



SEVENTH EDITION

Financial Markets and Institutions

Anthony Saunders / Marcia Millon Cornett

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Financial Markets *and* **Institutions**

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Financial Markets *and* Institutions

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To Ingo Walter: a mentor, coauthor, and friend.

—TONY SAUNDERS

To my parents, Tom and Sue.

—MARCIA MILLON CORNETT

ABOUT THE AUTHORS

Anthony Saunders

Anthony Saunders is the John M. Schiff Professor of Finance and former chair of the Department of Finance at the Stern School of Business at New York University. Professor Saunders received his PhD from the London School of Economics and has taught both undergraduate- and graduate-level courses at NYU since 1978. Throughout his academic career, his teaching and research have specialized in financial institutions and international banking. He has served as a visiting professor all over the world, including INSEAD, the Stockholm School of Economics, and the University of Melbourne.



Professor Saunders holds or has held positions on the Board of Academic Consultants of the Federal Reserve Board of Governors as well as the Council of Research Advisors for the Federal National Mortgage Association. In addition, Dr. Saunders has acted as a visiting scholar at the Comptroller of the Currency and at the International Monetary Fund. He is editor of the *Journal of Financial Markets, Instruments and Institutions*, as well as the associate editor of a number of other journals. His research has been published in all of the major finance and banking journals and in several books. He has just published a new edition of his textbook, with Dr. Marcia Millon Cornett, *Financial Institutions Management: A Risk Management Approach*, for McGraw-Hill/Irwin (ninth edition) as well as a third edition of his book on credit risk measurement for John Wiley & Sons. Professor Saunders was ranked the most prolific author out of more than 5,800 who have published in the seven leading finance academic journals from 1959 to 2008 (“Most Prolific Authors in the Financial Literature, 1959–2008,” Jean Heck and Philip Cooley).

Marcia Millon Cornett

Marcia Millon Cornett is the Robert A. and Julia E. Dorn Professor of Finance at Bentley University. She received her BS degree in economics from Knox College in Galesburg, Illinois, and her MBA and PhD degrees in finance from Indiana University in Bloomington, Indiana. Dr. Cornett has written and published several articles in the areas of bank performance, bank regulation, corporate finance, and investments. Articles authored by Dr. Cornett have appeared in such academic journals as the *Journal of Finance*, the *Journal of Money, Credit, and Banking*, the *Journal of Financial Economics*, *Financial Management*, and the *Journal of Banking and Finance*. She was recently ranked the 124th most published out of more than 17,600 authors and the number five female author in finance literature over the last 50 years. Along with Anthony Saunders, Dr. Cornett has recently completed work on the ninth edition of *Financial Institutions Management* (McGraw-Hill/Irwin). With Troy A. Adair Jr. (Harvard University) and John Nofsinger (University of Alaska, Anchorage), she has also recently completed work on the fourth edition of *Finance: Applications and Theory* and the third edition of *M: Finance* (McGraw-Hill/Irwin). Professor Cornett serves as an associate editor for the *Journal of Banking and Finance*, the *Journal of Financial Services Research*, *Review of Financial Economics*, *Financial Review*, and *Multi-national Finance Journal*. Dr. Cornett has served as a member of the Board of Directors, the Executive Committee, and the Finance Committee of the SIU Credit Union. She has also taught at Southern Illinois University at Carbondale, the University of Colorado, Boston College, Southern Methodist University, and Boston University.



T

he last 30 years have been dramatic for the financial services industry. In the 1990s and 2000s, boundaries between the traditional industry sectors, such as commercial banking and investment banking, broke down and competition became increasingly global in nature. Many forces contributed to this breakdown in interindustry and intercountry barriers, including financial innovation, technology, taxation, and regulation. Then in 2008–2009, the financial services industry experienced the worst financial crisis since the Great Depression. Even into the mid-2010s, the U.S. and world economies have not recovered from this crisis. It is in this context that this book is written.

As the economic and competitive environments change, attention to profit and, more than ever, risk become increasingly important. This book offers a unique analysis of the risks faced by investors and savers interacting through both financial institutions and financial markets, as well as strategies that can be adopted for controlling and better managing these risks. Special emphasis is also put on new areas of operations in financial markets and institutions such as asset securitization, off-balance-sheet activities, and globalization of financial services.

While maintaining a risk measurement and management framework, *Financial Markets and Institutions* provides a broad application of this important perspective. This book recognizes that domestic and foreign financial markets are becoming increasingly integrated and that financial intermediaries are evolving toward a single financial services industry. The analytical rigor is mathematically accessible to all levels of students, undergraduate and graduate, and is balanced by a comprehensive discussion of the unique environment within which financial markets and institutions operate. Important practical tools such as how to issue and trade financial securities and how to analyze financial statements and loan applications will arm students with the skills necessary to understand and manage financial market and institution risks in this dynamic environment. While descriptive concepts so important to financial management (financial market securities, regulation, industry trends, industry characteristics, etc.) are included in the book, ample analytical techniques are also included as practical tools to help students understand the operation of modern financial markets and institutions.

INTENDED AUDIENCE

Financial Markets and Institutions is aimed at the first course in financial markets and institutions at both the undergraduate and MBA levels. While topics covered in this book are found in more advanced textbooks on financial markets and institutions, the explanations and illustrations are aimed at those with little or no practical or academic experience beyond the introductory-level finance courses. In most chapters, the main relationships are presented by figures, graphs, and simple examples. The more complicated details and technical problems related to in-chapter discussion are provided in appendixes to the chapters (available through McGraw-Hill *Connect Finance* or your course instructor).

ORGANIZATION

Since our focus is on return and risk and the sources of that return and risk in domestic and foreign financial markets and institutions, this book relates ways in which a modern financial manager, saver, and investor can expand return with a managed level of risk to achieve the best, or most favorable, return–risk outcome.

Part 1 provides an introduction to the text and an overview of financial markets and institutions. Chapter 1 defines and introduces the various domestic and foreign financial markets and describes the special functions of FIs. This chapter also takes an analytical look at how financial markets and institutions benefit today’s economy. In Chapter 2, we provide an in-depth look at interest rates. We first look at factors that determine interest rate levels,

as well as their past, present, and expected future movements. We then review the concept of time value of money. Chapter 3 then applies these interest rates to security valuation. In Chapter 4, we describe the Federal Reserve System and how monetary policy implemented by the Federal Reserve affects interest rates and, ultimately, the overall economy.

Part 2 of the text presents an overview of the various securities markets. We describe each securities market, its participants, the securities traded in each, the trading process, and how changes in interest rates, inflation, and foreign exchange rates impact a financial manager's decisions to hedge risk. These chapters cover the money markets (Chapter 5), bond markets (Chapter 6), mortgage markets (Chapter 7), stock markets (Chapter 8), foreign exchange markets (Chapter 9), and derivative securities markets (Chapter 10).

Part 3 of the text summarizes the operations of commercial banks. Chapter 11 describes the key characteristics and recent trends in the commercial banking sector. Chapter 12 describes the financial statements of a typical commercial bank and the ratios used to analyze those statements. This chapter also analyzes actual financial statements for representative commercial banks. Chapter 13 provides a comprehensive look at the regulations under which these financial institutions operate and, particularly, the effect of recent changes in regulation.

Part 4 of the text provides an overview describing the key characteristics and regulatory features of the other major sectors of the U.S. financial services industry. We discuss other lending institutions (savings institutions, credit unions, and finance companies) in Chapter 14, insurance companies in Chapter 15, securities firms and investment banks in Chapter 16, investment companies in Chapter 17, and pension funds in Chapter 18.

Part 5 concludes the text by examining the risks facing a modern FI and FI managers and the various strategies for managing these risks. In Chapter 19, we preview the risk measurement and management chapters in this section with an overview of the risks facing a modern FI. We divide the chapters on risk measurement and management along two lines: measuring and managing risks on the balance sheet, and managing risks off the balance sheet. In Chapter 20, we begin the on-balance-sheet risk measurement and management section by looking at credit risk on individual loans and bonds and how these risks adversely impact an FI's profits and value. The chapter also discusses the lending process, including loans made to households and small, medium-size, and large corporations. Chapter 21 covers liquidity risk in financial institutions. This chapter includes a detailed analysis of the ways in which FIs can insulate themselves from liquidity risk and the key role deposit insurance and other guarantee schemes play in reducing liquidity risk.

In Chapter 22, we investigate the net interest margin as a source of profitability and risk, with a focus on the effects of interest rate risk and the mismatching of asset and liability maturities on FI risk exposure. At the core of FI risk insulation is the size and adequacy of the owner's capital stake, which is also a focus of this chapter.

The management of risk off the balance sheet is examined in Chapter 23. The chapter highlights various new markets and instruments that have emerged to allow FIs to better manage three important types of risk: interest rate risk, foreign exchange risk, and credit risk. These markets and instruments and their strategic use by FIs include forwards, futures, options, and swaps.

Finally, Chapter 24 explores ways of removing credit risk from the loan portfolio through asset sales and securitization.

NEW FEATURES

- Tables and figures in all chapters have been revised to include the most recently available data.
- Revised "After the Crisis" boxes highlighting significant events related to the financial crisis have been added to chapters throughout the book.
- Updates on the major changes proposed for the regulation of financial institutions are included where appropriate throughout the book.
- Discussion of how financial markets and institutions continue to recover from the financial crisis has been added throughout the book. Virtually every chapter includes

new material detailing how the financial crisis affected risk management in financial institutions.

- Several chapters include a discussion of Brexit as it affects the risk and return for investors in financial markets and financial institutions.
- Several chapters include a discussion of the impact of initial interest rate increases by the Federal Reserve.
- Several chapters include a discussion of the impact of China's economic policies and economic slowdown on financial markets.
- Chapter 1 includes a new section on enterprise risk management. The chapter also provides an update on the implementation of the Wall Street Reform and Consumer Protection Act enacted as a result of the financial crisis.
- Chapter 4 provides an update on the Federal Reserve's actions intended to strengthen the U.S. economy, including the interest rate increases instituted by the Fed.
- Chapter 5 includes updates on the LIBOR scandal.
- Chapter 6 discusses China's and worldwide Treasury holdings and the potential impact of these holdings on the U.S. economy.
- Chapter 8 includes more on dark pools and Brexit's impact on worldwide stock markets.
- Excel spreadsheets containing bank financial statements and ratio calculations have been added to Chapter 12.
- Chapter 13 includes a discussion of how the Volcker Rule and Consumer Protection Regulation have affected the operations of financial institutions.
- Chapter 14 includes a discussion of new payday lending legislation.
- Chapter 17 includes more on new regulations for money market mutual funds.
- Chapter 21 includes updates of the new international liquidity standards enacted as a result of the financial crisis.

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Anthony Saunders

Marcia Millon Cornett

WALKTHROUGH

Chapter Features

The following special features have been integrated throughout the text to encourage student interaction and to aid students in absorbing and retaining the material

CHAPTER-OPENING OUTLINES

These outlines offer students a snapshot view of what they can expect to learn from each chapter's discussion.

O U T L I N E

Major Duties and Responsibilities of the Federal Reserve System: Chapter Overview

Structure of the Federal Reserve System

- Organization of the Federal Reserve System
- Board of Governors of the Federal Reserve System

Learning Goals

- LG 4-1** Understand the major functions of the Federal Reserve System.
- LG 4-2** Identify the structure of the Federal Reserve System.
- LG 4-3** Identify the monetary policy tools used by the Federal Reserve.
- LG 4-4** Appreciate how monetary policy changes affect key economic variables.
- LG 4-5** Understand how central banks around the world adjusted their monetary policy during the recent financial crisis.

LEARNING GOALS

Learning goals (LGs) appear at the beginning of each chapter to provide a quick introduction to the key chapter material. These goals are also integrated with the end-of-chapter questions and problems, which allows instructors to easily emphasize the learning goal(s) as they choose.

Federal Open Market Committee (FOMC)

The major monetary policy-making body of the Federal Reserve System.

The **Federal Open Market Committee (FOMC)** is the primary body of the Federal Reserve System. It consists of the seven members of the Federal Reserve Board of Governors, and five members of the Federal Reserve Bank of New York, and four members of the Federal Reserve Banks of Atlanta, Chicago, Cleveland, and San Francisco. The chair of the FOMC is required to meet at least six times a year. The main responsibilities of the FOMC include employment, economic growth, and trade. The FOMC seeks to achieve its goals through open market operations. **Open market operations** are the purchase and sale of federal agency securities—i.e., Treasury bills, Treasury notes, and Treasury bonds (although the operation of the Federal Reserve Bank of New York

open market operations

Purchases and sales of U.S. government and fed-

www.occ.treas.gov

www.fdic.gov

subsidiaries), (2) state-chartered member banks (state-chartered member banks which U.S. banks conduct their business, including overseeing banks in all 50 States and the establishment of subsidiaries, and receiving and administering member activities of bank holding companies and administration of regulations under the Truth in Lending Act, the Equal Credit Opportunity Act, and Consumer Protection

BOLD KEY TERMS AND A MARGINAL GLOSSARY

The main terms and concepts are emphasized throughout the chapter by bold key terms called out in the text and defined in the margins

PERTINENT WEB ADDRESSES

Website addresses are referenced in the margins throughout each chapter, providing additional resources to aid in the learning process.

Pedagogical Features

DO YOU UNDERSTAND:

1. *What the main functions of Federal Reserve Banks are?*
2. *What the main responsibilities of the Federal Reserve Board are?*
3. *How the FOMC implements monetary policy?*
4. *What the main assets and*

as the Fed took and housing mar-
rities (MBS) ba
MBS purchase p
of agency MBS
through 2016. T
the financial ma
Gold and Fore
holds Treasury
sold. The Fed

“DO YOU UNDERSTAND” BOXES

These boxes allow students to test themselves on the main concepts presented within each major chapter section. Solutions are provided in Connect.

“IN THE NEWS” BOXES

These boxes demonstrate the application of chapter material to real current events.

IN-CHAPTER EXAMPLES

These examples provide numerical demonstrations of the analytical material described in many chapters.

IN THE NEWS

The Financial Crisis: Toward an Expla

In the first half of 2007, as the extent of declining home prices became apparent, banks and other financial institutions sought to reas-
off the company’s balance month, the board also ann the creation of the Term S Lending Facility (TSLF), sw

EXAMPLE 4-1 Purchases of Securities by the Federal R

Suppose the FOMC instructs the FRBNY Trading Desk to purchase \$50 billion of Treasury securities. Traders at the FRBNY call primary government securities dealers, commercial and investment banks (such as Goldman Sachs and Morgan Stanley), and provide a list of securities they have available for sale, including the de

AFTER THE CRISIS

Goldman Reaches \$5 Billion Settlement over

In January 2016, Goldman Sachs agreed to pay more than \$5 billion, the largest regulatory penalty in its history. In settling with the Justice Department and a collection of other state and
residential mortgages, and wh banks deceived investors by sending the quality of underlyi The government’s inquiry into related to mortgage-backed s


“AFTER THE CRISIS” BOXES

These boxes use articles pertaining to events caused or affected by the 2008–2009 financial crisis to elaborate on chapter material.

INTERNATIONAL COVERAGE

An international icon appears in the margin to easily communicate where international material is being introduced.

INTERNATIONAL MONETARY POLICIES AND STRATE



Central banks guide the monetary polic
European Central Bank (ECB) is the cent
of England is the central bank of the Unite
independent central banks whose decisio
In contrast, the People’s Bank of China, th
of Brazil are less independent in that the g
the operations of these central banks. Inde
the bank is free from pressure from poli

End-of-Chapter Features

EXCEL PROBLEMS

Excel problems are featured in selected chapters and are denoted by an icon. Spreadsheet templates are available in Connect.

7. Using a Spreadsheet to Calculate Mortgage Payments:

What is the monthly payment on a \$150,000, 30-year mortgage if the mortgage rate is 5.75 percent? 6.25 percent? 7.5 percent? 9 percent? (LG 7-4)

Present Value	Periods	Interest Rate	⇒	The Payment Will Be
\$150,000	30 × 12	5.75%/12		\$ 875.36
150,000	30 × 12	6.25%/12		923.58
150,000	30 × 12	7.50%/12		1,048.82
150,000	30 × 12	9.00%/12		1,206.93

QUESTIONS

- Describe the functions performed by Federal Reserve Banks. (LG 4-1)
- Define the discount rate and the discount window. (LG 4-2)
- Describe the structure of the Board of Governors of the Federal Reserve System. (LG 4-2)
- What are the primary responsibilities of the Federal Reserve Board? (LG 4-1)
- What are the primary responsibilities of the Federal Open Market Committee? (LG 4-2)
- What are the major liabilities of the Federal Reserve System? Describe each. (LG 4-2)
- Why did reserve deposits increase to the point that this account represented the largest liability account on the Federal Reserve's balance sheet in the late 2000s? (LG 4-2)
- What are the major assets of the Federal Reserve System? Describe each. (LG 4-2)
- Why did U.S. government agency securities go from nothing to being the largest asset account on the Federal Reserve's balance sheet in the late 2000s? (LG 4-2)

PROBLEMS

- Suppose the Federal Reserve instructs the Trading Desk to purchase \$1 billion of securities. Show the result of this transaction on the balance sheets of the Federal Reserve System and commercial banks. (LG 4-3)

END-OF-CHAPTER QUESTIONS AND PROBLEMS

The questions and problems in the end-of-chapter material appear in separate sections, allowing instructors to choose whether they prefer students to engage in quantitative or qualitative analysis of the material. Selected problems are assignable online in Connect.

SEARCH THE SITE

Featured among the end-of-chapter material in most chapters, these Internet exercises weave the web, real data, and practical applications with concepts found in the book.

SEARCH THE SITE

Go to the Federal Reserve Board website and find the latest information available on the three-month T-bill rate using the following steps. Go to www.federalreserve.gov, click on "Selected Interest Rates." Click on the most recent date. The data will be in the

Questions

- What are the current levels for each of these interest rates?
- Calculate the percentage change in each of these rates since June 2016.

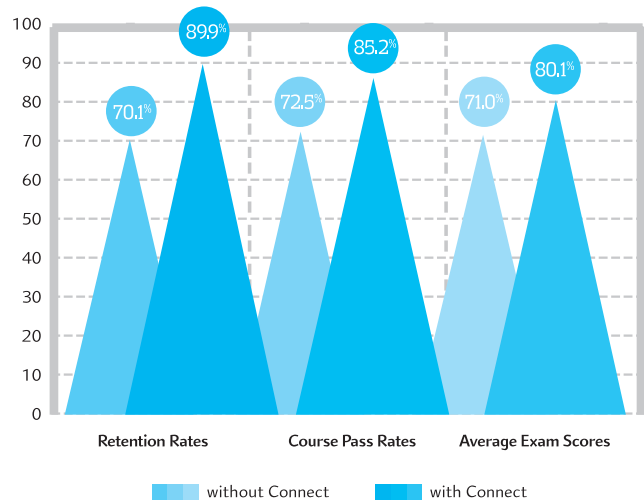
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- Multimedia content such as videos, simulations, and games drive student engagement and critical thinking skills.



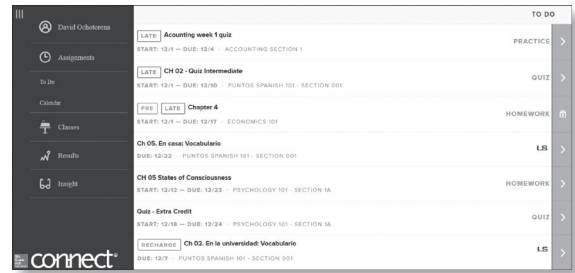
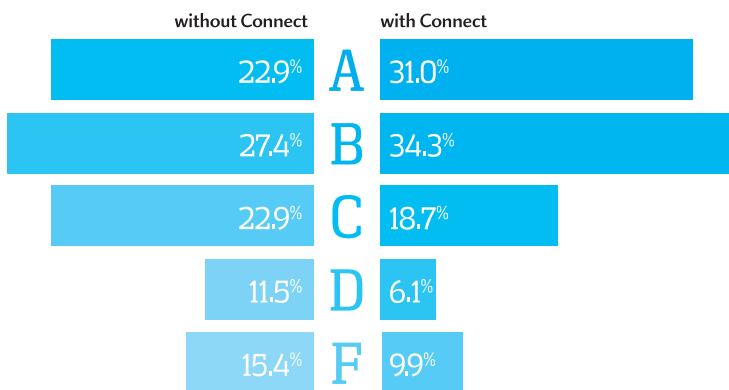
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FOR THE INSTRUCTOR

Instructors will have access to teaching support such as electronic files of the ancillary materials, described below, available within Connect.

- **Instructor's Manual** Prepared by Tim Manuel, University of Montana, the Instructor's Manual includes detailed chapter contents and outline, additional examples for use in the classroom, and extensive teaching notes.
- **Test Bank** Prepared by Ohaness Paskelian, University of Houston–Downtown, the Test Bank includes nearly 1,000 additional problems to be used for test material.
- **Solutions Manual** Prepared by coauthor Marcia Milon Cornett, this manual provides worked-out solutions to the end-of-chapter questions. Author involvement ensures consistency between the approaches presented in the text and those in the manual.
- **PowerPoint** Developed by Courtney Baggett, Troy University, the PowerPoint presentation includes full-color slides featuring lecture notes, figures, and tables. The slides can be easily downloaded and edited to better fit your lecture.

Student Resources

The Students Resources page in Connect is the place for students to access additional resources. The Student Study Center offers quick access to the web appendixes, Excel files and templates, eBooks, and more.

Student progress tracking

Connect Finance keeps instructors informed about how each student, section, and class is performing, allowing for more productive use of lecture and office hours. The progress-tracking function enables you to:

- View scored work immediately and track individual or group performance with assignment and grade reports.
- Access an instant view of student or class performance relative to learning objectives.
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CONTENTS IN BRIEF

Preface vii

- part 1** INTRODUCTION AND OVERVIEW OF FINANCIAL MARKETS 1
1. Introduction 1
 2. Determinants of Interest Rates 26
 3. Interest Rates and Security Valuation 58
 4. The Federal Reserve System, Monetary Policy, and Interest Rates 93
- part 2** SECURITIES MARKETS 132
5. Money Markets 132
 6. Bond Markets 169
 7. Mortgage Markets 208
 8. Stock Markets 240
 9. Foreign Exchange Markets 282
 10. Derivative Securities Markets 311
- part 3** COMMERCIAL BANKS 353
11. Commercial Banks: Industry Overview 353
 12. Commercial Banks' Financial Statements and Analysis 380
 13. Regulation of Commercial Banks 413

- part 4** OTHER FINANCIAL INSTITUTIONS 454
14. Other Lending Institutions: Savings Institutions, Credit Unions, and Finance Companies 454
 15. Insurance Companies 480
 16. Securities Firms and Investment Banks 506
 17. Investment Companies 531
 18. Pension Funds 564
- part 5** RISK MANAGEMENT IN FINANCIAL INSTITUTIONS 585
19. Types of Risks Incurred by Financial Institutions 585
 20. Managing Credit Risk on the Balance Sheet 604
 21. Managing Liquidity Risk on the Balance Sheet 632
 22. Managing Interest Rate Risk and Insolvency Risk on the Balance Sheet 655
 23. Managing Risk off the Balance Sheet with Derivative Securities 683
 24. Managing Risk off the Balance Sheet with Loan Sales and Securitization 712
- References* 739
Index 741

	<i>Preface</i>	<i>vii</i>
part 1	INTRODUCTION AND OVERVIEW OF FINANCIAL MARKETS	1
1	Introduction	1
	Why Study Financial Markets and Institutions?	
	Chapter Overview	1
	Overview of Financial Markets	3
	<i>Primary Markets versus Secondary Markets</i>	4
	<i>Money Markets versus Capital Markets</i>	6
	<i>Foreign Exchange Markets</i>	9
	<i>Derivative Security Markets</i>	9
	<i>Financial Market Regulation</i>	10
	Overview of Financial Institutions	11
	<i>Unique Economic Functions Performed by Financial Institutions</i>	12
	<i>Additional Benefits FIs Provide to Suppliers of Funds</i>	14
	<i>Economic Functions FIs Provide to the Financial System as a Whole</i>	15
	<i>Risks Incurred by Financial Institutions</i>	16
	<i>Regulation of Financial Institutions</i>	16
	<i>Trends in the United States</i>	17
	Globalization of Financial Markets and Institutions	21
	Appendix 1A: The Financial Crisis: The Failure of Financial Institutions' Specialness	25
2	Determinants of Interest Rates	26
	Interest Rate Fundamentals: Chapter Overview	26
	Loanable Funds Theory	27
	<i>Supply of Loanable Funds</i>	28
	<i>Demand for Loanable Funds</i>	29
	<i>Equilibrium Interest Rate</i>	30
	<i>Factors That Cause the Supply and Demand Curves for Loanable Funds to Shift</i>	31
	Movement Of Interest Rates Over Time	35
	Determinants of Interest Rates for Individual Securities	36
	<i>Inflation</i>	36
	<i>Real Risk-Free Rates</i>	36
	<i>Default or Credit Risk</i>	38
	<i>Liquidity Risk</i>	40
	<i>Special Provisions or Covenants</i>	40
	<i>Term to Maturity</i>	40
	Term Structure of Interest Rates	42
	<i>Unbiased Expectations Theory</i>	42
	<i>Liquidity Premium Theory</i>	44
	<i>Market Segmentation Theory</i>	46
	Forecasting Interest Rates	48
	Time Value of Money and Interest Rates	49
	<i>Time Value of Money</i>	49
	<i>Lump Sum Valuation</i>	50
	<i>Annuity Valuation</i>	52
3	Interest Rates and Security Valuation	58
	Interest Rates as a Determinant of Financial Security Values: Chapter Overview	58
	Various Interest Rate Measures	59
	<i>Coupon Rate</i>	59
	<i>Required Rate of Return</i>	59
	<i>Expected Rate of Return</i>	60
	<i>Required versus Expected Rates of Return: The Role of Efficient Markets</i>	61
	<i>Realized Rate of Return</i>	62
	Bond Valuation	63
	<i>Bond Valuation Formula Used to Calculate Fair Present Values</i>	63
	<i>Bond Valuation Formula Used to Calculate Yield to Maturity</i>	65
	Equity Valuation	66
	<i>Zero Growth in Dividends</i>	68
	<i>Constant Growth in Dividends</i>	69
	<i>Supernormal (or Nonconstant) Growth in Dividends</i>	70
	Impact of Interest Rate Changes on Security Values	71
	Impact of Maturity on Security Values	72
	<i>Maturity and Security Prices</i>	73
	<i>Maturity and Security Price Sensitivity to Changes in Interest Rates</i>	73
	Impact of Coupon Rates on Security Values	74
	<i>Coupon Rate and Security Price</i>	75
	<i>Coupon Rate and Security Price Sensitivity to Changes in Interest Rates</i>	75
	Duration	76
	<i>A Simple Illustration of Duration</i>	76
	<i>A General Formula for Duration</i>	78
	<i>Features of Duration</i>	82
	<i>Economic Meaning of Duration</i>	83
	<i>Large Interest Rate Changes and Duration</i>	85
	Appendix 3A: Duration and Immunization	92
	Appendix 3B: More on Convexity	92

4 The Federal Reserve System, Monetary Policy, and Interest Rates 93

Major Duties and Responsibilities of the Federal Reserve System: Chapter Overview 93

Structure of the Federal Reserve System 94
Organization of the Federal Reserve System 94
Board of Governors of the Federal Reserve System 96
Federal Open Market Committee 97
Functions Performed by Federal Reserve Banks 97
Balance Sheet of the Federal Reserve 102

Monetary Policy Tools 105
Open Market Operations 108
The Discount Rate 110
Reserve Requirements (Reserve Ratios) 113

The Federal Reserve, the Money Supply, and Interest Rates 116
Effects of Monetary Tools on Various Economic Variables 117
Money Supply versus Interest Rate Targeting 118

International Monetary Policies and Strategies 123
Systemwide Rescue Programs Employed during the Financial Crisis 123
Challenges Remain after the Crisis 128

part 2 SECURITIES MARKETS 132

5 Money Markets 132

Definition of Money Markets: Chapter Overview 132

Money Markets 133

Yields on Money Market Securities 133
Bond Equivalent Yields 134
Effective Annual Return 134
Discount Yields 134
Single-Payment Yields 135

Money Market Securities 136
Treasury Bills 138
Federal Funds 144
Repurchase Agreements 145
Commercial Paper 148
Negotiable Certificates of Deposit 153
Banker's Acceptances 154
Comparison of Money Market Securities 155

Money Market Participants 155
The U.S. Treasury 156
The Federal Reserve 156
Commercial Banks 156
Money Market Mutual Funds 157
Brokers and Dealers 157
Corporations 158

Other Financial Institutions 158
Individuals 158

International Aspects of Money Markets 158
Euro Money Markets 160

Appendix 5A: Single versus Discriminating Price Treasury Auctions 168

Appendix 5B: Creation of a Banker's Acceptance 168

6 Bond Markets 169

Definition of Bond Markets: Chapter Overview 169

Bond Market Securities 170
Treasury Notes and Bonds 170
Municipal Bonds 181
Corporate Bonds 187
Bond Ratings and Interest Rate Spreads 193
Bond Market Indexes 196

Bond Market Participants 197

Comparison of Bond Market Securities 198

International Aspects of Bond Markets 198
Eurobonds, Foreign Bonds, and Sovereign Bonds 201

7 Mortgage Markets 208

Mortgages and Mortgage-Backed Securities: Chapter Overview 208

Primary Mortgage Market 210
Mortgage Characteristics 211
Mortgage Amortization 216
Other Types of Mortgages 221

Secondary Mortgage Markets 223
History and Background of Secondary Mortgage Markets 224
Mortgage Sales 225
Mortgage-Backed Securities 225

Participants in the Mortgage Markets 233

International Trends in Securitization 234

Appendix 7A: Amortization Schedules for 30-Year Mortgage in Example 7-2 and No-Points versus Points Mortgages in Example 7-4 239

8 Stock Markets 240

The Stock Markets: Chapter Overview 240

Stock Market Securities 242
Common Stock 242
Preferred Stock 245

Primary and Secondary Stock Markets 247
Primary Stock Markets 247
Secondary Stock Markets 252
Stock Market Indexes 262

Stock Market Participants	266		
Other Issues Pertaining to Stock Markets	268		
<i>Economic Indicators</i>	268		
<i>Market Efficiency</i>	269		
<i>Stock Market Regulations</i>	272		
International Aspects of Stock Markets	274		
Appendix 8A: The Capital Asset Pricing Model	281		
Appendix 8B: Event Study Tests	281		
9 Foreign Exchange Markets	282		
Foreign Exchange Markets and Risk: Chapter Overview	282		
Background and History of Foreign Exchange Markets	283		
Foreign Exchange Rates and Transactions	288		
<i>Foreign Exchange Rates</i>	288		
<i>Foreign Exchange Transactions</i>	288		
<i>Return and Risk of Foreign Exchange Transactions</i>	293		
<i>Role of Financial Institutions in Foreign Exchange Transactions</i>	299		
Interaction of Interest Rates, Inflation, and Exchange Rates	302		
<i>Purchasing Power Parity</i>	303		
<i>Interest Rate Parity</i>	305		
Appendix 9A: Balance of Payment Accounts	310		
10 Derivative Securities Markets	311		
Derivative Securities: Chapter Overview	311		
Forwards and Futures	313		
<i>Spot Markets</i>	313		
<i>Forward Markets</i>	314		
<i>Futures Markets</i>	316		
Options	323		
<i>Call Options</i>	323		
<i>Put Options</i>	325		
<i>Option Values</i>	327		
<i>Option Markets</i>	329		
Regulation of Futures and Options Markets	335		
Swaps	336		
<i>Interest Rate Swaps</i>	337		
<i>Currency Swaps</i>	341		
<i>Credit Swaps</i>	342		
<i>Swap Markets</i>	343		
Caps, Floors, and Collars	345		
International Aspects of Derivative Securities Markets	347		
Appendix 10A: Black–Scholes Option Pricing Model	352		
part 3 COMMERCIAL BANKS	353		
11 Commercial Banks: Industry Overview	353		
Commercial Banks as a Sector of the Financial Institutions Industry: Chapter Overview	353		
Definition of a Commercial Bank	355		
Balance Sheets and Recent Trends	355		
<i>Assets</i>	355		
<i>Liabilities</i>	358		
<i>Equity</i>	359		
<i>Off-Balance-Sheet Activities</i>	359		
<i>Other Fee-Generating Activities</i>	363		
Size, Structure, and Composition of the Industry	364		
<i>Bank Size and Concentration</i>	365		
<i>Bank Size and Activities</i>	367		
Industry Performance	368		
Regulators	371		
<i>Federal Deposit Insurance Corporation</i>	371		
<i>Office of the Comptroller of the Currency</i>	372		
<i>Federal Reserve System</i>	373		
<i>State Authorities</i>	373		
Global Issues	373		
<i>Advantages and Disadvantages of International Expansion</i>	373		
<i>Global Banking Performance</i>	375		
12 Commercial Banks' Financial Statements and Analysis	380		
Why Evaluate the Performance of Commercial Banks? Chapter Overview	380		
Financial Statements of Commercial Banks	382		
<i>Balance Sheet Structure</i>	383		
<i>Off-Balance-Sheet Assets and Liabilities</i>	389		
<i>Other Fee-Generating Activities</i>	392		
<i>Income Statement</i>	393		
<i>Direct Relationship between the Income Statement and the Balance Sheet</i>	397		
Financial Statement Analysis Using a Return on Equity Framework	398		
<i>Return on Equity and Its Components</i>	399		
<i>Return on Assets and Its Components</i>	401		
<i>Other Ratios</i>	406		
Impact of Market Niche and Bank Size on Financial Statement Analysis	407		
<i>Impact of a Bank's Market Niche</i>	407		
<i>Impact of Size on Financial Statement Analysis</i>	407		

13 Regulation of Commercial Banks 413

Specialness and Regulation: Chapter Overview 413

Types of Regulations and the Regulators 414

Safety and Soundness Regulation 414

Monetary Policy Regulation 417

Credit Allocation Regulation 417

Consumer Protection Regulation 417

Investor Protection Regulation 418

Entry and Chartering Regulation 418

Regulators 419

Regulation of Product and Geographic

Expansion 419

Product Segmentation in the U.S. Commercial Banking Industry 419

Geographic Expansion in the U.S. Commercial Banking Industry 426

Bank and Savings Institution Guarantee

Funds 427

The Federal Deposit Insurance Corporation (FDIC) 428

The Demise of the Federal Savings and Loan Insurance Corporation (FSLIC) 429

Reform of Deposit Insurance 430

Non-U.S. Deposit Insurance Systems 431

Balance Sheet Regulations 431

Regulations on Commercial Bank

Liquidity 431

Regulations on Capital Adequacy

(Leverage) 432

Foreign versus Domestic Regulation of Commercial Banks 437

Product Diversification Activities 437

Global or International Expansion Activities 438

Appendix 13A: Calculating Deposit Insurance Premium Assessments 445

Appendix 13B: Calculating Minimum Required Reserves at U.S. Depository Institutions 450

Appendix 13C: Primary Regulators of Depository Institutions 453

Appendix 13D: Deposit Insurance Coverage for Commercial Banks in Various Countries 453

Appendix 13E: Calculating Risk-Based Capital Ratios 453

part 4 OTHER FINANCIAL INSTITUTIONS 454

14 Other Lending Institutions 454

Other Lending Institutions: Chapter

Overview 454

Savings Institutions 455

Size, Structure, and Composition of the Industry 455

Balance Sheets and Recent Trends 457

Regulators 459

Savings Institution Recent Performance 460

Credit Unions 461

Size, Structure, and Composition of the Industry 462

Balance Sheets and Recent Trends 464

Regulators 466

Industry Performance 466

Finance Companies 468

Size, Structure, and Composition of the Industry 468

Balance Sheets and Recent Trends 469

Industry Performance 474

Regulation 475

Global Issues 476

15 Insurance Companies 480

Two Categories of Insurance Companies: Chapter Overview 480

Life Insurance Companies 481

Size, Structure, and Composition of the Industry 481

Balance Sheets and Recent Trends 486

Regulation 489

Property-Casualty Insurance Companies 490

Size, Structure, and Composition of the Industry 490

Balance Sheets and Recent Trends 492

Regulation 500

Global Issues 501

16 Securities Firms and Investment Banks 506

Services Offered by Securities Firms versus Investment Banks: Chapter Overview 506

Size, Structure, and Composition of the Industry 508

Securities Firm and Investment Bank Activity Areas 510

Investment Banking 510

Venture Capital 512

Market Making 514

Trading 514

Investing 515

Cash Management 516

Mergers and Acquisitions 516

Other Service Functions 516

Recent Trends and Balance Sheets 517

Recent Trends 517

Balance Sheets 520

Regulation 522

Global Issues 525

17 Investment Companies 531

Investment Companies: Chapter Overview 531

Size, Structure, and Composition of the Mutual Fund Industry 532

Historical Trends 532*Different Types of Mutual Funds* 533*Other Types of Investment Company Funds* 538

Mutual Fund Returns and Costs 539

Mutual Fund Prospectuses and Objectives 539*Investor Returns from Mutual Fund**Ownership* 542*Mutual Fund Costs* 544

Mutual Fund Balance Sheets and Recent

Trends 547

Long-Term Funds 547*Money Market Funds* 548

Mutual Fund Regulation 549

Mutual Fund Global Issues 552

Hedge Funds 552

Types of Hedge Funds 555*Fees on Hedge Funds* 558*Offshore Hedge Funds* 559*Regulation of Hedge Funds* 560**18 Pension Funds 564**

Pension Funds Defined: Chapter Overview 564

Size, Structure, and Composition of the Industry 565

Defined Benefit versus Defined Contribution Pension Funds 565*Insured versus Noninsured Pension Funds* 567*Private Pension Funds* 568*Public Pension Funds* 575

Financial Asset Investments and Recent

Trends 576

Private Pension Funds 576*Public Pension Funds* 577

Regulation 579

Global Issues 581

Appendix 18A: Calculation of Growth in IRA Value during an Individual's Working Years 584

part 5 RISK MANAGEMENT IN FINANCIAL INSTITUTIONS 585**19 Types of Risks Incurred by Financial Institutions 585**

Why Financial Institutions Need to Manage Risk: Chapter Overview 585

Credit Risk 586

Liquidity Risk 589

Interest Rate Risk 590

Market Risk 592

Off-Balance-Sheet Risk 594

Foreign Exchange Risk 596

Country or Sovereign Risk 598

Technology and Operational Risk 598

Insolvency Risk 600

Other Risks and Interaction among Risks 600

20 Managing Credit Risk on the Balance Sheet 604

Credit Risk Management: Chapter Overview 604

Credit Quality Problems 606

Credit Analysis 607

Real Estate Lending 608*Consumer (Individual) and Small-Business Lending* 611*Mid-Market Commercial and Industrial Lending* 612*Large Commercial and Industrial Lending* 620

Calculating the Return on a Loan 624

Return on Assets (ROA) 624*RAROC Models* 626

Appendix 20A: Loan Portfolio Risk and Management 631

21 Managing Liquidity Risk on the Balance Sheet 632

Liquidity Risk Management: Chapter Overview 632

Causes of Liquidity Risk 633

Liquidity Risk and Depository Institutions 634

Liability-Side Liquidity Risk 634*Asset-Side Liquidity Risk* 637*Measuring a DI's Liquidity Exposure* 638*Liquidity Risk, Unexpected Deposit Drains, and Bank Runs* 643*Bank Runs, the Discount Window, and Deposit Insurance* 644

Liquidity Risk and Insurance Companies 647

Life Insurance Companies 647*Property-Casualty Insurance Companies* 648*Guarantee Programs for Life and**Property-Casualty Insurance**Companies* 649

Liquidity Risk and Investment Funds 649

Appendix 21A: Sources and Uses of Funds Statement: J.P. Morgan Chase, September 2016 654

Appendix 21B: New Liquidity Risk Measures Implemented by the Bank for International Settlements	654	Comparison of Hedging Methods	703
		<i>Writing versus Buying Options</i>	703
		<i>Futures versus Options Hedging</i>	705
		<i>Swaps versus Forwards, Futures, and Options</i>	706
22 Managing Interest Rate Risk and Insolvency Risk on the Balance Sheet	655	Appendix 23A: Hedging with Futures Contracts	711
Interest Rate and Insolvency Risk Management: Chapter Overview	655	Appendix 23B: Hedging with Options	711
Interest Rate Risk Measurement and Management	656	Appendix 23C: Hedging with Caps, Floors, and Collars	711
<i>Repricing Gap Model</i>	656	24 Managing Risk off the Balance Sheet with Loan Sales and Securitization	712
<i>Duration Gap Model</i>	665	Why Financial Institutions Sell and Securitiz	
Insolvency Risk Management	673	Loans: Chapter Overview	712
<i>Capital and Insolvency Risk</i>	673	Loan Sales	713
23 Managing Risk off the Balance Sheet with Derivative Securities	683	<i>Types of Loan Sales Contracts</i>	715
Derivative Securities used to Manage Risk: Chapter Overview	683	<i>The Loan Sales Market</i>	715
Forward and Futures Contracts	684	<i>Secondary Market for Less Developed Country Debt</i>	718
<i>Hedging with Forward Contracts</i>	685	<i>Factors Encouraging Future Loan Sales Growth</i>	719
<i>Hedging with Futures Contracts</i>	686	<i>Factors Deterring Future Loan Sales Growth</i>	720
Options	689	Loan Securitization	721
<i>Basic Features of Options</i>	689	<i>Pass-Through Security</i>	721
<i>Actual Interest Rate Options</i>	692	<i>Collateralized Mortgage Obligation</i>	728
<i>Hedging with Options</i>	692	<i>Mortgage-Backed Bond</i>	732
<i>Caps, Floors, and Collars</i>	693	Securitization of Other Assets	734
Risks Associated with Futures, Forwards, and Options	694	Can All Assets Be Securitized?	734
Swaps	695	<i>References</i>	739
<i>Hedging with Interest Rate Swaps</i>	695	<i>Index</i>	741
<i>Hedging with Currency Swaps</i>	698		
<i>Credit Swaps</i>	699		
<i>Credit Risk Concerns with Swaps</i>	702		

Introduction

chapter

1

Learning Goals

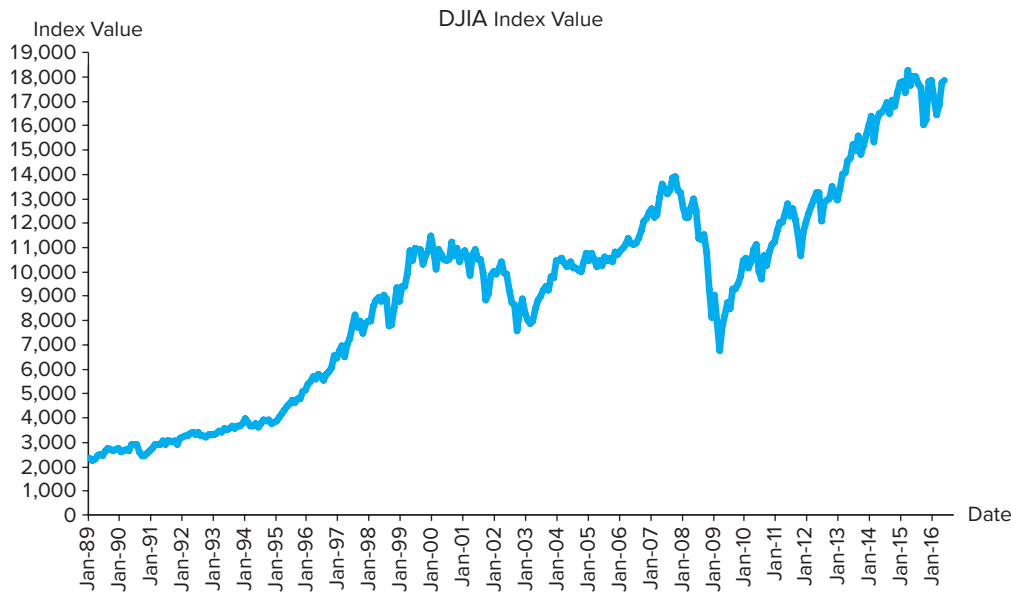
- LG 1-1** Differentiate between primary and secondary markets.
- LG 1-2** Differentiate between money and capital markets.
- LG 1-3** Understand what foreign exchange markets are.
- LG 1-4** Understand what derivative security markets are.
- LG 1-5** Distinguish between the different types of financial institutions.
- LG 1-6** Know the services financial institutions perform.
- LG 1-7** Know the risks financial institutions face.
- LG 1-8** Appreciate why financial institutions are regulated.
- LG 1-9** Recognize that financial markets are becoming increasingly global.

WHY STUDY FINANCIAL MARKETS AND INSTITUTIONS? CHAPTER OVERVIEW

In the 1990s, financial markets in the United States boomed. As seen in Figure 1–1, the Dow Jones Industrial Index—a widely quoted index of the values of 30 large corporations (see Chapter 8)—rose from a level of 2,800 in January 1990 to more than 11,000 by the end of the decade; this compares to a move from 100 at its inception in 1906 to 2,800 eighty-four years later. In the early 2000s, as a result of an economic downturn in the United States and elsewhere, this index fell back below 10,000. The index rose to over 14,000 in July 2007, but (because of an increasing mortgage market credit crunch, particularly the subprime mortgage market) fell back to below 13,000 within a month of hitting the all-time high. By 2008, problems in the subprime mortgage market escalated to a full-blown financial crisis and the worst recession in the United States since the Great Depression. The Dow Jones Industrial Average (DJIA) fell to 6,547 in March 2009 before recovering, along with the economy, to over 11,000 in April 2010. However, it took until March 5, 2013, for the DJIA to surpass its pre-crisis high of 14,164.53, closing at 14,253.77 for the day, and the DJIA rose to over 21,000 in mid-2017.

OUTLINE

- Why Study Financial Markets and Institutions? Chapter Overview
- Overview of Financial Markets
 - Primary Markets versus Secondary Markets
 - Money Markets versus Capital Markets
 - Foreign Exchange Markets
 - Derivative Security Markets
 - Financial Market Regulation
- Overview of Financial Institutions
 - Unique Economic Functions Performed by Financial Institutions
 - Additional Benefits Fls Provide to Suppliers of Funds
 - Economic Functions Fls Provide to the Financial System as a Whole
 - Risks Incurred by Financial Institutions
 - Regulation of Financial Institutions
 - Trends in the United States
- Globalization of Financial Markets and Institutions
- Appendix 1A: The Financial Crisis: The Failure of Financial Institutions' Specialness (available through Connect or your course instructor)

Figure 1–1 The Dow Jones Industrial Average, 1989–2016

During the financial crisis of 2008–2009, market swings seen in the United States quickly spread worldwide. Stock markets saw huge swings in value as investors tried to sort out who might survive and who would not (and markets from Russia to Europe were forced to suspend trading as stock prices plunged). As U.S. markets recovered in 2010–2013 and, as mentioned earlier, surpassed their pre-crisis highs, European stock markets struggled as Greece battled with a severe debt crisis that eventually spread to other European nations with fiscal problems, such as Portugal, Spain, and Italy. Even the growth in the robust Chinese economy slowed to 6.7 percent in 2016, the lowest level in seven years.

World markets were rocked again in June 2016 when the people of the United Kingdom voted to leave the European Union (EU) after 43 years (dubbed “Brexit”). The shock from the UK’s surprise vote to leave the EU swept across global markets, triggering steep drops in stock markets and the British pound and a flight into safe assets such as U.S. bonds and gold. The pound fell more than 11 percent to its lowest point since 1985. The DJIA dropped 610.32 points, or 3.4 percent. The Stoxx Europe 600 index fell 7 percent, its steepest drop since 2008, while Japan’s Nikkei Stock Average declined 7.9 percent. Bonds also sold off sharply, pushing UK government borrowing costs sharply higher, as traders and investors grappled with the market implications of Brexit. The UK had its credit rating outlook cut to “negative” by the ratings agency Moody’s.

The UK’s vote to leave the European Union shook the region, precipitating an immediate political crisis in Britain and shifting the path of a European project created to bind a continent torn by World War II. Prime Minister David Cameron, who had led the campaign to stay inside the 28-nation bloc, announced he would step down, setting off a leadership contest among Conservatives. Britain’s decision, one of the most momentous by a Western country in the past 50 years, reverses the course of expansion for the EU. It had grown over decades to include most of Europe, absorbing former dictatorships in Greece, Spain, and Portugal, and the countries of the east, formerly under Soviet domination. The UK would be the first member nation to leave, a step some leaders warned beforehand would diminish the global influence of the UK and the EU and risk setting in motion the European bloc’s eventual disintegration. The vote also raised questions about whether the UK itself would split. After a large majority of Scottish citizens voted to remain a part of the EU, Scotland’s First Minister said the Scottish National Party would seek to hold a new referendum on the country’s exit from the EU.

Originally the banking industry operated as a full-service industry, performing directly or indirectly all financial services (commercial banking, investment banking, stock investing, insurance provision, etc.). In the early 1930s, the economic and industrial collapse resulted in the separation of some of these activities. In the 1970s and 1980s new, relatively unregulated financial services industries sprang up (e.g., mutual funds, brokerage funds) that separated the financial service functions even further.

The last 30 years, however, have seen a reversal of these trends. In the 1990s and 2000s, regulatory barriers, technology, and financial innovation changes were such that a full set of financial services could again be offered by a single financial services firm under the umbrella of a financial services holding company. For example, J.P. Morgan Chase & Co. operates a commercial bank (J.P. Morgan Chase Bank), an investment bank (J. P. Morgan Securities, which also sells mutual funds), and an insurance company (J. P. Morgan Insurance Agency). Not only did the boundaries between traditional industry sectors change, but competition became global in nature as well. For example, J.P. Morgan Chase is the world's seventh-largest bank holding company, operating in 60 countries.

The financial crisis produced another reshaping of all financial institution (FI) sectors and the end of many major FIs (e.g., Bear Stearns and Lehman Brothers), with the two most prominent investment banks in the world, Goldman Sachs and Morgan Stanley, converting to bank holding company status. Indeed, as of 2010, all the major U.S. investment banks had either failed, been acquired by a commercial bank, or become bank holding companies. Further, legislation enacted as a result of the financial crisis represents an attempt to again separate FI activities. For example, the "Volcker Rule" provision of the Wall Street Reform and Consumer Protection Act prohibits bank holding companies from engaging in proprietary trading and limits their investments in hedge funds, private equity, and related vehicles. Despite these most recent changes, many FIs operate in more than one FI sector.

As economic and competitive environments change, attention to profit and, more than ever, risk becomes increasingly important. This book provides a detailed overview and analysis of the financial system in which financial managers and individual investors operate. Making investment and financing decisions requires managers and individuals to understand the flow of funds throughout the economy as well as the operation and structure of domestic and international financial markets. In particular, this book offers a unique analysis of the risks faced by investors and savers, as well as strategies that can be adopted for controlling and managing these risks. Newer areas of operations such as asset securitization, derivative securities, and internationalization of financial services also receive special emphasis. Further, as the United States and the world continue to recover from the collapse of the financial markets, this book highlights and discusses the impact of this crisis on the various financial markets and the financial institutions that operate in them.

This introductory chapter provides an overview of the structure and operations of various financial markets and financial institutions. Financial markets are differentiated by the characteristics (such as maturity) of the financial instruments or securities that are exchanged. Moreover, each financial market, in turn, depends in part or in whole on financial institutions. Indeed, FIs play a special role in the functioning of financial markets. In particular, FIs often provide the least costly and most efficient way to channel funds to and from financial markets. As part of this discussion, we briefly examine how changes in the way FIs deliver services played a major part in the events leading up to the severe financial crisis of the late 2000s. A more detailed discussion of the causes of, the major events during, and the regulatory and industry changes resulting from the financial crisis is provided in Appendix 1A to the chapter (available through Connect or your course instructor).

OVERVIEW OF FINANCIAL MARKETS

financial markets

The arenas through which funds flow.

Financial markets are structures through which funds flow. Table 1–1 summarizes the financial markets discussed in this section. Financial markets can be distinguished along two major dimensions: (1) primary versus secondary markets and (2) money versus capital markets. The next sections discuss each of these dimensions.

TABLE 1–1 Types of Financial Markets

Primary markets —markets in which corporations raise funds through new issues of securities.
Secondary markets —markets that trade financial instruments once they are issued.
Money markets —markets that trade debt securities or instruments with maturities of less than one year.
Capital markets —markets that trade debt and equity instruments with maturities of more than one year.
Foreign exchange markets —markets in which cash flows from the sale of products or assets denominated in a foreign currency are transacted.
Derivative markets —markets in which derivative securities trade.

LG 1-1**Primary Markets versus Secondary Markets****primary markets**

Markets in which corporations raise funds through new issues of securities.

Primary Markets. **Primary markets** are markets in which users of funds (e.g., corporations) raise funds through new issues of financial instruments, such as stocks and bonds. Table 1–2 lists data on primary market sales of securities from 2000 through 2016. Note the impact the financial crisis had on primary market sales by firms. New issues fell to \$1,068.0 billion in 2008, during the worst of the crisis, from \$2,389.1 billion in 2007, pre-crisis. As of 2015, primary market sales had still not recovered as only \$1,843.2 billion new securities were issued for the year.

Fund users have new projects or expanded production needs, but do not have sufficient internally generated funds (such as retained earnings) to support these needs. Thus, the fund users issue securities in the external primary markets to raise additional funds. New issues of financial instruments are sold to the initial suppliers of funds (e.g., households) in exchange for funds (money) that the issuer or user of funds needs.¹ Most primary market transactions in the United States are arranged through financial institutions called investment banks—for example, Morgan Stanley or Bank of America Merrill Lynch—that serve as intermediaries between the issuing corporations (fund users) and investors (fund suppliers). For these public offerings, the investment bank provides the securities issuer (the funds user) with advice on the securities issue (such as the offer price and number of securities to issue) and attracts the initial public purchasers of the securities for the funds user. By issuing primary market securities with the help of an investment bank, the funds user saves the risk and cost of creating a market for its securities on its own (see the following discussion). Figure 1–2 illustrates a time line for the primary market exchange of funds for a new issue of corporate bonds or equity. We discuss this process in detail in Chapters 6 and 8.

initial public offering (IPO)

The first public issue of a financial instrument by a firm.

Primary market financial instruments include issues of equity by firms initially going public (e.g., allowing their equity—shares—to be publicly traded on stock markets for the first time). These first-time issues are usually referred to as **initial public offerings (IPOs)**. For example, on June 16, 2015, Fitbit announced a \$732 million IPO of its common stock.

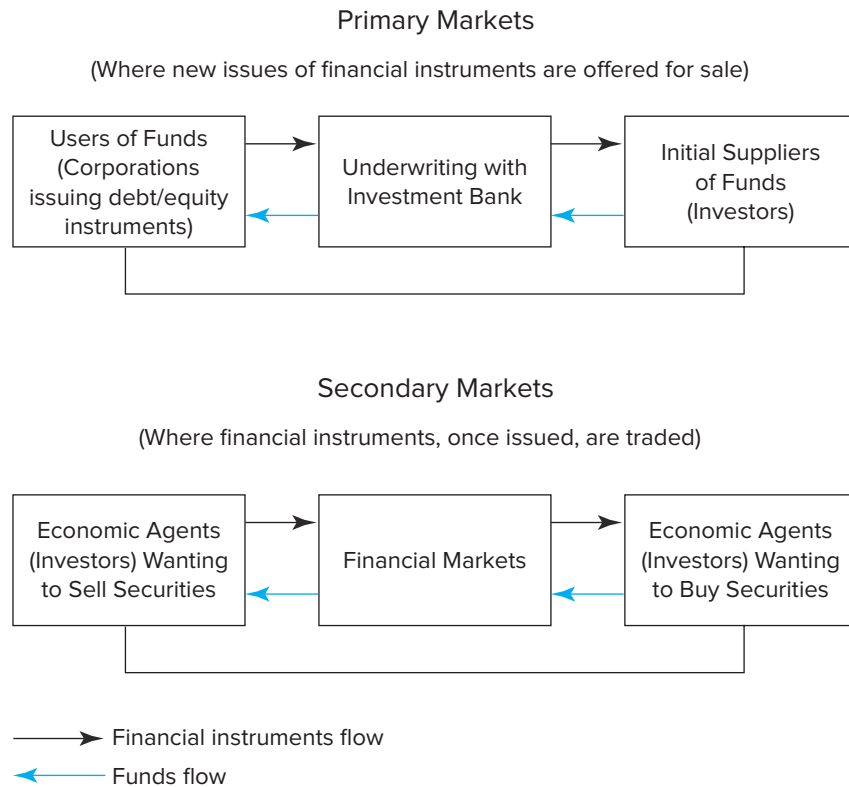
TABLE 1–2 Primary Market Sales of Securities (in billions of dollars)

Security Type	2000	2005	2007	2008	2010	2012	2015	2016*
All issues	\$1,256.7	\$2,439.0	\$2,389.1	\$1,068.0	\$1,024.7	\$1,401.0	\$1,843.2	\$318.9
Bonds	944.8	2,323.7	2,220.3	861.2	893.7	1,242.5	1,611.3	285.3
Stocks	311.9	115.3	168.8	206.8	131.0	129.5	174.0	33.2
Private placements	196.5	24.6	20.1	16.2	22.2	21.4	28.8	n.a. [†]
IPOs	97.0	36.7	46.3	26.4	37.0	40.9	29.1	0.4

*Through first quarter.

[†]n.a. = not applicable.

1. We discuss the users and suppliers of funds in more detail in Chapter 2.

Figure 1–2 Primary and Secondary Market Transfer of Funds Time Line

The company's stock was underwritten by several investment banks, including Morgan Stanley, Deutsche Bank, and Bank of America Merrill Lynch. Primary market securities also include the issue of additional equity or debt instruments of an already publicly traded firm. For example, on January 28, 2016, Molson Coors Brewing Company announced the sale of an additional 29.88 million shares of common stock underwritten by investment banks such as UBS, Bank of America Merrill Lynch, and Citigroup.

secondary market

A market that trades financial instruments once they are issued.

Secondary Markets. Once financial instruments such as stocks are issued in primary markets, they are then traded—that is, rebought and resold—in **secondary markets**. For example, on April 12, 2016, 9.7 million shares of ExxonMobil were traded in the secondary stock market. Buyers of secondary market securities are economic agents (consumers, businesses, and governments) with excess funds. Sellers of secondary market financial instruments are economic agents in need of funds. Secondary markets provide a centralized marketplace where economic agents know they can transact quickly and efficiently.

These markets therefore save economic agents the search and other costs of seeking buyers or sellers on their own. Figure 1–2 illustrates a secondary market transfer of funds. When an economic agent buys a financial instrument in a secondary market, funds are exchanged, usually with the help of a securities broker such as Charles Schwab acting as an intermediary between the buyer and the seller of the instrument (see Chapter 8). The original issuer of the instrument (user of funds) is not involved in this transfer. The New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotation (NASDAQ) system are two well-known examples of secondary markets for trading stocks. We discuss the details of each of these markets in Chapter 8.

derivative security

A financial security whose payoffs are linked to other, previously issued securities or indices.

In addition to stocks and bonds, secondary markets also exist for financial instruments backed by mortgages and other assets (see Chapter 7), foreign exchange (see Chapter 9), and futures and options (i.e., **derivative securities**—financial securities whose payoffs

are linked to other, previously issued [or underlying] primary securities or indexes of primary securities) (see Chapter 10). As we will see in Chapter 10, derivative securities have existed for centuries, but the growth in derivative securities markets occurred mainly in the 1980s through 2000s. As major markets, therefore, derivative securities markets are among the newest of the financial security markets.

Secondary markets offer benefits to both investors (suppliers of funds) and issuing corporations (users of funds). For investors, secondary markets provide the opportunity to trade securities at their market values quickly as well as to purchase securities with varying risk-return characteristics (see Chapter 2). Corporate security issuers are not directly involved in the transfer of funds or instruments in the secondary market. However, the issuer does obtain information about the current market value of its financial instruments, and thus the value of the corporation as perceived by investors such as its stockholders, through tracking the prices at which its financial instruments are being traded on secondary markets. This price information allows issuers to evaluate how well they are using the funds generated from the financial instruments they have already issued and provides information on how well any subsequent offerings of debt or equity might do in terms of raising additional money (and at what cost).

Secondary markets offer buyers and sellers **liquidity**—the ability to turn an asset into cash quickly at its fair market value—as well as information about the prices or the value of their investments. Increased liquidity makes it more desirable and easier for the issuing firm to sell a security initially in the primary market. Further, the existence of centralized markets for buying and selling financial instruments allows investors to trade these instruments at low transaction costs.

liquidity

The ease with which an asset can be converted into cash quickly and at fair market value.

LG 1-2

money markets

Markets that trade debt securities or instruments with maturities of one year or less.

over-the-counter (OTC) markets

Markets that do not operate in a specific fixed location—rather, transactions occur via telephones, wire transfers, and computer trading.

Money Markets versus Capital Markets

Money Markets. Money markets are markets that trade debt securities or instruments with maturities of one year or less (see Figure 1–3). In the money markets, economic agents with short-term excess supplies of funds can lend funds (i.e., buy money market instruments) to economic agents who have short-term needs or shortages of funds (i.e., they sell money market instruments). The short-term nature of these instruments means that fluctuations in their prices in the secondary markets in which they trade are usually quite small (see Chapters 3 and 22 on interest rate risk). In the United States, money markets do not operate in a specific location—rather, transactions occur via telephones, wire transfers, and computer trading. Thus, most U.S. money markets are said to be **over-the-counter (OTC) markets**.

Money Market Instruments. A variety of money market securities are issued by corporations and government units to obtain short-term funds. These securities include Treasury bills, federal funds, repurchase agreements, commercial paper, negotiable certificates of deposit, and banker's acceptances. Table 1–3 lists and defines the major money market securities. Figure 1–4 shows outstanding amounts of money market instruments in the United States in 1990, 2000, 2010, and 2016. Notice that in 2016 federal funds and repurchase agreements, followed by negotiable CDs, Treasury bills, and commercial paper, had the largest amounts outstanding. Money market instruments and the operation of the money markets are described and discussed in detail in Chapter 5.

Figure 1–3 Money versus Capital Market Maturities

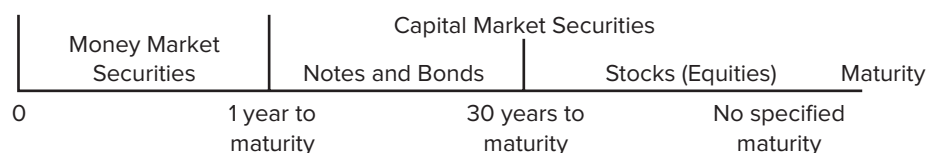
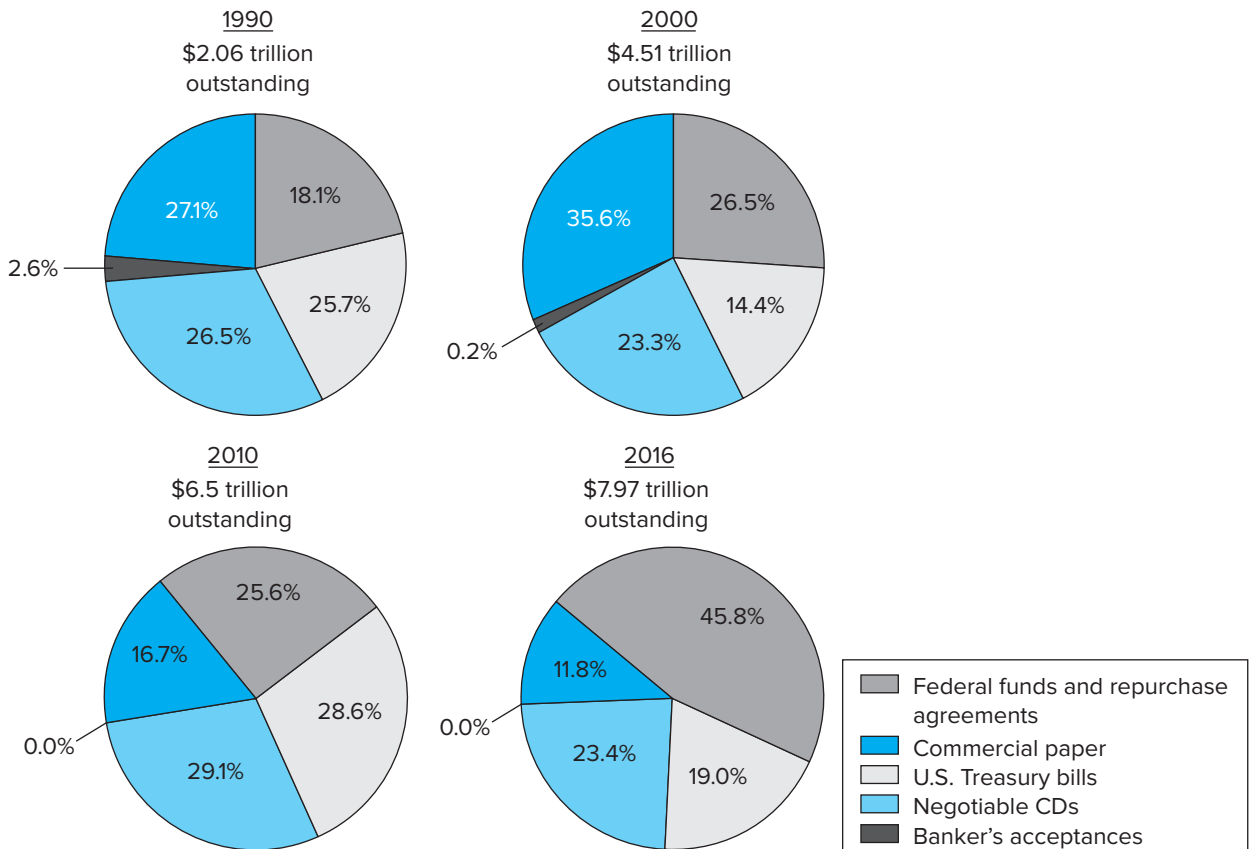


TABLE 1-3 Money and Capital Market Instruments

MONEY MARKET INSTRUMENTS	
Treasury bills	—short-term obligations issued by the U.S. government.
Federal funds	—short-term funds transferred between financial institutions usually for no more than one day.
Repurchase agreements	—agreements involving the sale of securities by one party to another with a promise by the seller to repurchase the same securities from the buyer at a specified date and price.
Commercial paper	—short-term unsecured promissory notes issued by a company to raise short-term cash.
Negotiable certificates of deposit	—bank-issued time deposits that specify an interest rate and maturity date and are negotiable (i.e., can be sold by the holder to another party).
Banker’s acceptances	—time drafts payable to a seller of goods, with payment guaranteed by a bank.
CAPITAL MARKET INSTRUMENTS	
Corporate stock	—the fundamental ownership claim in a public corporation.
Mortgages	—loans to individuals or businesses to purchase a home, land, or other real property.
Corporate bonds	—long-term bonds issued by corporations.
Treasury bonds	—long-term bonds issued by the U.S. government.
State and local government bonds	—long-term bonds issued by state and local governments.
U.S. government agency bonds	—long-term bonds collateralized by a pool of assets and issued by agencies of the U.S. government.
Bank and consumer loans	—loans to commercial banks and individuals.

Figure 1-4 Money Market Instruments Outstanding



Sources: Federal Reserve Board, “Financial Accounts of the United States,” *Statistical Releases*, Washington, DC, various issues. www.federalreserve.gov

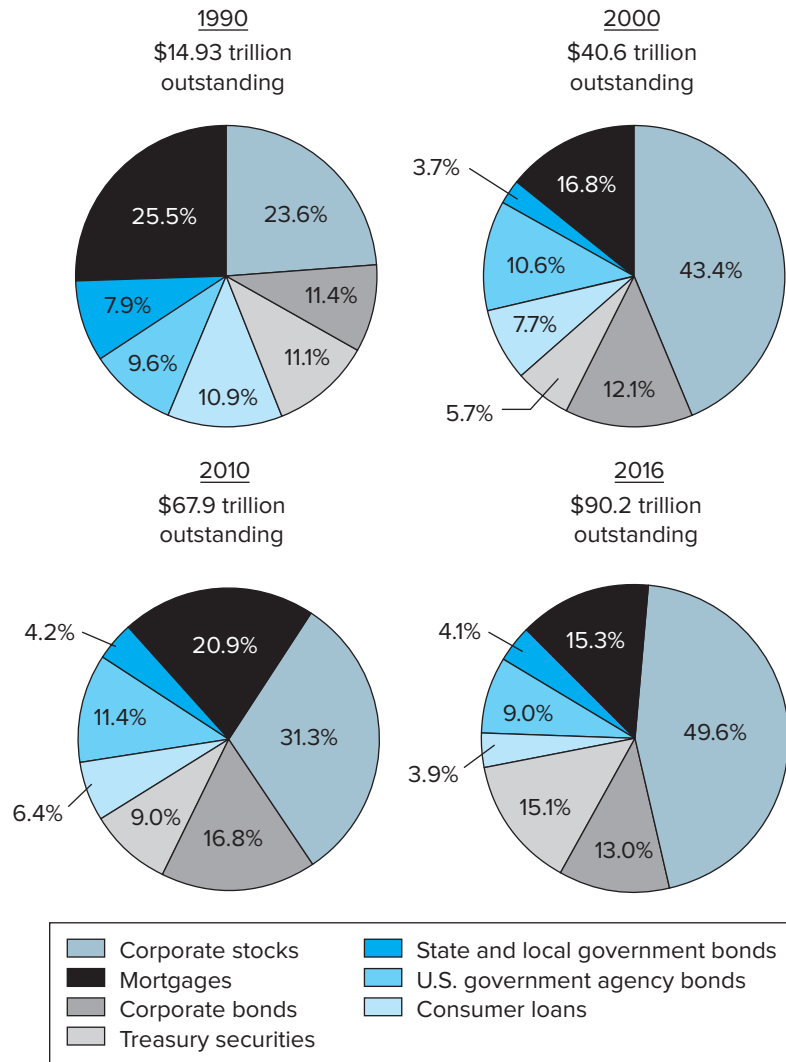
capital markets

Markets that trade debt (bonds) and equity (stocks) instruments with maturities of more than one year.

Capital Markets. Capital markets are markets that trade equity (stocks) and debt (bonds) instruments with maturities of more than one year (see Figure 1–3). The major suppliers of capital market securities (or users of funds) are corporations and governments. Households are the major suppliers of funds for these securities. Given their longer maturity, these instruments experience wider price fluctuations in the secondary markets in which they trade than do money market instruments. For example, all else constant, long-term maturity debt instruments experience wider price fluctuations for a given change in interest rates than short-term maturity debt instruments (see Chapter 3).

Capital Market Instruments. Table 1–3 lists and defines the major capital market securities. Figure 1–5 shows their outstanding amounts by dollar market value. Notice that in 2000, 2010, and 2016, corporate stocks or equities represent the largest capital market instrument, followed by mortgages and corporate bonds. The relative size of the market value of capital market instruments outstanding depends on two factors: the number of

Figure 1–5 Capital Market Instruments Outstanding



Sources: Federal Reserve Board, "Financial Accounts of the United States," *Statistical Releases*, Washington, DC, various issues. www.federalreserve.gov

securities issued and their market prices.² One reason for the sharp increase in the value of equities outstanding is the bull market in stock prices in the 1990s. Stock values fell in the early 2000s as the U.S. economy experienced a downturn—partly because of 9/11 and partly because interest rates began to rise—and stock prices fell. Stock prices in most sectors subsequently recovered and, by 2007, even surpassed their 1999 levels. Stock prices fell precipitously during the financial crisis of 2008–2009. As of mid-March 2009, the Dow Jones Industrial Average (DJIA) had fallen 53.8 percent in value in less than 1½ years, larger than the decline during the market crash of 1929 when it fell 49 percent. However, stock prices recovered, along with the economy, in the last half of 2009, rising 71.1 percent between March 2009 and April 2010. Capital market instruments and their operations are discussed in detail in Chapters 6, 7, and 8.

LG 1-3

Foreign Exchange Markets



In addition to understanding the operations of domestic financial markets, a financial manager must also understand the operations of foreign exchange markets and foreign capital markets. Today's U.S.-based companies operate globally. It is therefore essential that financial managers understand how events and movements in financial markets in other countries affect the profitability and performance of their own companies. For example, in 2015 a strengthening dollar reduced profits for internationally active firms. IBM experienced a drop in its 2015 earnings per share of \$1.10 due to foreign exchange trends. Coca-Cola, which gets the majority of its sales from outside the United States, saw 2015 revenues decrease by 5.1 percent as the U.S. dollar strengthened relative to foreign currencies.

Cash flows from the sale of securities (or other assets) denominated in a foreign currency expose U.S. corporations and investors to risk regarding the value at which foreign currency cash flows can be converted into U.S. dollars. For example, the actual amount of U.S. dollars received on a foreign investment depends on the exchange rate between the U.S. dollar and the foreign currency when the nondollar cash flow is converted into U.S. dollars. If a foreign currency depreciates (declines in value) relative to the U.S. dollar over the investment period (i.e., the period between the time a foreign investment is made and the time it is terminated), the dollar value of cash flows received will fall. If the foreign currency appreciates, or rises in value, relative to the U.S. dollar, the dollar value of cash flows received on the foreign investment will increase.

While foreign currency exchange rates are often flexible—they vary day to day with demand for and supply of a foreign currency for dollars—central governments sometimes intervene in foreign exchange markets directly or affect foreign exchange rates indirectly by altering interest rates. We discuss the motivation and effects of these interventions in Chapters 4 and 9. The sensitivity of the value of cash flows on foreign investments to changes in the foreign currency's price in terms of dollars is referred to as *foreign exchange risk* and is discussed in more detail in Chapter 9. Techniques for managing, or “hedging,” foreign exchange risk, such as using derivative securities like foreign exchange (FX) futures, options, and swaps, are discussed in Chapter 23.

DO YOU UNDERSTAND:

1. *The difference between primary and secondary markets?*
2. *The major distinction between money markets and capital markets?*
3. *What the major instruments traded in the capital markets are?*
4. *What happens to the dollar value of a U.S. investor's holding of British pounds if the pound appreciates (rises) in value against the dollar?*
5. *What derivative security markets are?*

LG 1-4

Derivative Security Markets

derivative security markets

The markets in which derivative securities trade.

Derivative security markets are markets in which derivative securities trade. A **derivative security** is a financial security (such as a futures contract, option contract, swap contract, or mortgage-backed security) whose payoff is linked to another, previously issued security such as a security traded in capital or foreign exchange markets. Derivative securities generally involve an agreement between two parties to exchange a standard quantity of an asset or cash flow at a predetermined price and at a specified date in the future. As the

2. For example, the market value of equity is the product of the price of the equity times the number of shares that are issued.