Consumer borrowing

ASSIGNMENT Roles and functions of Financial s and Markets: Households, Individuals, Businesses and Governments require funds to fulfill their needs of additional finance. These households, businesses, financial institutions and financial markets together form what is known as the Financial System. In simple words, we can define financial system as a process through funds are transferred efficiently from lenders (savers) to borrowers (users) of money. Savers (people, businesses, entities and government) are those with extra funds. For a variety of reasons, they choose not to spend all of their current income so they have a surplus of funds. On the other hand, there are users whose spending needs exceed their current income levels so they have a deficit. Therefore, they require additional funds to make up the difference.

These funds can be trasferred from suppliers to demanders of money in two ways. First is through Financial institutions that are of two types including depository insitutions such as commercial banks, saving and credit unions (also known as financial intermediaries) and non-depository instituions such as life insurance companies, pension funds and finance companies. Depository institutions especially banks accept deposits from savers (lenders) of money that they can withdraw on demand. They pool customer deposits and use these funds to make loans or investments to demanders or borrowers of money (consumers and businesses). These institutions make money because of interests rate that they charge from demanders, which is higher than what they to pay to savers or depositors of money. On the other hand, non-depositry institutions such as insurance companies accept business risks of their customers in return for a series of payments called premiums. They then invest their excessive funds after meeting their operating expenses (insurance claims, salaries etc). Finance companies offer short-term loans to borrowers. They usually sell securities or borrow funds from commercial banks therefore they tend to charge higher interest rates as compared to banks.

Second is through financial markets where people and organizations wanting to borrow money are brought together with those having surplus funds. Financial markets are primarily divided into primary and secondary markets. Primary market are those in which corporations raise funds by issuing new securities. In Secondary markets, on the other hand, previously issued securities such as mortgages, bonds and stocks are traded among investors. Stock exchanges are perhaps the best example of these type of markets. Whenever, a company sells stocks or bonds publicly or privately, funds are being transferred between savers and users. Savers can expect some sort of return from the company in the form of dividends or interest for the use of their money. (Boone and Kurtz, 2002)

Financial intermediaries are those entities with " low-cost" money such as banks, mutual funds etc. that provide funds for all manner of borrowers and investors; For example a bank providing a personal loan, a mortgage lender or financial entities creating investment markets, financial intermediaries keep the flow of funds moving. (William Pirraglia)

Examples:

Consider a saver who has surplus funds plans to invest US$30, 000 in buying a one-year certificate of deposit (CD) which is safer and more liquid than mortgages because it usually has a fixed rate of return. He or she might visit the nearest bank which offers CDs. The saver who opens a CD may receive a paper certificate but today it is common for a CD to consist simply of a book entry and an item shown in the savers bank statements. After the maturity, the saver would receive the principle plus interest.

In other situation, the bank can use the saver's money to lend a consumer willing to borrow US$30, 000 to finance the purchase of a new car. In this case, the financial intermediary will charge a specified interest rate higher than what it will pay to its original depositor. The borrower would pay monthly installments which would include the principle plus interest.

If there were no financial intermediaries, borrowers have to personally search for savers to meet their funds requirements and involve in direct dealing which would be costlier than the indirect transfer of funds through intermediaries.

Works Cited

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