts. |  |
| ii. M2 equals M1 plus balances in some savings accounts and money market mutual funds. |  |
| * 1. The Fed has three major policy tools for controlling the growth in the supply of money and credit: reserve requirements, the discount rate, and open market operations. | PowerPoint Slide 29  Table 16.3 Tools Used by the Federal Reserve to Regulate the Growth in the Money Supply |
| * 1. The Fed can change reserve requirements—the percentage of deposits held as reserves. |  |
| * + 1. The higher the reserve requirement, the less banks can lend; lower reserve requirements give banks more to lend. |  |
| * + 1. Since this has a dramatic effect on the money supply, the Fed rarely uses this tool. |  |
| * 1. The Fed can change the *discount rate*—the interest rate at which its Fed banks make short-term loans to member banks. |  |
| * 1. Higher discount rates make it more expensive to borrow, which leads to higher interest rates on loans and a slower economy; lower rates do the opposite. |  |
| * 1. The Fed can use *open market operations,* the technique of controlling the money supply growth rate by buying or selling U.S. Treasury securities. |  |

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| * + 1. If it buys securities, it increases the money supply and lowers interest rates; selling securities does the opposite. |  |
| * + 1. The Fed employs the *federal funds rate*—the rate at which banks lend money to one another overnight—as its benchmark. |  |
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| * 1. The Fed can inject capital into the financial system in response to a financial crisis. | *Lecture Enhancer: Did the Fed need to inject capital into the financial system during the recent economic crisis?* |
| * 1. The Fed can lower the exchange value of the dollar by selling dollars and buying foreign currencies, and it can raise the dollar’s exchange value by doing the opposite—buying dollars and selling foreign currencies. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

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Assessment Check Answers

**6.1 What is the Federal Reserve System?**

*The Federal Reserve System is the U.S. central bank. It is responsible for regulating banks, providing banking-related services for the federal government, acting as the banker’s bank, and setting monetary policy.*

**6.2 How is the Fed organized?**

*The country is divided into 12 districts, each of which has a Federal Reserve Bank. The Fed is run by a seven-member board of governors headed by a chair and vice chair. An important part of the Fed is the Federal Open Markets Committee, which sets monetary and interest rate policy. The Fed is designed to be politically independent.*

**6.3 List the three tools the Fed uses to control the supply of money and credit.**

*The four tools are reserve requirements, the discount rate, and open market operations.*

**Learning Objective 7: Describe the regulationof the financial system.**

*Commercial banks, savings banks, and credit unions in the United States are heavily regulated by federal or state banking authorities. Banking regulators require institutions to follow sound banking practices and have the power to close noncompliant ones. In the United States, financial markets are regulated at both the federal and state levels. Markets are also heavily self-regulated by the financial markets and professional organizations. The chief regulatory body is the Securities and Exchange Commission. It sets the requirements for both primary and secondary market activity, prohibiting a number of practices, including insider trading. The SEC also requires public companies to disclose financial information regularly. Professional organizations and the securities markets also have rules and procedures that all members must follow.*

**Annotated Lecture Outline**

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| **REGULATION OF THE FINANCIAL SYSTEM** | PowerPoint Slide 30 |
| * + - 1. **Bank Regulation** |  |
| * 1. Banks are among the nation’s most heavily regulated businesses. |  |
| * + 1. Bank regulation ensures public confidence in the safety and security of the banking system. |  |
| * + 1. Banks are critical to the overall functioning of the economy, so any collapse would lead to disaster. |  |
| * 1. Federally chartered banks are regulated by the FDIC. |  |
| * 1. State-chartered banks are regulated by the appropriate state banking authorities. |  |

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| * + - 1. **Government Regulation of the Financial Markets** |  |
| * 1. Federal regulations grew from abuses in the 1920s and the depression in the 1930s. | Solving an Ethical Controversy: Are Debit Card Fees too High? |
| * 1. The principal federal regulator is the Securities and Exchange Commission (SEC), created in 1934. |  |
| * + 1. Its mission is to administer securities laws and protect investors in public securities transactions. |  |
| * + 1. It has broad enforcement power, though criminal charges are referred to the Justice Department. |  |
| * 1. SEC requires registration of all new public issues of corporate securities. |  |
| * + 1. The registration process seeks to guarantee full and fair disclosure. |  |
| * + 1. SEC regulation extends to secondary markets, as it ensures that trading is fair to all participants. |  |
| * + 1. The Market Reform Act of 1990 gave the SEC emergency authority to halt trading or restrict certain practices if trading is extremely volatile. |  |

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| d. The SEC investigates *insider trading*—the use of nonpublic information to make investment profits. | *Lecture Enhancer: Provide examples of inside information that would be considered inappropriate to share within a company.* |
| i. Public corporations must file several reports annually. | *Class Activity:*  *Ask students to discuss how FDA approval or rejection of a new drug to treat cancer might affect the stock price of a company when the news is disclosed to the media.* |
| ii. The SEC requires reports when executives buy or sell stock, or when an investor owns more than 5 percent of all outstanding stock. |  |
| 1. **Industry Self-Regulation** |  |
| * 1. Industry self-regulation is designed to ensure fair and orderly markets and to promote investor confidence. |  |
| * 1. **Professional Rules of Conduct** |  |
| * + 1. Rules of conduct are established and updated by the National Association of Securities Dealers (NASD). |  |

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| * + 1. Ensure that brokers perform their basic functions honestly and fairly, under constant supervision. |  |
| * 1. **Market Surveillance** |  |
| * + 1. All securities markets use a variety of methods to spot possible violations of trading rules or securities laws. |  |
| * + 1. NYSE uses Stock Watch to flag unusual price and volume activity. |  |
| * + 1. Market participants keep detailed records about transactions. |  |
| * + 1. The NYSE can impose penalties for infractions. |  |
| * + 1. Some contend that the industry can never truly regulate itself effectively in today’s market environment. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Assessment Check Answers

**7.1 Who regulates banks?**

*All banks have either state or federal charters. Federally chartered banks are regulated by the Federal Reserve, the FDIC, and the Comptroller of the Currency. State-chartered banks are regulated by state banking authorities and the FDIC.*

**7.2 Define *insider trading.***

*Insider trading is defined as the use of material nonpublic information to make an investment profit.*

**7.3 List two ways in which the securities markets are self-regulated.**

*Professional organizations such as the National Association of Securities Dealers have codes of conduct that members are expected to follow. Major financial markets have trading rules and procedures to identify suspicious trading activity.*

**Learning Objective 8: Describe the global perspective of the financial system.**

*Financial markets exist throughout the world and are increasingly interconnected. Investors in other countries purchase U.S. securities, and U.S. investors purchase foreign securities. Large U.S. banks and other financial institutions have a global presence. They accept deposits, make loans, and have branches throughout the world. Foreign banks also operate worldwide. The average European or Japanese bank is much larger than the average American bank. Virtually all nations have central banks that perform the same roles as the U.S. Federal Reserve System. Central bankers often act together, raising and lowering interest rates as economic conditions warrant.*

**Annotated Lecture Outline**

|  |  |
| --- | --- |
| **THE FINANCIAL SYSTEM: A GLOBAL PERSPECTIVE** | PowerPoint Slide 31 |
| 1. The global financial system is becoming more integrated each year. |  |
| 1. Major U.S. banks have extensive international operations. |  |
| * 1. U.S. banks have more than $200 billion in outstanding loans to international customers. |  |
| * 1. Only 2 of the 20 largest banks in the world are U.S. institutions—JPMorgan Chase (10th) and Bank of America (17th). |  |
| 1. The world’s largest bank, Paris-based BNP Paribas SA, has almost $2.7 trillion in assets. |  |
| 1. Central banks in other nations: |  |
| * 1. Virtually all nations have central banks whose functions are similar to those of the Federal Reserve System. |  |
| * 1. Policymakers at other nations’ central banks respond to changes in the U.S. financial system by making similar changes in their own systems. |  |
| * + 1. If the Fed pushes U.S. interest rates lower, central banks in Japan and Europe push their interest rates lower. |  |
| * + 1. Lower U.S. and European interest rates decrease the cost of borrowing for U.S. and European firms and increase the money available for loans to other countries. |  |

**Notes:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_**

Assessment Check Answers

**8.1 Where do U.S. banks rank compared with international banks?**

*Banks in Asia and Europe are generally much larger than U.S. banks. In fact, only 3 out of the world’s 30 largest banks are based in the United States.*

**8.2 Do other countries have organizations that play roles similar to those played by the Federal Reserve?**

*Yes, virtually all nations have central banks that perform many of the same functions the U.S. Federal Reserve System does.*

**Answers to Review Questions**

**1. What is the financial system? Why is the direct transfer of funds from savers to users rare?**

*The financial system is the process by which funds are transferred between savers and users, encompassing households, businesses, government, financial institutions, and financial markets*.

*The direct transfer of funds between savers and users is rare because it is difficult for a company to obtain inventory or a consumer to make a major purchase without financing, and it’s difficult for a modern economy to function without well-developed financial institutions. They increase the efficiency and effectiveness of the transfer of funds between savers and users, thus eliminating a direct transfer. Because of them, savers actually earn more and users pay less than they would without them.*

**2. What is a security? Give several examples.**

*Securities, also called financial instruments, represent obligations on the part of issuers—businesses and governments—to provide purchasers with expected or stated returns on the funds invested or loaned. Securities can be classified into three categories: money market instruments, bonds, and stock. Money market instruments and bonds are debt instruments. Money market instruments are short-term debt securities and tend to be low-risk securities. Bonds are longer-term debt securities and pay a fixed amount of interest each year.* *Common stock represents ownership in corporations. Common stockholders have voting rights and a residual claim on the firm’s assets.*

**3. List the major types of bonds. Explain a mortgage pass-through.**

*Bonds are longer-term debt securities and pay a fixed amount of interest each year*.

* *A government bond is sold by the U.S. Treasury and backed by the full faith and credit of the U.S. government, so it has very low risk.*
* *A municipal bond is issued by a state or local government, and interest received is exempt from federal income taxes.* *Most municipal bonds have risk ratings.*
* *Secured bonds are backed by a specific asset pledged as collateral (such as real estate, buildings, machinery) and are less risky than those without collateral, so have lower rates.*
* *Unsecured bonds (also called debentures) are backed only by the financial reputation of the issuing corporation, so are riskier than secured bonds.*
* *Mortgage pass-through securities are bonds backed by a pool of mortgage loans.*

**4. What are the differences between common stock and preferred stock?**

* *Common stock is the basis of corporate ownership, since its purchasers are true owners of the firm. They have the right to vote on major corporate decisions, elect a board of directors, and expect some return on their investment. They make money if the firm prospers and the stock rises, but can lose their entire investment if the company fails.*
* *Preferred stock is designed so that its holders receive preference in the payments of dividends and have claims on the firm’s assets that are ahead of claims of common stockholders. But holders have no voting rights. The dividend paid on a preferred stock issue rarely changes over time, regardless of the firm’s profitability, so it’s similar to a bond.*

**5. Explain the differences between a primary market and a secondary market.**

*Securities are sold in two financial markets—primary and secondary.*

* *In a primary market, firms or government agencies issue securities and sell them to the public as investors. So when a firm needs money to expand, build, or buy inventory (or when a government needs funds), it can act as issuer of the security and receive the proceeds.*
* *In a secondary market, previously issued securities are traded among investors. Most U.S. investment activity occurs in the secondary market, which is actually a collection of financial markets. The corporations and governments that issued the securities being traded are not directly involved, do not make payments when securities are sold, and do not receive proceeds when they’re purchased.*

**6. Why are commercial banks, savings banks, and credit unions classified as depository financial institutions? How do the three differ?**

* *Commercial banks are the largest and probably most important financial institution in the United States and in most nations. They are the most common type and offer the most services of any institution.*
* *Savings banks (once called savings and loan associations or thrift institutions) offer many of the same services as commercial banks but focus on accepting savings deposits and lending the funds to individuals for mortgage loans, much more than to businesses.*
* *Credit unions also offer similar services, but they’re unique, not-for-profit financial cooperatives owned by depositors, all of whom are members.*

**7. Why are life insurance companies, pension funds, and mutual funds considered financial institutions?**

*Financial institutions act as intermediaries between savers and users of funds. The two major types of financial institutions are depository institutions (those that accept checking and similar accounts) and nondepository institutions.*

*Nondepository institutions include pension funds and insurance companies. Nondepository institutions invest a large portion of their funds in stocks, bonds, and real estate and offer short- and long-term loans to businesses, thereby generating revenue into the economy. Insurance companies often lend larger funds to firms that need cash over long periods, such as when they’re buying real estate or investing in equipment. Similarly, because pension funds can be expected to have long-term cash coming in, they invest heavily in assets such as stocks, bonds, and real estate.*

*Mutual funds are another important financial institution. These companies sell shares to investors and, in turn, invest the proceeds in securities. Many individuals today invest a large portion of their retirement savings in mutual fund shares.*

**8. Briefly explain the role of the Federal Reserve and list the tools it uses to control the supply of money and credit.**

*The Federal Reserve is the national bank, a key part in the entire U.S. financial system. Not all banks are members of the Federal Reserve, but all federally chartered banks are required to belong. The Fed is divided into 12 districts, each with its own district bank run by a board of directors and president. The Fed itself is governed by a seven-member board appointed by the President and confirmed by the Senate. Its 12-member Federal Open Markets Committee (FOMC) sets policy on monetary issues and interest rates. One of the Fed’s responsibilities is to help facilitate check clearing, the process by which funds are transferred from check writer to recipient. If the writer and recipient are in separate states, the check goes through the Federal Reserve System.*

*The four tools the Fed uses to control the supply of money and credit are the following: reserve requirements, the discount rate, open market operations, and term auction facility loans.*

**9. What methods are used to regulate banks? Why are state-chartered banks also regulated by the FDIC?**

*Commercial banks, savings banks, and credit unions in the United States are heavily regulated by federal or state banking authorities. Banks have either state or federal charters. Federally chartered banks are regulated by the Federal Reserve, the FDIC, and the Comptroller of the Currency. State-chartered banks are regulated by state banking authorities and the FDIC. Banking regulators require institutions to follow sound banking practices and have the power to close noncompliant ones.*

*State chartered banks are also regulated by the FDIC because the FDIC guarantees that insured depositors won’t lose their money (up to $250,000) even if the bank fails. This increases confidence in the safety and security of the banking system, prevents bank runs, or massive withdrawals if a bank’s finances are suspect, and shifts any risk to the FDIC.*

**10. Explain how the Federal Reserve, acting in conjunction with other central banks, could affect exchange rates.**

*Transactions in the foreign exchange markets affect the U.S. money supply and interest rates. The Fed can lower the exchange value of the dollar by selling dollars and buying foreign currencies, and it can raise the dollar’s exchange value by doing the opposite—buying dollars and selling foreign currencies. When the Fed buys foreign currencies, the effect is the same as buying securities because it increases the U.S. banking system’s reserves. Selling foreign currencies, on the other hand, is like selling securities, in that it reduces bank reserves.*

**Projects and Teamwork Applications**

1. Have students share the information found on the two types of U.S. savings bonds, the pros and cons of each, and which type they prefer. Where did they find their information—through the U.S. Department of Treasury, or some other source? How may their source have affected the information found and ultimately the decision they made?

2. The Treasury’s definitions of the two types are as follows: Inflation-Indexed Bonds (I Bonds) are low-risk products that earn interest for up to 30 years, and are protected from inflation by assuring a real rate of return over and above inflation. They’re sold at face value in denominations between $50 and $10,000. Series EE Savings Bonds (EE Bonds) are secure products that also pay interest for up to 30 years, but are based on current market rates set by participants in the large government bond trading market. They’re sold at face value electronically or at half face value on paper.

3. Have students discuss their decisions about whether they would buy shares of Lowe’s, Home Depot, or neither, based on their analysis. What features of each company did they compare? Did they find the firms to be very similar, very different, or somewhere in between? Did either company stand out as a stronger and more secure investment?

4. Ask teams to share which bank and which business they chose. How did their financial statements differ? How were they similar? Overall, how did these documents compare to one another?

5. Students will specify several investment criteria they believe are most important. After doing the research, they will identify at least three mutual funds that best meet their criteria. After choosing one of the funds and researching it, they will share their answers with the class. How well did the fund perform relative to its peer group and relative to an index such as the S&P 500?

**Web Assignments**

1. **Online stock trading.** Visit the Web site of a brokerage firm that offers online trading, such as E\*Trade ([www.etrade.com](http://www.etrade.com)) or Charles Schwab ([www.schwab.com](http://www.schwab.com)), to learn more about online trading. Most electronic brokerage firms also offer a trading demonstration. Use the demonstration to see how you obtain price information, company news, place buy or sell orders, and check account balances. Make some notes about your experience and bring them to class to participate in a class discussion.
2. **Banking statistics.** Visit the Web site listed here. Access the most recent year you can find and answer the following questions:
   1. How many commercial banks were in operation at the end of the year? How many savings banks (institutions) were in operation?
   2. What were the total assets of commercial banks and savings banks at the end of the year?
   3. How many commercial banks had assets in excess of $5 billion at the end of the year? How many commercial banks had assets of less than $500 million at the end of the year?

<http://www2.fdic.gov/sdi/sob/>

1. **Federal reserve system.** Go to the Web site of the Board of Governors of the Federal Reserve System ([www.federalreserve.gov)](http://www.federalreserve.gov)/). Prepare a short report on the seven-member board. Who are the current members? What are their backgrounds? When were they appointed? When do their terms expire?

*Note: Internet Web addresses change frequently. If you don’t find the exact sites listed, you may need to access the organization’s home page and search from there or use a search engine such as Bing or Google.*

Case 16.1

Silicon Valley’s Banker

**Answers to Questions for Critical Thinking:**

1. **Do you agree with observers’ explanations for Quattrone’s success? Why or why not?**

*I agree with observers because success in any industry is a combination of luck, financial saavy, and strong business relationships*.

1. **Why are banker-client relationships important in billion-dollar deals?**

*Banker-client relationships are important in billion-dollar deals because the client wants to be able to trust the banker so that they get the best deal.*

Case 16.2

Credit Unions Find a Silver Lining in the Financial Crisis

**Answers to Questions for Critical Thinking:**

1. **Why is an organization like the Credit Union National Association important to the credit-union industry?**

*Trade organizations can provide added credibility to member organizations. Additionally, trust is an important element with customers when they are considering a banking choice. Finally, the trade organization can provide standards in ethics and operating procedures that can help reduce expenses and enhance profits for its members.*

1. **Go online to the CUNA or the NCUA Web site to find a credit union near you. If you are eligible to join, compare the credit union with your current bank. What are the advantages of joining the credit unionor staying with your bank?**

*Students answer individually.*

Video Case 16.3

New Harvest Coffee Goes Beyond Fair Trade

**Answers to Questions for Critical Thinking:**

**1. What are the benefits and drawbacks of treating coffee as a commodity in the marketplace? What do you predict will be the future of Fair Trade?**

*The benefit of treating coffee as a commodity is that no matter how low the prices drop, the price paid for it can’t go below a certain point. This helps the growers from going broke. The drawback is that roasters, retailers, and consumers may be paying more for coffee than it is worth.*

**2. Should the entire coffee market be regulated in any way? Why or why not? If so, how?**

*The coffee market should have some regulations to help keep the growers in business. The Artisan Coffee movement, where growers, roasters, and retailers deal directly with each other as individual businesses, could help be the solution to regulation. The growers are paid fairly for the quality of their coffee through a simplier process that involves individual businesses.*

**3. How would New Harvest change as a business if it made an initial public offering (IPO)?**

*If New Harvest made an IPO, people would be able to buy shares in the company. It would have more access to capital funding for growth and would also gain widespread exposure and visibility.*

**4. What is your opinion of the so-called Artisan Coffee movement as a business model? Do you think it will be successful in the long run? Why or why not?**

*I believe that it will be successful in the long run because consumers want the best cup of coffee through fair practices, meaning that they will spend a bit more to achieve this goal.***CHAPTER 16: COLLABORATIVE LEARNING EXERCISES**

# **1 - Credit Cards**

Learning Objectives: 5

Purpose:

To explore the implications of credit card debt

Background:

An astonishing number of college students already struggle with credit card debt, and the problem is likely only to escalate given that credit card companies actively target college students. This exercise is designed to heighten student awareness of the true impact of credit card debt on their personal budgets, while making them less vulnerable targets for credit card marketers.

Relationship to Text:

Learning Objective 5 – Credit Cards

Estimated Class Time:

About 10 minutes

Exercise:

Ask your students to brainstorm some $1000 items they would like to purchase and write them on the board. Then ask for a show of hands regarding how many would consider purchasing each item on a credit card if they had the opportunity. Ask how much that $1,000 item would cost if they paid for it at $50 per month on a credit card that charged 17 percent interest. (If you include an annual fee of $30 per year, the answer is $1,210, or 21 percent more than the actual purchase price.) Finally, brainstorm other options for financing larger purchases (e.g., seeking and capitalizing on 0 percent financing deals, planning purchases through allocated savings per month, borrowing at a more reasonable rate from a credit union if possible, etc.).

You may want to close by pointing out the major revenue sources for credit card companies: interest, late fees, annual fees, and retailer transaction fees. Once students are aware that their credit card usage is creating enormous revenue streams for the issuing companies, some become determined to participate only on their own terms (e.g., paying off balances on a monthly basis, actively seeking lower interest rates, request annual fee waivers, etc.).

# **2 - Banks as Creators of Money**

Learning Objective: 5

Purpose:

To demonstrate to students how banks “create” money

Background:

Students are often astonished to learn that much of the cash in the money supply is somewhat illusory, “created” by the ability of banks to lend their deposits to other borrowers. This simple, high-impact demonstration is designed to help students understand how the process functions.

Relationship to Text:

Learning Objective 5 – Functioning of Financial Institutions

Estimated Class Time:

About 10 minutes

Preparation/Materials:

You’ll need to gather $100 worth of play money (real money is even better). Be sure to include largely small bills.

Exercise:

Request eight volunteers, and invite them to the front of the room. Appoint volunteer A to represent the banking system. Give the $100 to volunteer B as a “gift,” and suggest that he or she deposit it in the “bank.” Explain that the Federal Reserve requires the bank to hold 7 percent of all deposits in reserve, but allows the bank to lend the remainder.

Ask volunteer C to request a loan of $93, to buy a DVD player from volunteer D. Suggest that volunteer D deposit the money in the bank. Ask volunteer E to borrow $86 from the bank to buy a textbook from volunteer F. Suggest that volunteer F deposit the money in the bank. Ask volunteer G to borrow $80 from the bank to buy a jacket from volunteer H. Suggest that volunteer H deposit the money in the bank.

Ask volunteers B, D, F, and H how much money each has in the bank. Write the amounts on the board and add them together (the total should be $359). Now ask volunteer A to count the cash available in the “banking system” (the total will of course be only $100). The implication: The banking system multiplied the money in the economy by a factor of three. Clearly, the growth would increase yet further as the economy continues to thrive.

Ask your class what would happen if volunteers B, D, F, and H all wanted to withdraw their money from the banking system at the same time. The potential for disaster will be clear. This gives you a great opportunity to introduce the FDIC, and to explain its creation in the wake of the banking failures of the Great Depression.

# **3 - Banking Relationships**

Learning Objective: 5

Purpose:

To trigger student thinking on how to maintain a positive relationship with their banker, even through business downturns

Background:

Many people seem to regard business-banking relationships as fundamentally adversarial. But businesses—especially entrepreneurs—can reap significant rewards from collaborative banking relationships, especially during the sometimes turbulent periods following the inception of their company. This discussion exercise is designed to initiate student thinking on how to buck the stereotype and forge a true partnership with their business bankers … even after the initial “honeymoon.”

Relationship to Text:

Learning Objective 5 – Financial Institutions

Estimated Class Time:

About 10 minutes

Preparation/Materials:

None needed

Exercise:

Share with your class the classic Mark Twain quote: A banker is a fellow who lends you his umbrella when the sun is shining, and wants it back the minute it begins to rain. (You may want to write it on the board.)

Ask your students what this quote means. Why would your banker call in your loans just when you most need the money? Help your class appreciate the banker’s position: his obligation to minimize risk on behalf of his institution by calling loans at early signs of trouble.

Then ask your class how—understanding the banker’s responsibility—they can develop a collaborative partnership with him. Help them understand that they can assist the banker in achieving lower risk by sharing potential problems before they surface rather than pleading their case mid-crisis. Open information—both positive and negative—builds trust. Help them see that a banker who believes they are personally trustworthy is much more likely to let them keep his umbrella even when it begins to storm.