Chapter 2
Firms and the Financial Market

■ Chapter Overview

This chapter provides an overview of U.S. financial markets. Financial markets consist of the institutions that facilitate the transfer of money from investors to companies and individuals. The three principal players in the financial markets are borrowers, savers (i.e., investors), and financial institutions (i.e., intermediaries). There is a wide variety of financial institutions that make up our financial markets, including commercial banks, financial services corporations, insurance companies, investment banks, investment companies, mutual funds and exchange traded funds, hedge funds, and private equity firms.

The purpose of each of these institutions is to bring borrowers and investors together. Borrowers and investors are linked together through the buying and selling of a variety of securities that are traded on financial markets. While there are innumerable types of financial instruments traded on financial markets, most are some form of debt or equity security.

■ Chapter Outline

2.1 The Basic Structure of U.S. Financial Markets

A. A financial market is any place where money and credit are exchanged.

B. The three principal sets of players in financial markets are borrowers, savers (investors), and financial institutions (intermediaries).

2.2 The Financial Marketplace: Financial Institutions

A. The financial institutions that make up the financial marketplace facilitate the movement of money from savers to borrowers.
   1. The money market refers to transactions in short-term debt instruments.
   2. Capital markets are markets for long-term financial instruments.

B. A major category of financial institutions includes depository institutions.
   1. Depository institutions include commercial banks, savings and loan associations, and credit unions.
   2. Depository institutions collect savings from individuals and businesses and then lend these pooled savings to other individuals and businesses.

C. Non-bank (or non-depository) financial intermediaries provide financial services to businesses. There are a variety of non-bank financial intermediaries.
   1. Financial services corporations are in the lending or financing business, but they are not commercial banks.
   2. Insurance companies are in the business of selling insurance to individuals and businesses to protect their investments.

3. Investment banks are specialized financial intermediaries that help companies and governments raise money, and provide advisory services to client firms.
4. Investment companies are financial institutions that pool the savings of individual savers and invest the money in the securities issued by other companies purely for investment purposes.
5. Mutual funds and exchange traded funds (ETFs) are special types of intermediaries through which individuals can invest in virtually all of the securities offered in the financial markets.
6. Hedge funds are like mutual funds, but are more regulated and tend to take on greater risk.
7. Private equity firms include venture capital firms and leveraged buyout funds.

2.3 The Financial Marketplace: Securities Markets

A. A security is a negotiable instrument that represents a financial claim and can take the form of ownership (stocks) or a debt agreement.

B. Firms borrow money by issuing debt securities. These can be either short-term (i.e., notes) or long-term (i.e., bonds) securities.

C. Equity securities represent ownership of the corporation.
   1. Common stock is a security that represents equity ownership, provides voting rights, and entitles the holder to a share of the company's earnings in the form of dividends or capital appreciation.
   2. Preferred stock is an equity security without voting rights but with a defined dividend payment. Preferred stock dividends must be paid before common stock dividends can be distributed.

D. Stock markets consist of both physical trading areas (i.e., organized security exchanges) and electronic trading areas (i.e., over-the-counter markets).

E. A primary market is a market in which new securities are bought and sold for the first time. A secondary market is where all subsequent trading of previously issued securities takes place.

■ Learning Objectives

2-1. Describe the structure and functions of financial markets.

2-2. Distinguish between commercial banks and other financial institutions in the financial marketplace.

2-3. Describe the different securities markets for bonds and stock.

■ Lecture Tips

1. Bring in a copy of the *Wall Street Journal* and have the students look at the various tables relevant to the security markets. Discuss the meaning of the information and how the numbers and terms relate to the chapter.

2. Simulate the start-up of a corporation with various class members playing the roles of creditors and shareholders of the firm.

Questions for Further Class Discussion

1. Why is it important to distinguish between depository and non-depository financial institutions?

2. Why are secondary markets important?

Internet Resources

http://www.ibanknet.com/scripts/callreports/fiList.aspx?type=031
http://www.sec.gov/answers/mutfund.htm
www.sec.gov/investor/tools/mfcc/mfcc-int.htm
www.google.com/finance
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