Contents in Brief

Contents in Detail
Preface xxviii
How To Use This Book xxx

1 Overview of the Financial Services Industry 1

○ Part I – Domestic Money Markets 19
  2 Money 21
  3 Money Markets 43

○ Part II – Domestic Capital Markets 75
  4 Capital Market Instruments 77
  5 Capital Markets and International Diversification 103
  6 Investment Banking 123
  7 Derivative Securities 137

○ Part III – International Financial Markets 159
  8 Foreign Exchange Markets 161
  9 Euromarkets and the European Union 182

○ Part IV – The Interest Rate Environment 197
  10 Interest Rate Fundamentals 199
  11 Interest and Exchange Rate Patterns 216

○ Part V – The Formation of US Bank Regulation 235
  13 US Monetary Policy, Deregulation, and Deposit Insurance 251
  14 Central Banks and Regulatory Systems Outside the US 267
Part VI – Management of Financial Institutions
15 Profitability, Liquidity, and Liability Management 281
16 Investment and Loan Portfolio Management 283
17 Capital and Asset/Liability Management 308
18 Bank Valuation 324
19 Regional Trade Agreements and Financial Services 349

Part VII – Bank Operations
20 Commercial and Noncommercial Banks 389
21 The Domestic Operations of Commercial Banks 391
22 The International Operations of Commercial Banks 421
23 The Impact of Technological Change 432
24 Commercial Banks and the Securities Markets 447
25 Nationwide Banking and the Riegle–Neal Act 467

Part VIII – Nonbank Financial Institutions
26 Savings and Loan Associations and Mutual Savings Banks 491
27 Credit Unions 493
28 Investment Companies 514
29 Pension Funds 528
30 Insurance Companies 546
31 Finance Companies 567

Appendix A 581
Index 595

604
## Contents in Detail

Preface
How To Use This Book

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Overview of the Financial Services Industry</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Chapter Overview</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Key Terms</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Chapter Outline</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>Introduction</td>
<td>2</td>
</tr>
<tr>
<td>1</td>
<td>The Role of Financial Institutions</td>
<td>2</td>
</tr>
<tr>
<td>2</td>
<td>Example of a Financial Transaction</td>
<td>3</td>
</tr>
<tr>
<td>2.1</td>
<td>Savings Units</td>
<td>3</td>
</tr>
<tr>
<td>2.2</td>
<td>Direct Financing</td>
<td>3</td>
</tr>
<tr>
<td>3</td>
<td>Financial Intermediation</td>
<td>4</td>
</tr>
<tr>
<td>3.1</td>
<td>An Expanded Example</td>
<td>4</td>
</tr>
<tr>
<td>3.2</td>
<td>Forms of Financial Intermediation</td>
<td>4</td>
</tr>
<tr>
<td>3.3</td>
<td>Other Financial Intermediaries – Briefly</td>
<td>6</td>
</tr>
<tr>
<td>3.3.1</td>
<td>Depository Institutions</td>
<td>6</td>
</tr>
<tr>
<td>3.3.2</td>
<td>Non-depository Financial Institutions</td>
<td>7</td>
</tr>
<tr>
<td>4</td>
<td>An Analysis of Financial Intermediation</td>
<td>7</td>
</tr>
<tr>
<td>4.1</td>
<td>The Balance Sheet</td>
<td>7</td>
</tr>
<tr>
<td>4.2</td>
<td>Income and Expense</td>
<td>8</td>
</tr>
<tr>
<td>5</td>
<td>Direct Financing</td>
<td>9</td>
</tr>
<tr>
<td>6</td>
<td>The Changing Face of Financial Intermediation</td>
<td>11</td>
</tr>
<tr>
<td>6.1</td>
<td>Changing Market Niches</td>
<td>11</td>
</tr>
<tr>
<td>6.2</td>
<td>Changing Banking Industry Structure</td>
<td>14</td>
</tr>
<tr>
<td>6.3</td>
<td>A More Global Industry</td>
<td>15</td>
</tr>
</tbody>
</table>
Contents in Detail

Summary 16
End-of-chapter Questions 17
Selected References 18

Part I – Domestic Money Markets 19

2 Money 21
   Chapter Overview 21
   Key Terms 21
   Chapter Outline 21
   Introduction 22
   1 The Functions of Money 22
   2 Monetary Systems 24
      2.1 Barter System 24
      2.2 Full-bodied Money 25
      2.3 Paper Money 26
      2.4 Deposit Money 26
      2.5 Electronic Money 26
   3 Monetary Standards 27
   4 The Adoption of Monetary Standards 28
      4.1 Bretton Woods, 1944 28
      4.2 The Smithsonian Agreement, 1971 29
      4.3 The Snake in the Tunnel 29
      4.4 Floating Exchange Rates, 1973 30
   5 Expansion of the Money Supply by Banks 33
      5.1 Bank Reserves 34
      5.2 Money Supply Expansion 34
      5.3 Defining the Money Supply 36
   Summary 39
   End-of-chapter Questions 39
   End-of-chapter Problems 40
   Notes 41
   Selected References 41

3 Money Markets 43
   Chapter Overview 43
   Key Terms 43
   Chapter Outline 43
   Introduction 44
   1 What is a Money Market? 45
   2 Money Market Participants 46
      2.1 The United States 46
      2.2 The United Kingdom and Japan 47
Contents in Detail

Chapter Outline
Introduction

1 The Nature of Derivative Securities 138
2 Futures Contracts 139
3 Options Contracts
   3.1 Intrinsic Value of Options 142
   3.2 Options Exchanges and Underlying Assets of Traded Options 143
   3.3 Risk and Return 145
4 Swap Contracts 149
Summary 151
End-of-chapter Questions 151
Selected References 152
Appendix 7.1 Black–Scholes Option Pricing Model 154
Appendix 7.2 Black Futures Option Pricing Model 158

Part III – International Financial Markets 159

8 Foreign Exchange Markets 161
   Chapter Overview 161
   Key Terms 161
   Chapter Outline 161
   Introduction 162
1 Foreign Currency Exchange 162
   1.1 Exchange Rate Risk Example 162
   1.2 Foreign Exchange Hedging and Speculating 163
   1.3 Spot Market Exchange 164
   1.4 Forward Exchange
      1.4.1 Forward Rate Determination 166
      1.4.2 Other Forward Contracts 168
   1.5 Currency Swaps 171
   1.6 Foreign Exchange Futures 171
   1.7 Foreign Exchange Options 173
2 The Operation of Foreign Exchange Markets 174
   2.1 Spot and Forward Markets 174
   2.2 Swap Market 174
   2.3 Futures Market 174
   2.4 Options Market 176
Summary 179
End-of-chapter Questions 179
End-of-chapter Problems 180
Notes 181
Selected References 181
Contents in Detail

9 Euromarkets and the European Union
   Chapter Overview 182
   Key Terms 182
   Chapter Outline 182
   Introduction 183
   1 Euromarkets 183
      1.1 Eurodollars 184
         1.1.1 Development of the Eurodollar Market 184
         1.1.2 Euromarket Locations 184
      1.2 Eurobonds and Foreign Bonds 185
      1.3 Eurocommercial Paper and Euronotes 186
      1.4 Euroequities 187
   2 The European Union 188
      2.1 Development of the Single European Market 188
      2.2 Banking Directives and the Single Passport 189
      2.3 Economic and Monetary Union 190
         2.3.1 The European Monetary System and the ECU 190
         2.3.2 The Maastricht Treaty 192
   Summary 193
   End-of-chapter Questions 194
   Selected References 194

Part IV – The Interest Rate Environment 197

10 Interest Rate Fundamentals 199
   Chapter Overview 199
   Key Terms 199
   Chapter Outline 199
   Introduction 200
   1 Interest Rate Theory 200
      1.1 The Yield Curve 201
      1.2 Interest Rates and Bond Prices 202
      1.3 Theories Explaining the Term Structure of Interest Rates 204
         1.3.1 Unbiased Expectations Theory 204
         1.3.2 Liquidity Preference Theory 207
         1.3.3 Market Segmentation Theory 207
   2 Interest Rates and Inflation 208
      2.1 Price Indexes 208
         2.1.1 Types of Price Indexes 208
         2.1.2 International Comparisons 208
      2.2 The Fisher Effect 210
      2.3 Nominal and Real Rates of Return in Selected Countries 210
Contents in Detail

Summary 213
End-of-chapter Questions 214
End-of-chapter Problems 214
Notes 215
Selected References 215

11 Interest and Exchange Rate Patterns 216
Chapter Overview 216
Key Terms 216
Chapter Outline 216
Introduction 217
1 Default Risk 217
  1.1 Bond Ratings 217
  1.2 Default Risk Premiums 219
2 Factors Influencing Currency Exchange Rates 221
  2.1 Purchasing Power Parity 222
  2.2 Other Factors 222
3 Recent Patterns of Currency Exchange Rates 224
  3.1 Exchange Rates during the 1980s and 1990s – Selected Currencies 224
  3.2 The Case of Latin America 228
    3.2.1 External Debt and Inflation 228
    3.2.2 Argentina 230
    3.2.3 Brazil 230
    3.2.4 Mexico 231
Summary 232
End-of-chapter Questions 232
Note 233
Selected References 233

Part V – The Formation of US Bank Regulation 235

Chapter Overview 237
Key Terms 237
Chapter Outline 237
Introduction 238
1 Early Bank Regulation 238
  1.1 The National Bank Act of 1863 239
  1.2 The Federal Reserve Act 240
2 Characteristics of Modern Central Banking 241
  2.1 Government Relations 241
  2.2 Commercial Banking Responsibilities 242
  2.3 Orderly Financial Markets 242
13 US Monetary Policy, Deregulation, and Deposit Insurance

Chapter Overview 251
Key Terms 251
Chapter Outline 251
Introduction 252
1 Fiscal Policy 252
2 Monetary Policy 253
   2.1 The Tools of Monetary Policy 253
      2.1.1 Reserve Requirements 253
      2.1.2 The Discount Rate 254
      2.1.3 Open-market Operations 254
   2.2 The Mechanics of Open-market Operations 254
      2.2.1 The Federal Reserve Balance Sheet 254
      2.2.2 Reserves and the Money Supply 256
3 Deregulation 257
   3.1 Disintermediation 257
   3.2 The Depository Institutions Deregulation and Monetary Control Act of 1980 258
   3.3 The Garn–St. Germain Depository Institutions Act of 1982 260
4 Deposit Insurance 261
   4.1 Too Big to Fail 261
   4.2 The Crisis and FIRREA 261
   4.3 After FIRREA 262
   4.4 FDIC Improvement Act of 1991 262
   4.5 Restoration of the Insurance Funds 264
Summary 264
End-of-chapter Questions 265
Notes 265
Selected References 266
### 14 Central Banks and Regulatory Systems Outside the US

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter Overview</td>
<td>267</td>
</tr>
<tr>
<td>Key Terms</td>
<td>267</td>
</tr>
<tr>
<td>Chapter Outline</td>
<td>267</td>
</tr>
<tr>
<td>Introduction</td>
<td>268</td>
</tr>
<tr>
<td>1 Regulatory Trends</td>
<td></td>
</tr>
<tr>
<td>1.1 Regulatory Systems</td>
<td>268</td>
</tr>
<tr>
<td>1.2 International Coordination</td>
<td>269</td>
</tr>
<tr>
<td>2 Selected Regulatory Systems</td>
<td></td>
</tr>
<tr>
<td>2.1 Japan</td>
<td>271</td>
</tr>
<tr>
<td>2.2 Germany</td>
<td>271</td>
</tr>
<tr>
<td>2.3 Canada</td>
<td>273</td>
</tr>
<tr>
<td>2.4 The Netherlands</td>
<td>273</td>
</tr>
<tr>
<td>2.5 Malaysia</td>
<td>274</td>
</tr>
<tr>
<td>2.6 Taiwan</td>
<td>274</td>
</tr>
<tr>
<td>2.7 Korea</td>
<td>275</td>
</tr>
<tr>
<td>2.8 Brazil</td>
<td>275</td>
</tr>
<tr>
<td>2.9 Mexico</td>
<td>276</td>
</tr>
<tr>
<td>Summary</td>
<td>277</td>
</tr>
<tr>
<td>End-of-chapter Questions</td>
<td>278</td>
</tr>
<tr>
<td>Selected References</td>
<td>279</td>
</tr>
</tbody>
</table>

### Part VI – Management of Financial Institutions

### 15 Profitability, Liquidity, and Liability Management

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter Overview</td>
<td>283</td>
</tr>
<tr>
<td>Key Terms</td>
<td>283</td>
</tr>
<tr>
<td>Chapter Outline</td>
<td>283</td>
</tr>
<tr>
<td>Introduction</td>
<td>284</td>
</tr>
<tr>
<td>1 Bank Profitability</td>
<td></td>
</tr>
<tr>
<td>1.1 Bank Assets</td>
<td>284</td>
</tr>
<tr>
<td>1.2 Bank Industry Assets</td>
<td>285</td>
</tr>
<tr>
<td>1.3 Bank Liabilities and Capital</td>
<td>287</td>
</tr>
<tr>
<td>1.4 Banking Industry Liabilities</td>
<td>287</td>
</tr>
<tr>
<td>1.5 Income and Expense</td>
<td>289</td>
</tr>
<tr>
<td>1.5.1 First National</td>
<td>289</td>
</tr>
<tr>
<td>1.5.2 Banking Industry</td>
<td>291</td>
</tr>
<tr>
<td>1.6 Rates Earned and Paid</td>
<td></td>
</tr>
<tr>
<td>1.6.1 First National</td>
<td>292</td>
</tr>
<tr>
<td>1.6.2 Banking Industry Rates</td>
<td>297</td>
</tr>
</tbody>
</table>
Contents in Detail

1 Bank Capital
   1.1 Equity and Nonequity Capital
   1.2 The Need for Bank Capital
   1.3 Regulation of Bank Capital
      1.3.1 United States
      1.3.2 International Coordination
   1.4 Capital Ratios in the United States
   1.5 Capital Management Outside the United States
   1.6 Income Effects

2 Interest Rate Risk and Bank Capital Changes
   2.1 Interest Rate Changes and Net Worth
   2.2 Duration
   2.3 Duration and Net Worth

3 Hedging Financial Portfolios
   3.1 Interest Rate Futures
   3.2 Options on Futures Contracts
   3.3 Interest Rate Swaps

Summary
End-of-chapter Questions
End-of-chapter Problems
Notes
Selected References
Appendix 17.1 Market Value Accounting

18 Bank Valuation
   Chapter Overview
   Key Terms
   Chapter Outline
   Introduction
   1 The Debate over Market Value vs. Book Value
   2 Market Valuation Models for the Balance Sheet
      2.1 Cash
      2.2 Temporary Investments
         2.2.1 Interest-bearing Deposits in Other Banks
         2.2.2 Federal Funds Sold
         2.2.3 Term Federal Funds Sold
         2.2.4 Securities Purchased under Agreement to Resell
      2.3 Investment Securities
         2.3.1 Treasury Bills
         2.3.2 Treasury Notes and Bonds
         2.3.3 Municipal Bonds
2.4 Loans
  2.4.1 Commercial Loans
    Bullet Loans
    Working Capital Lines of Credit
    Term Loans
  2.4.2 Mortgage Loans
    Fixed-rate Mortgages
    Adjustable Rate Mortgages
    Balloon Mortgages
  2.4.3 Consumer Installment Loans
  2.4.4 Lease Financing
2.5 Other Assets
2.6 Liabilities
  2.6.1 Transactions and Savings Accounts
  2.6.2 Time Deposits
  2.6.3 Short-term Borrowings
  2.6.4 Long-term Borrowings
Summary
End-of-chapter Questions
Notes
Selected References
Appendix 18.1 Summary of Valuation Concepts

19 Regional Trade Agreements and Financial Services
  Chapter Overview
  Key Terms
  Chapter Outline
  Introduction
  1 GATT: The Fundation of Regional Trade
    1.1 The Motivation for GATT
    1.2 The Basic Principles of GATT
    1.3 The Final Act of the Uruguay Round
  2 The World Trade Organization
    2.1 Objectives and Functions
    2.2 Regional Trade Agreements under the WTO
  3 NAFTA
    3.1 NAFTA Provisions for Financial Services
    3.2 The Mexican Banking System before NAFTA
    3.3 NAFTA and the Mexican Banking System
  4 Regional Integration in Latin America
    4.1 The Stages of Regional Integration
Part VII – Bank Operations

20 Commercial and Noncommercial Banks

Chapter Overview
Key Terms
Chapter Outline
Introduction

1 Commercial Banks
   1.1 United States
   1.2 The United Kingdom
   1.3 Canada
   1.4 Germany
   1.5 France
   1.6 Switzerland
   1.7 Japan
   1.8 A Cross-country Comparison
      1.8.1 Total Assets
      1.8.2 Average Size
      1.8.3 Population Per Bank

2 Noncommercial Banks
   2.1 Bank for International Settlements
      2.1.1 Origin and Objectives
      2.1.2 Structure and Membership
      2.1.3 Operations
   2.2 International Monetary Fund
      2.2.1 Objectives
      2.2.2 Structure and Quotas
      2.2.3 Special Drawing Rights
      2.2.4 Balance Sheet
   2.3 The World Bank Group
      2.3.1 International Bank for Reconstruction and Development
      2.3.2 International Development Association
      2.3.3 International Finance Corporation
      2.3.4 Multilateral Investment Guarantee Agency
3 International Lending
   3.1 Syndicated Loans 441
   3.2 Note Issuance Facilities 442
   3.3 Risk in International Lending 442
Summary 443
End-of-chapter Questions 444
Selected References 445

23 The Impact of Technological Change 447
Chapter Overview 447
Key Terms 447
Chapter Outline 447
Introduction 448
1 Payments Mechanisms 449
   1.1 Check Clearing 449
      1.1.1 The Check Clearing Process 449
      1.1.2 Private Check Clearing Services 451
      1.1.3 Canada, Europe, and Japan 451
      1.1.4 Electronic Check Presentment 452
      1.1.5 Check Truncation 453
      1.1.6 Imaging Technology 453
   1.2 Credit Cards 454
      1.2.1 The United States 454
      1.2.2 Japan 455
   1.3 Wire Transfers 456
   1.4 Other Retail Electronic Payments 457
      1.4.1 ATMs 458
         The United States 458
         Canada and Mexico 458
      1.4.2 Debit Cards 458
      1.4.3 Smart Cards 459
2 Direct Banking 460
3 The Securities Industry and Technology 461
   3.1 Back-office Operations and Order Execution 461
   3.2 Financial Information Services 462
   3.3 Instinet 463
   3.4 Expert Systems 463
4 The Internet 463
Summary 464
End-of-chapter Questions 465
Selected References 466

24 Commercial Banks and the Securities Markets 467
Chapter Overview 467
Key Terms 467
Chapter Outline

Introduction

1 Origins of the Thrift Industry
   1.1 Savings and Loan Associations
      1.1.1 The United States
      1.1.2 The United Kingdom
   1.2 Mutual Savings Banks

2 Evolution of the Thrift Industry

3 Regulation and Deregulation
   3.1 Before the Great Depression
   3.2 Federal Regulation since the 1930s
      3.2.1 Federal Charters
      3.2.2 Deposit Insurance
   3.3 Deregulation of the 1970s and 1980s
      3.3.1 Deposits
      3.3.2 Assets
      3.3.3 Regulatory Excesses
      3.3.4 US Congressional Action

4 Thrift Assets and Liabilities
   4.1 Financial Assets
   4.2 Liabilities
   4.3 Share of the Mortgage Loan Market

5 Thrifts in Other Countries
   5.1 The United Kingdom
   5.2 The European Community
   5.3 Canada
   5.4 Japan

Summary

End-of-chapter Questions

Selected References

27 Credit Unions

Chapter Overview

Key Terms

Chapter Outline

Introduction

1 Credit Unions as Compared to Thrifts

2 Unique Characteristics
   2.1 The Common Bond
   2.2 Other Characteristics

3 Development of Credit Unions
   3.1 Trade Associations
   3.2 Credit Union Growth
4 Credit Union Regulation 520
5 Assets and Liabilities 522
  5.1 Assets 522
  5.2 Liabilities 524
6 Credit Unions Around the World 525
  Summary 525
  End-of-chapter Questions 526
  Note 527
  Selected References 527

28 **Investment Companies** 528
  Chapter Overview 528
  Key Terms 528
  Chapter Outline 528
  Introduction 529
  1 The Nature of Investment Companies 529
    1.1 Closed-end Funds 530
    1.2 Mutual Funds 531
    1.3 Money Market Mutual Funds 533
    1.4 Growth of Mutual Funds 534
  2 Investment Company Organization 535
    2.1 Financial Management 535
    2.2 Investors 537
  3 Share Pricing 537
    3.1 Open-end Funds 537
      3.1.1 Net Asset Value 537
      3.1.2 Sales Charges 538
      3.1.3 Management Fees 538
    3.2 Closed-end Funds 539
  4 Investment Company Regulation 539
  5 Mutual Fund Assets 540
  6 International Operations 543
  Summary 543
  End-of-chapter Questions 544
  Selected References 545

29 **Pension Funds** 546
  Chapter Overview 546
  Key Terms 546
  Chapter Outline 546
  Introduction 547
  1 Types of Pension Plans 547
    1.1 Classification by Sponsor 548
1.2 Classification by Defined Attribute
   1.2.1 Defined Benefit Plan
   1.2.2 Defined Contribution Plan
2 Government Pensions
   2.1 Social Security
      2.1.1 Coverage and Contributions
      2.1.2 Trust Fund Assets and Payments
   2.2 State and Local Government Pensions
3 Private Pension Funds
   3.1 Defined Benefit Plans
      3.1.1 Unit-benefit Formula
      3.1.2 Flat-benefit Formula
   3.2 Defined Contribution Plans
   3.3 Other Private Pension Plans
      3.3.1 401(k) Plans
      3.3.2 Individual Retirement Accounts
      3.3.3 Keogh Accounts
4 Regulation
   4.1 Funding
   4.2 Vesting and Coverage
   4.3 Fiduciary Responsibility
5 Pension Fund Assets
   Summary
   End-of-chapter Questions
   Notes
   Selected References

30 Insurance Companies
   Chapter Overview
   Key Terms
   Chapter Outline
   Introduction
1 The Nature of Insurance
   1.1 Insurance Classifications
      1.1.1 Life Insurance
      1.1.2 Property and Casualty Insurance
   1.2 Basic Principles of Insurance
2 Insurance Companies
   2.1 Income and Expense
      2.1.1 Life Insurance Companies
      2.1.2 Property and Casualty Insurance Companies
   2.2 Insurance Industry Participants
   2.3 Life Insurance in Force in Selected Countries
2.4 Regulation 575
   2.4.1 The United States 575
   2.4.2 Canada, Latin America, Europe, and Japan 575
3 Assets and Liabilities 576
   3.1 Life Insurance Companies 576
   3.2 Property and Casualty Companies 579
Summary 579
End-of-chapter Questions 579
Selected References 580

31 Finance Companies 581
Chapter Overview 581
Key Terms 581
Chapter Outline 581
Introduction 582
1 The Early Years 582
   1.1 Commercial Finance Companies 582
   1.2 Sales Finance Companies 583
   1.3 Consumer Finance Companies 584
2 The Industry Today 584
   2.1 Consumer Services 585
      2.1.1 Financing Retail Purchases 585
      2.1.2 Credit Cards 586
      2.1.3 Bank Activities 586
      2.1.4 Investment Products 587
   2.2 Mortgages 587
   2.3 Business Services 588
3 Assets and Liabilities 591
   3.1 Assets 591
   3.2 Liabilities 591
Summary 591
End-of-chapter Questions 593
Selected References 594

Appendix A 595
   Present Value of $1 596
   Present Value of an Annuity of $1 598
   Future Value of $1 600
   Future Value of an Annuity of $1 602

Index 604