

TEN BH Em I TÁI O N

FINANCIAL INSTITUTIONS, MARKETS, AND MONEY

David S. Kidwell
University of Minnesota

David J. Blackwell
Texas A&M University

David A. Whidbee
Washington State University

Richard L. Peterson
Texas Tech University

UNIVERSITÄT
LIECHTENSTEIN
Bibliothek

BICENTENNIAL

1807

©WILEY

2007

John Wiley & Sons, Inc.

CONTENTS

THE FINANCIAL SYSTEM 1

PART I *

Chapter 1 An Overview of Financial Markets and Institutions 3

Chapter Preview 3

Purpose 4

Learning Objectives 4

Role of the Financial System 4

Moving Funds from SSUs to DSUs 7

Do You Understand? 11

The Benefits of Financial Intermediation 11

PEOPLE & EVENTS: Wall Street Faces Global Competition 12

Do You Understand? 14

Types of Financial Intermediaries 15

Do You Understand? 20

Tapes of Financial Markets 20

The Money Markets 22

The Capital Markets 23

Financial Market Efficiency 25

Risks Faced by Financial Institutions 26

Chapter Take-Aways 28

Key Terms 29

Questions and Problems 29

Internet Exercise 30

Chapter 2 The Federal Reserve and Its Powers 31

Chapter Preview 31

Purpose 32

Learning Objectives 32

Origins Of The Federal Reserve System 32

PEOPLE & EVENTS: Wildcat Banks: Red Dogs and Cow Chips 35

The Current Structure of the Fed 36

Monetary Powers of the Board of Governors 39

The Fed's Regulatory Powers 41

Independence of the Fed 43

Do You Understand? 45

The Fed's Balance Sheet 46

The Fed's Role in Check Clearing 49
Federal Reserve Tools of Monetary Policy 50
PEOPLE & EVENTS: Changing the Guard 51
Chapter Take-Aways 57
Key Terms 57
Questions and Problems 57
Internet Exercise 58

Chapter 3 The Fed and Interest Rates 59

Chapter Preview 59
Purpose 60
Learning Objectives 60
Federal Reserve Control of the Money Supply 60
The Fed's Control Over Interest Rates 63
Do You Understand? 68
Objectives of Monetary Policy 68
*PEOPLE & EVENTS: The Fed as Lender of Last Resort: Preventing a
Financial Panic* 74
The Fed and the Economy 76
PEOPLE & EVENTS: A More Forthcoming Fed 79
Complications of Monetary Policy 79
Do You Understand? 81
Chapter Take-Aways 81
Key Terms 82
Questions and Problems 82
Internet Exercise 82

PART II

HOW INTEREST RATES ARE DETERMINED 85

Chapter 4 The Level of Interest Rates 87

Chapter Preview 87
Purpose 88
Learning Objectives 88
What Are Interest Rates? 88
The Real Rate of Interest 89
Loanable Funds Theory of Interest 90
Do You Understand? 93
« *Price Expectations and Interest Rates* 94
*PEOPLE & EVENTS: Irving Fisher (1867-1947): Economist
and Social Reformer* 96
Do You Understand? 99
PEOPLE & EVENTS: Can Interest Rates Be Negative? 99
Forecasting Interest Rates 100
Chapter Take-Aways 102
Key Terms 102
Questions and Problems 102
Internet Exercise 103

Chapter 5	Bond Prices and Interest Rate Risk	104	
	<i>Chapter Preview</i>	104	
	<i>Purpose</i>	105	j
	<i>Learning Objectives</i>	105	
	<i>The Time Value of Money</i>	105	
	<i>Do You Understand?</i>	107	
	<i>Bond Pricing</i>	108	
	<i>PEOPLE & EVENTS: College Student Wins \$ 100 Million Lottery!</i>	109	
	<i>Bond Yields</i>	112	
	<i>Do You Understand?</i>	117	
	<i>Important Bond Pricing Relationships</i>	117	
	<i>Interest Rate Risk and Duration</i>	121	
	<i>PEOPLE & EVENTS: junk Bonds: A Really Bad Month</i>	129	
	<i>Do You Understand?</i>	132	
	<i>Chapter Take-Aways</i>	133	
	<i>Key Terms</i>	134	
	<i>Questions and Problems</i>	134	
	<i>Internet Exercise</i>	135	
Chapter 6	The Structure of Interest Rates	136	
	<i>Chapter Preview</i>	136	
	<i>Purpose</i>	137	
	<i>Learning Objectives</i>	137	
	<i>The Term Structure of Interest Rates</i>	137	
	<i>Do You Understand?</i>	147	
	<i>Default Risk</i>	148	
	<i>PEOPLE & EVENTS: The Credit-Rating Club</i>	153	
	<i>Tax Treatment</i>	154	
	<i>Do You Understand?</i>	156	
	<i>Marketability</i>	157	
	<i>Options on Debt Securities</i>	157	
	<i>PEOPLE & EVENTS: Hot CoCo Options</i>	159	
	<i>Do You Understand?</i>	160	
	<i>Chapter Take-Aways</i>	161	
	<i>Key Terms</i>	161	
	<i>Questions and Problems</i>	162	
	<i>Internet Exercise</i>	163	
FINANCIAL MARKETS		165	PART III
Chapter 7	Money Markets	167	
	<i>Chapter Preview</i>	167	
	<i>Purpose</i>	168	
	<i>Learning Objectives</i>	168	
	<i>How the Money Markets Work</i>	169	

Economic Role of the Money Market 169
Characteristics of Money Market Instruments 170
Treasury Bills 171
Do You Understand? 177
Federal Agency Securities 178
Federal Funds 180
Repurchase Agreements 182
PEOPLE & EVENTS: The Collapse of ESM: Life in the Fast Lane 183
Commercial Paper 184
PEOPLE & EVENTS: The Perils of Commercial Paper—Being Kicked Out of the Club 187
Negotiable Certificates of Deposit 188
Banker's Acceptance 190
Money Market Participants 193
The Interrelationship of Money Market Interest Rates 196
Do You Understand? 197
Chapter Take-Aways 197
Key Terms 198
Questions and Problems 198
Internet Exercise 199

Chapter 8 Bond Markets 200

Chapter Preview 200
Purpose 201
Learning Objectives 201
Functions of the Capital Markets 201
U.S. Government and Agency Securities 204
Do You Understand? 208
State and Local Government Bonds 208
PEOPLE & EVENTS: How Orange County Got It Wrong 212
Corporate Bonds 214
Do You Understand? 220
Financial Guarantees 220
Securitized Credit Instruments 221
Financial Market Regulators 222
PEOPLE & EVENTS: Securitization "Rocks" 223
Bond Markets Around the World are Increasingly Linked 224
* *Do You Understand?* 225
Chapter Take-Aways 225
Key Terms - 226
Questions and Problems 226
Internet Exercise 227

Chapter 9 Mortgage Markets 228

Chapter Preview 228
Purpose 229
Learning Objectives 229

<i>The Unique Nature of Mortgage Markets</i>	229
<i>Types of Mortgages</i>	230
<i>PEOPLE & EVENTS: Option Arms: Useful Tool or Ticking Timebomb?</i>	238
<i>Do You Understand?</i>	241
<i>Mortgage-Backed Securities</i>	241
<i>Mortgage Prepayment Risk</i>	248
<i>Do You Understand?</i>	250
<i>Participants in the Mortgage Markets</i>	250
<i>PEOPLE & EVENTS: Predators Fall Prey to Their Own Devices in Subprime Mortgage Markets</i>	255
<i>Relationship Between Mortgage Markets and the Capital Markets</i>	256
<i>Chapter Take-Aways</i>	256
<i>Key Terms</i>	257
<i>Questions and Problems</i>	258
<i>Internet Exercise</i>	258

Chapter 10 Equity Markets 260

<i>Chapter Preview</i>	260
<i>Purpose</i>	261
<i>Learning Objectives</i>	261
<i>What are Equity Securities?</i>	261
<i>Equity Markets</i>	264
• <i>Equity Trading</i>	269
<i>Global Stock Markets</i>	272
<i>PEOPLE & EVENTS: A Quieter Trading Floor</i>	273
<i>Regulation of Equity Markets</i>	274
<i>Do You Understand?</i>	275
<i>Equity Valuation Basics</i>	275
<i>Equity Risk</i>	279
<i>Do You Understand?</i>	283
<i>Stock Market Indexes</i>	283
<i>PEOPLE & EVENTS: Chapter 11 Bankruptcies Create Zombie Firms</i>	284
<i>The Stock-Market as a Predictor of Economic Activity</i>	287
<i>Chapter Take-Aways</i>	289
<i>Key Terms</i>	290
<i>Questions and Problems</i>	290
<i>Internet Exercise</i>	291

Chapter 11 Derivatives Markets 292

- <i>Chapter Preview</i>	292
«» <i>Purpose</i>	293
. <i>Learning Objectives</i>	293
<i>The Nature of Derivative Securities</i>	293
<i>Forward Markets</i>	294
<i>Futures Markets</i>	295
<i>PEOPLE & EVENTS: Rogue Traders Can Sink Large Institutions</i>	303

Do You Understand? 304
Uses of the Financial Futures Markets 304
PEOPLE & EVENTS: Talking and Trading Politics and Weather 311
Risks in the Futures Markets 312
Do You Understand? 313
Options Markets 313
Do You Understand? 319
Regulation of the Futures and Options Markets 320
Swap Markets 321
Chapter Take-Aways 324
Key Terms 325
Questions and Problems 325
Internet Exercise 326

Chapter 12 International Markets 327

Chapter Preview 327
Purpose 328
Learning Objectives 328 ""
The Difficulties of International Trade 328
Exchange Rates 329
Balance of Payments 333
International Trade and Exchange Rates 337
*PEOPLE & EVENTS: Burgernomics Tests the Purchasing
Power Parity Theory* 338
Capital Flows and Exchange Rates 347
Do You Understand? 344
Government Intervention in Foreign Exchange Markets 344
Foreign Exchange Markets 347
Spot and Forward Transactions 348
PEOPLE & EVENTS: Prices and Earnings: A Global Comparison 349
Financing International Trade 351
Do You Understand? 354
International Money and Capital Markets 355
The Internationalization of Financial Markets 358
Chapter Take-Aways 360
Key Terms 361
Questions and Problems 361
Internet Exercise 362

PART IV

COMMERCIAL BANKING 363

Chapter 13 Commercial Bank Operations 365

Chapter Preview 365
An Overview of the Banking Industry 366
Learning Objectives 366

>

<i>Purpose</i>	366
<i>The Source of Bank Funds</i>	370
<i>Balance Sheet for a Commercial Bank</i>	370
<i>PEOPLE & EVENTS: Banks Learn from Wal-Mart and Other Retailers</i>	374
<i>Do You Understand?</i>	377
<i>Bank Uses of Funds: Bank Investments and Cash Assets</i>	377
<i>Bank Uses of Funds: Loans and Leases</i>	380
<i>Loan Pricing</i>	384
<i>Analysis of Loan Credit Risk</i>	387
<i>PEOPLE & EVENTS: What's Your Score?</i>	388
<i>Do You Understand?</i>	389
<i>Pricing Bank Deposits</i>	389
<i>Fee-Based Services</i>	390
<i>Off-Balance-Sheet Banking</i>	393
<i>Bank and Financial Holding Companies</i>	397
<i>Do You Understand?</i>	398
<i>Chapter Take-Aways</i>	399
<i>Key Terms</i>	399
<i>Questions and Problems</i>	400
<i>Internet Exercise</i>	400

Chapter 14 Bank Management and Profitability 402

<i>Chapter Preview</i>	402
<i>Purpose</i>	403
<i>Learning Objectives</i>	403
<i>Bank Earnings</i>	403
<i>Bank Performance</i>	408
<i>A Banking Dilemma: Profitability Versus Safety</i>	408
<i>Liquidity Management</i>	411
<i>Do You Understand?</i>	414
<i>Bank Capital Management</i>	414
<i>PEOPLE & EVENTS: Increased Focus on Operational Risk</i>	419
<i>Managing Credit Risk</i>	419
<i>PEOPLE & EVENTS: "Bank of Presidents" Loses More Than a Sock in the Laundry</i>	421
<i>Do You Understand?</i>	424
<i>Managing Interest Rate Risk</i>	424
<i>Hedging Interest Rate Risk</i>	432
<i>Do You Understand?</i>	437
<i>Chapter Take-Aways</i>	438 *
<i>Key Terms</i>	~ 438
<i>Questions and Problems</i>	439
<i>Internet Exercise</i>	440

*«w

Chapter 15 International Banking 441

<i>Chapter Preview</i>	441
<i>Purpose</i>	442
<i>Learning Objectives</i>	442

<i>Development of International Banking</i>	442
<i>Regulation of Overseas Banking Activities</i>	445
<i>Delivery of Overseas Banking Services</i>	448
<i>PEOPLE & EVENTS: Coming Soon: The Bank of Europe</i>	452
<i>Do You Understand?</i>	453
<i>International Lending</i>	453
<i>PEOPLE & EVENTS: A Banker to the Rescue?</i>	456
<i>PEOPLE & EVENTS: Swiss Banking: Neutrality and Confidentiality After the Holocaust Banking Scandals</i>	461
<i>Do You Understand?</i>	462
<i>Foreign Banks in the United States</i>	462
<i>Future Directions of International Banking</i>	466
<i>Chapter Take-Aways</i>	467
<i>Key Terms</i>	467
<i>Questions and Problems</i>	467
<i>Internet Exercise</i>	468

Chapter 16 Regulation of Financial Institutions 469

<i>Chapter Preview</i>	469
<i>Purpose</i>	470
<i>Learning Objectives</i>	470
<i>Reasons for Regulation</i>	471
<i>Bank Failures and Regulation</i>	473
<i>Safety and Soundness Regulation: Deposit Insurance</i>	478
<i>Do You Understand?</i>	482
<i>Deposit Insurance Issues</i>	482
<i>Do You Understand?</i>	486
<i>PEOPLE & EVENTS: The Comptroller of the Currency: Then and Now</i>	487
<i>Bank Examinations</i>	487
<i>Structure and Competition Regulations</i>	490
<i>Consumer Protection Regulations</i>	493
<i>PEOPLE & EVENTS: Dual or Dueling Banking Systems?</i>	494
<i>Bank Regulators</i>	496
<i>Do You Understand?</i>	498
<i>Chapter Take-Aways</i>	499
<i>Key Terms</i>	499
<i>Questions and Problems</i>	500
<i>Internet Exercise</i>	500

Chapter 17 Thrift Institutions and Finance Companies 505

<i>Chapter Preview</i>	505
<i>Purpose</i>	506
<i>Learning Objectives</i>	507
<i>Historical Development of Savings Institutions</i>	507

<i>Operations of Savings Institutions</i>	511
<i>Do You Understand?</i>	518
<i>Credit Unions</i>	519
<i>PEOPLE & EVENTS: Demographic Change Brings Opportunity</i>	520
<i>PEOPLE & EVENTS: Commercial Banks vs. Credit Unions</i>	527
<i>Thrift Institutions Around the Globe</i>	528
<i>Do You Understand?</i>	528
<i>Finance Companies</i>	528
<i>Do You Understand?</i>	536
<i>Chapter Take-Aways</i>	536
<i>Key Terms</i>	537
<i>Questions and Problems</i>	537
<i>Internet Exercise</i>	538

Chapter 18 Insurance Companies and Pension Funds 539

<i>Chapter Preview</i>	539
<i>Purpose</i>	540
<i>Learning Objectives</i>	540
<i>Insurance</i>	540
<i>PEOPLE & EVENTS: Credit History and Personal Lines Underwriting</i>	542
<i>PEOPLE & EVENTS: 9/11 and Katrina: Insurance Coverage Disputes</i>	543
<i>The Insurance Industry</i>	546
<i>Do You Understand?</i>	553
<i>Life and Health Insurance</i>	553
<i>Do You Understand?</i>	559
<i>Property and Liability Insurance</i>	559
<i>Do You Understand?</i>	562
<i>Pensions</i>	562
<i>Do You Understand?</i>	567
<i>Chapter Take-Aways</i>	568
<i>Key Terms</i>	569
<i>Questions and Problems</i>	569
<i>Internet Exercise</i>	570

Chapter 19 Investment Banking 571

<i>Chapter Preview</i>	571
<i>Purpose</i>	572
<i>Learning Objectives</i>	572
<i>The Relationship Between Commercial and Investment Banking</i>	572
<i>PEOPLE & EVENTS: The Fall of the House that Junk Built</i>	573
<i>Primary Services of an Investment Bank</i>	579

*1 *«« PEOPLE & EVENTS: A Loose E-mail Clogs the IPO Money Machine 584

<i>Do You Understand?</i>	590
<i>Venture Capital</i>	590
<i>Do You Understand?</i>	594
<i>Chapter Take-Aways</i>	594
<i>Key Terms</i>	595

Contents

Questions and Problems 595

Internet Exercise 595

Chapter 20 Investment Companies 596

Chapter Preview 596

Purpose 597

Learning Objectives 597

Investment Companies 597

PEOPLE & EVENTS: Batman Saves Gotham City! 601

Mutual Funds 606

Do You Understand? 612

Hedge Funds 614

PEOPLE & EVENTS: The Demise of Long-Term Capital Management 616

Do You Understand? 618

Money Market Mutual Funds 619

Real Estate Investment Trusts 622

Do You Understand? 624

Chapter Take-Aways 625 • -

Key Terms 625

Questions and Problems 625

Internet Exercise 626

Glossary 627-653

Credits and Acknowledgments 654-655

Index 656-671