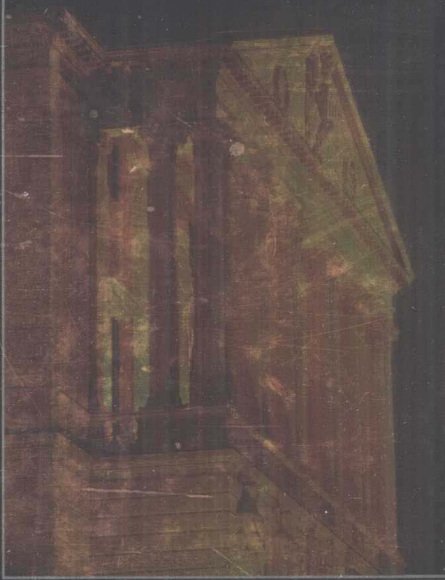
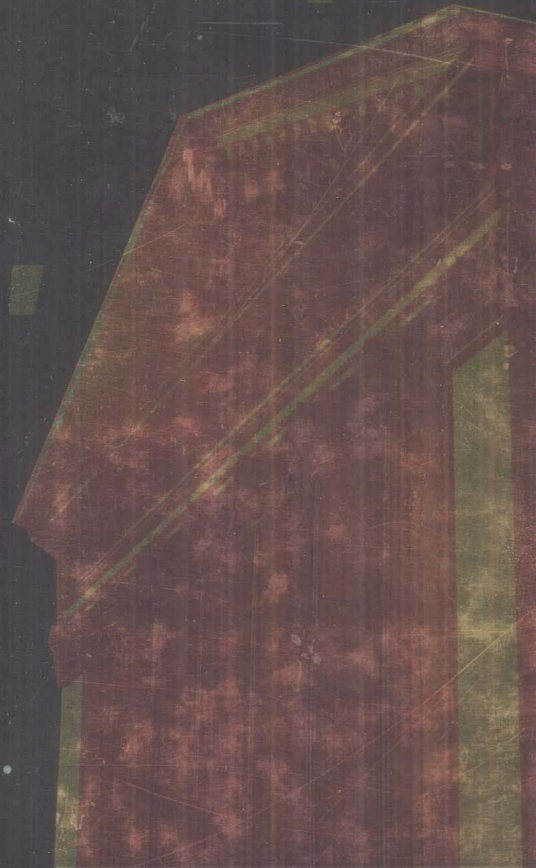


8<sup>TH</sup> EDITION



FINANCIAL  
INSTITUTIONS,  
MARKETS,  
AND  
MONEY



DAVID S. KIDWELL ♦ RICHARD L. PETERSON

DAVID W. BLACKWELL ♦ DAVID A. WHITE



EIGHTH EDITION

# FINANCIAL INSTITUTIONS, MARKETS, AND MONEY

David S. Kidwell  
*University of Minnesota*

Richard L. Peterson  
*Texas Tech University*

David W. Blackwell  
*Texas A&M University*

David A. Whidbee  
*Washington State University*



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# PREFACE

## TO THE STUDENT

We hope you are as excited about taking a course on financial institutions and markets as we were about writing the book. The core topics covered in the book are at the heart of what happens every day in the financial sector of the economy. When you have finished the course, reading the *Wall Street Journal*, the *Financial Times*, or the business section of the *New York Times* will be a piece of cake. You will dazzle your friends, family, and future colleagues with your insights.

As an introductory book, we stress fundamental concepts with an emphasis on understanding how things really work. At the same time, the vibrancy and excitement created by the dramatic changes taking place in the U.S. financial system are also an integral part of the text. Our goal is to provide you with a book that can guide you to a confident mastery and understanding of the U.S. financial system in an interesting and, at times, a provocative and entertaining manner. The book should be your passport to linking your classroom experience to what is happening in the real world. We want to make learning this material as easy and enjoyable as possible. The material that you learn will be applicable to anyone interested in a business career or, simply, to anyone interested in better managing their personal financial affairs.

## TO THE FACULTY

The focus of the eighth edition of *Financial Institutions, Markets, and Money* is the same as the previous editions: to provide students a balanced introduction to the operation, mechanics, and structure of the U.S. financial system, emphasizing its institutions, markets, and financial instruments. The Federal Reserve System and its conduct of monetary policy are given special attention. We stress the impact of monetary policy on interest rates and the way financial institutions adjust their operations to reduce risk caused by changes to the interest rate environment. Throughout the book we also stress the risks that financial institutions face and how they can manage those risks in financial markets. These risks include interest rate risk, credit risk, liquidity risk, foreign exchange risk, and political (or regulatory) risk. Further, we recognize throughout the book the impact technology and globalization are having on the operations and structure of the financial system. The book is written with a strong historical perspective. Throughout the book we give attention to the historical development of financial institutions and markets and discuss important historical events. We believe that relating historical events to the book's fundamental concepts gives the students a richer understanding of the material and a better perspective from which to evaluate current developments. As with the first edition, we continue our free market approach to the analysis of economic, market, and regulatory issues.

WHY READ  
THIS BOOK?

*Teacher-Friendly.* In revising the book, we are mindful of the demands on faculty who are asked to do more with less. We want to help make your course on financial institutions and markets as successful as possible. To that end, we have worked hard to write in a clear and understandable manner. Also, we have put much effort into updating and improving the chapter features, including for example, chapter previews, boxed items, and chapter “take-aways” to better facilitate student learning. Finally, we provide first-rate teaching and learning aids such as the instructor’s manual, test bank, study guide, and PowerPoint presentations that accompany each chapter.

*The Book’s Evolution.* Our book, like the financial system, has had to adapt to the rapidly changing economic environment. When we published our first edition, the existing textbooks were primarily descriptive, merely describing the activities of financial institutions, or they were *de facto* money and banking texts, primarily focused on the banking system and monetary policy. In our first edition, we broke new ground by emphasizing both financial institutions and markets, and how monetary policy affected financial institutions. At that time, our “free-market” approach to regulation, which emphasized market-oriented rather than government-imposed solutions to problems, not mainstream and, to some, was considered controversial.

As technology, regulation, and financial innovation changed the financial landscape, our book has had to evolve. In subsequent editions, we increased our emphasis on how interest rates are determined and on the structure of interest rates. We also increased our emphasis on the risks faced by financial institutions and on how institutions manage these risks using the financial markets. Over the years, we expanded our coverage of financial markets and, now, for example, the book has separate chapters on mortgage markets, derivatives markets, and international markets.

*The Competitive Edge.* Our approach to the topic made our book very successful in the early editions and it continues to be successful today. Imitation is the sincerest form of flattery, and we have seen a number of imitators of our approach, which, apart from the wide use of the book, is the best evidence of its appeal both to students and faculty. *Our* competitive edge, however, comes from our adherence to the approach for the book that was set in the first edition. First, we stress the mastery of fundamental material, placing an emphasis on how things really work in a market context. Second, we have a balanced coverage of the U.S. financial system with strong emphasis on both institutions *and* markets. Third, we continually update the book to reflect major new developments in the financial system or to highlight changing trends. Finally, we focus on writing a book *for the students*, our most important audience, that facilitates learning and makes the study of financial institutions and markets an enjoyable experience.

*Let Us Hear from You.* We thank the faculty that have adopted our book and the students that have purchased our book. As you go through your course, we hope that we have lived up to our promise of providing a clear, concise, well-written, and academically sound text on the U.S. financial system. If we disappoint you, we would like to hear your concerns so that we can address them in the next edition of the book. And, of course, if there are aspects of the book that work well, we would like to hear about these too. Please feel free to contact us via our e-mail addresses, which are listed at the end of the preface.

WHY IS  
THIS EDITION  
BETTER  
THAN THE  
PREVIOUS  
ONE?

Our goal in revising for the eighth edition was to significantly improve the student's ability to learn from the book. Apart from the customary updating of facts and exhibits throughout the book, we have worked painstakingly to improve the readability and the chapter features in this edition to better facilitate student mastery of the material. Consequently, we believe this edition of the book is substantially better than the seventh edition for a number of reasons, which we discuss below.

### **THE BOOK IS SHORTER**

Like an old house, a book entering its eighth edition accumulates clutter. In the eighth edition, we have “cleaned out the attic,” meticulously reviewing all material and retaining only that which we believed essential for students to take away. As a result, the text material in the book has been reduced by approximately 20 percent. Each chapter is shorter and crisper, making it more accessible to the students and easier to cover more of the material in one term. In cleaning out the proverbial attic, we have, of course, remained true to our philosophy of focusing on the key fundamental concepts and updating to reflect current developments and trends.

### **MORE QUANTITATIVE EXAMPLES**

Where appropriate, but especially in the financial markets chapters, we have increased the number of quantitative examples, in most cases using real-world data in the examples. Whenever we present an equation, we work through at least one example in detail and also explain the different ways in which the equation can be used. With our approach, the students will be able to see exactly how the featured equation works and how to apply it in different situations.

### **INCREASED EMPHASIS ON REAL-WORLD DATA**

In this edition, especially in the chapters on financial markets, we have increased our emphasis on demonstrating to students how to read and interpret actual financial data, such as that reported in the *Wall Street Journal* or the *Financial Times*. A couple of representative examples include Chapter 10 (Equity Markets), in which we lead students through how to interpret the stock listings from the *Wall Street Journal*, and Chapter 12 (International Markets), in which we explain how to use exchange rates reported in the financial press.

### **REVISED CHAPTER OPENERS**

Our chapter openers, now called “Chapter Previews,” have been thoroughly revised, and in most cases replaced, throughout the book. The chapter openers are now much shorter and read more crisply and are consistent in tone and readability throughout the book. All Chapter Previews are focused on motivating students to read the chapter, and in many cases, use examples that students will be able to relate to their lives outside the classroom.

## **HELP STUDENTS PREVIEW AND REVIEW IMPORTANT CONCEPTS**

Each chapter now begins with a list of “Learning Objectives” that highlight for students the most important concepts. At the end of the chapter, we have added a section called “Chapter Take-aways” that provides a brief explication of each of the important concepts highlighted in the Learning Objectives. To make learning easy, there is a one-to-one correspondence between the Learning Objectives and the correspondingly numbered Chapter Take-aways.

## **CLEANER EXHIBITS AND BETTER EXPLANATIONS**

We have updated and revised all of the book’s exhibits as necessary, but we also simplified and streamlined many of the tables, charts, and graphs to allow students to better understand the point of the exhibit. We have also expanded discussion of the exhibits in the text to better explain to students what it is they should be taking away from the exhibits. There is a descriptive legend on each exhibit, as appropriate, that gives a brief statement of what students should be learning from the exhibit.

### **PEDAGOGICAL FEATURES**

The eighth edition has a number of features to motivate the interest of students and to help them learn the material. As we discussed above, each chapter begins with a Chapter Preview to motivate student interest in the chapter. Each chapter includes “Do You Understand?” questions, which appear several times in each chapter. These questions check student understanding of critical concepts in the material just covered or ask students to apply what they have just read to real-world situations. To give students feedback on the “Do You Understand?” questions, we include the answers on the book’s Web site, which is described below. The answers are also included in the Instructor’s Manual. We provide captions for the exhibits to inform students of the main point they should draw from the exhibit. Learning Objectives appear at the beginning of each chapter and corresponding Chapter Take-aways at the end of the chapter, as described above. We include a list of key terms and concepts at the end of each chapter. The terms appearing in the list are printed in boldface the first time they appear in the chapter. The definitions of all key terms and concepts appear in the glossary at the end of the book. Each chapter ends with questions and problems. The answers to these questions and problems are in the Instructor’s Manual. Finally, we have provided an Internet Exercise at the end of each chapter. These exercises direct students to Web sites from which they can obtain additional information about the chapter’s topic or from which they obtain and analyze data that illustrate key points from the chapter.

### **ORGANIZA- TION OF THE BOOK**

## **REORGANIZATION AND NEW MATERIAL IN THE EIGHTH EDITION**

In shortening the book, we found that we were able to reorganize the material to achieve a better logical flow. Here we summarize the major changes to the organ-

ization from the seventh edition. For those wanting to know more, see the detailed table of contents.

Part I, “The Financial System,” now consists of one introductory chapter and two chapters on the Federal Reserve System. We consolidated the introductory material into Chapter 1, “An Overview of Financial Markets and Institutions.” In this edition we have moved the material on the Federal Reserve System earlier in the book. Chapter 2, “The Federal Reserve and Its Powers,” focuses on the structure, responsibilities, and powers of the Federal Reserve System. Chapter 3, “The Fed and Interest Rates,” covers how the Federal Reserve implements economic policy and how its policies affect interest rates. Other than moving the material on the Federal Reserve System to Part I, the organization of Part II, “How Interest Rates Are Determined,” has not changed.

We have made several changes to Part III, “Financial Markets.” First, throughout the financial markets chapters we added more quantitative examples using data from the financial press. Second, we have split the material on fixed-income securities into two chapters, Chapter 7, “Money Markets,” and Chapter 8, “Bond Markets.” Third, we have moved the mortgage markets chapter (now Chapter 9) earlier so that it is now grouped with the other chapters that cover debt securities. Also, we have moved the material on mortgage banking, which was previously in the chapter on thrift institutions, into the mortgage markets chapter. In Chapter 12, “International Markets,” we have reorganized and clarified the discussion of the determinants of exchange rates and we simplified our treatment of the balance of payments and its impact on the economy.

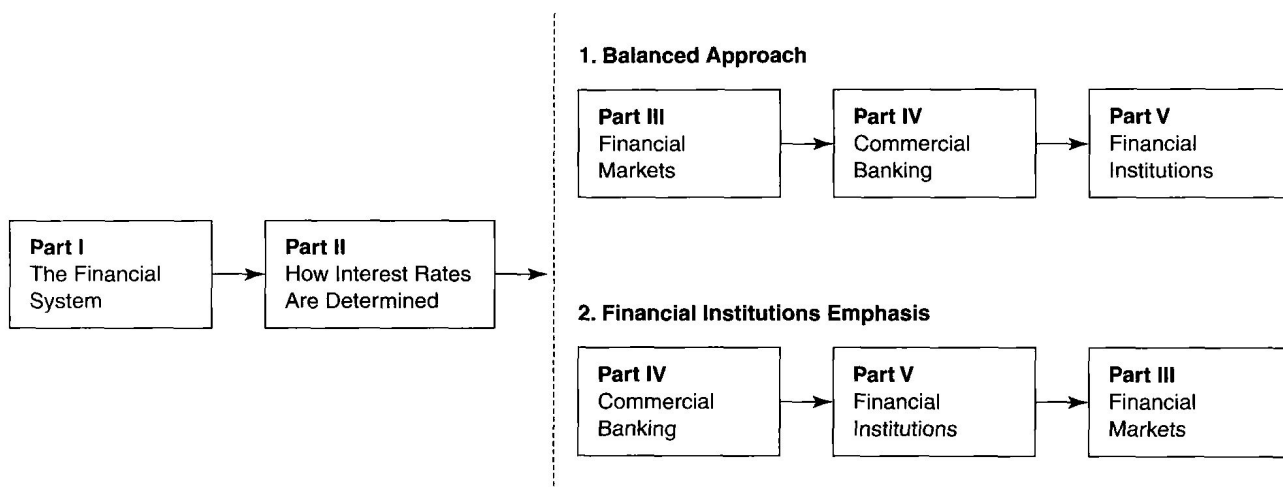
In Part IV, “Commercial Banking,” we have four chapters, similar to the previous edition. However, we have significantly revised the banking chapters to reflect regulatory changes, primarily those resulting from the Gramm-Leach-Bliley Act of 1999. We also streamlined and reorganized the chapter on regulation of financial institutions.

Part V, “Financial Institutions,” has been reorganized into four chapters and shortened. Chapter 17, “Thrift Institutions and Finance Companies,” now covers savings institutions (savings associations and savings banks), credit unions, and finance companies. The material on hedge funds, formerly appearing in the investment banking chapter, has been grouped with the material on investment funds to create a new Chapter 20, “Investment Companies and Hedge Funds.”

## **POSSIBLE COURSE OUTLINES**

We have organized this book to reflect a balanced approach to both financial markets and institutions, which reflects a typical course outline. However, depending on individual preference and course emphasis, there are alternative ways to organize the course and our book is written to allow a different ordering of the chapters for professors that wish to give primary focus either to institutions or markets. The only constraint in our flexible design is that Parts I and II should be assigned first, because they provide the conceptual foundation and vocabulary for the financial system regardless of subsequent topic emphasis. The diagram on the next page shows the balanced approach and an alternative sequence that emphasizes financial institutions:





## ANCILLARY PACKAGE

For this edition of the book, we offer updated, complementary materials that should help both the students and the instructors who use the book.

### INSTRUCTOR'S MANUAL WITH TEST QUESTIONS

Written by David R. Durst at the University of Akron, this volume contains a wealth of useful teaching aids, including chapter-by-chapter learning objectives, key points and concepts, answers to end-of-chapter questions and problems, and an outline of changes from the previous edition. Finally, the Test Bank, which includes at least 75 examination questions per chapter, has been updated to reflect the textbook's greater emphasis on numerical problems. It consists of true/false, multiple-choice, and essay questions.

### COMPUTERIZED TEST BANK

A computerized version of the Test Bank is available for use on an IBM PC computer (or compatible) running on MS-Windows. It contains content from the test bank provided within a Test Generating Program that allows instructors to customize their exams by choosing from a pool of true/false, multiple-choice, and essay questions.

### STUDY GUIDE

Written by David R. Durst of the University of Akron, students will find this tool to be a valuable part of the learning package. Each chapter provides a detailed chapter overview and list of learning objectives, topic outline, key terms review, completion, true/false and multiple-choice questions, problems, and annotated solutions. Each chapter also includes a short "Career Planning" section designed to encourage students to begin thinking about their careers. There is a special "Supplementary Material" section that expands and applies each chapter's

concepts to the real world by providing library references and assignments and flow-of-funds data analysis assignments. In addition, each of the early chapters features a “How to Use the *Wall Street Journal*” section intended to acquaint students with the organization of the *WSJ*. In later chapters, specific sections, data tables, and other features that appear regularly in the *WSJ* are explained and assignments are made.

## **POWERPOINT® PRESENTATIONS**

David Durst of the University of Akron has updated the existing PowerPoint® Presentations so they reflect the updates within this revision. These chapter presentations are available on the companion Web site. The presentation for each chapter provides bulleted lecture notes and figures, tables, and graphs selected from the text, ready for classroom presentation using the PowerPoint® Viewer, which we provide. Instructors with the full version of PowerPoint® can customize the lectures to reflect their personal course notes.

## **WEB SITE MATERIALS**

John Wiley & Sons hosts a Web site that provides additional resources for students and faculty. The Web site, which can be accessed at [www.wiley.com/college/kidwell](http://www.wiley.com/college/kidwell) will contain answers to the “Do You Understand?” questions found in each of the chapters of the text. The answers are accessible to both faculty and students. In addition, faculty adopting the book will be able to access an electronic version of the Instructor’s Manual and Test Bank on the Web site. Faculty and students will also be able to access the PowerPoint lecture notes on the Web site.

There will be additional supplemental materials available on the companion Web site. Two additional chapters will be available for faculty adopting the book to download, print, and duplicate for class. First will be a chapter titled “History of the Financial System,” which long-time users of the book will recall from previous editions. Second, we will provide an updated version of “Looking Ahead,” which was a chapter appearing in previous editions. “Looking Ahead” discusses issues that are of importance to contemporary managers of financial institutions. It considers how financial markets are changing and are likely to change in the future, focusing on technological and regulatory developments and their effects on electronic finance, global finance, control of the money supply, and payments and settlements systems. Finally, the Web site will contain a technical note on the deposit expansion process for instructors who wish to go into more detail about how to measure changes in the money supply resulting from Fed policy actions.

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As with any textbook, the authors owe an enormous debt of gratitude to many people. First, we thank the reviewers who have contributed valuable suggestions for this eighth edition:

M.E. Bond, University of Memphis  
Myles J. Callan, University of Virginia

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Robert Schweitzer, University of Delaware  
Joe Sinkey, University of Georgia

We also appreciate the many thoughtful reviews we have received over the previous seven editions. While the names of the reviewers are too numerous to list here, we are nonetheless grateful for their efforts and credit them with helping the book to remain a success.

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David S. Kidwell  
*Washington, D.C.*  
david@dskidwell.com

Richard L. Peterson  
*Lubbock, Texas*  
chippete@aol.com

David W. Blackwell  
*College Station, Texas*  
dblackwell@cgsb.tamu.edu

David A. Whidbee  
*Pullman, Washington*  
whidbee@wsu.edu

---

# ABOUT THE AUTHORS

## DAVID S. KIDWELL

Dr. David S. Kidwell is Professor of Finance and Dean Emeritus at the Curtis L. Carlson School of Management at the University of Minnesota. He holds an undergraduate degree in mechanical engineering from California State University at San Diego, an MBA from California State University at San Francisco, and a Ph.D. in finance from the University of Oregon.

Before joining the University of Minnesota, Dr. Kidwell was Dean of the School of Business Administration at the University of Connecticut. Prior to joining the University of Connecticut, he held endowed Chairs in banking and finance at Tulane University, the University of Tennessee, and Texas Tech University. He was also on the faculty at the Krannert Graduate School of Management, Purdue University, where he was twice voted the outstanding undergraduate teacher of the year for the School of Business. Dr. Kidwell has published research in the leading journals, including *Journal of Finance*, *Journal of Financial Economics*, *Journal of Financial and Quantitative Analysis*, *Financial Management*, and *Journal of Money, Credit, and Banking*.

Dr. Kidwell has been a management consultant for Coopers & Lybrand and a sales engineer for Bethlehem Steel Corporation. He is an expert on the U.S. financial system and is the author of over 80 articles dealing with the U.S. financial system and capital markets. Dr. Kidwell has participated in a number of research grants funded by the National Science Foundation to study the efficiency of U.S. capital markets, and to study the impact of government regulations upon the delivery of consumer financial services.

Dr. Kidwell currently serves on the Boards of Schwan's Sales Enterprises, and Minnesota Life Insurance Company. He is the past Secretary-Treasurer of the Board of Directors of AACSB, the International Association for Management Education. He is a past member of the Boards of the Minnesota Council for Quality, the Stonier Graduate School of Banking, and the Minnesota Center for Corporate Responsibility. He has also served as an Examiner for the 1995 Malcolm Baldrige National Quality Award and is on the Board of Directors of the Juran Center for Leadership in Quality.

## RICHARD L. PETERSON

Dr. Richard L. Peterson is Professor of Finance Emeritus at Texas Tech University. Dr. Peterson was the "High Scholarship Graduate in Economics" from Iowa State University in 1962, and received a Ph.D. in Economics from the University of Michigan in 1966. Subsequently, he taught economics at Southern Methodist University, was a financial economist on the staff of the Board of Governors of the Federal Reserve System, and served as the Associate Director of Purdue Uni-

versity's Credit Research Center before joining Texas Tech University in 1982 as a Professor of Finance and holder of the I. Wylie and Elizabeth Briscoe Chair of Bank Management. He has taught at numerous schools in the United States and abroad for domestic and international financial institution executives and has consulted for Dun and Bradstreet, Chemical Bank, Citicorp, and the National Second Mortgage Association. He has served as an expert witness for law firms representing the FDIC in savings and loan litigation, in New York Stock Exchange arbitration hearings, and in other matters.

Dr. Peterson has also written a book titled *The REAL Social Security Problem* and has published numerous papers. His papers have appeared in the *Journal of Money, Credit, and Banking*; *Journal of Finance*; *Journal of Financial and Quantitative Analysis*; *Journal of Financial Research*; *Journal of Financial Services Research*; *Journal of Futures Markets*; *Bell Journal of Economics*; *Quarterly Journal of Economics*; *Journal of Macroeconomics*; *American Banker*; *Banker's Magazine*; and numerous other publications. He also has presented papers at numerous academic meetings and at conferences sponsored by Federal Reserve Banks and Federal Home Loan Banks, and he participated in the American Assembly's comprehensive study of the U.S. financial system and its regulation.

He received Texas Tech's President's Excellence in Teaching Award in 1989 and its Academic Achievement Award in 1992. Dr. Peterson remains active in practical finance as a writer of tracts on financial and economic policy issues and as an investor in real estate, stocks, bonds, futures, and options.

### **DAVID W. BLACKWELL**

Dr. David W. Blackwell is the James W. Aston/RepublicBank Professor of Finance and Head of the Department of Finance at Texas A&M University. Prior to joining Texas A&M, Dr. Blackwell worked several years as a consultant with PricewaterhouseCoopers LLP and KPMG LLP. Before his stint in the Big 4, Dr. Blackwell served on the faculties of the University of Georgia, the University of Houston, and Emory University. He was also a visiting professor at the University of Rochester.

Dr. Blackwell's areas of expertise include corporate finance, commercial bank management, and executive compensation. His publications have appeared in the leading scholarly journals of finance and accounting such as *Journal of Finance*, *Journal of Financial Economics*, *Journal of Financial and Quantitative Analysis*, *Financial Management*, *Journal of Financial Research*, *Journal of Accounting Research*, and *Journal of Accounting and Economics*.

While in the Big 4, Dr. Blackwell consulted on a broad range of litigation matters including securities, breach of contract, and intellectual property infringement cases. He also consulted on matters involving securities and business valuation, corporate governance, and executive compensation.

In addition, Dr. Blackwell has delivered executive education seminars in corporate finance and management of financial institutions for IBM, Kaiser Permanente, Chemical Bank, Southwire Company, Georgia Bankers Association, Warsaw Institute of Banking, Bratislava Institute of Banking, and the People's Construction Bank of China (PRC).

Dr. Blackwell earned his Ph.D. in Finance in 1986 and his BS in Economics in 1981, both from the University of Tennessee, Knoxville. He is a past president of the Southern Finance Association and a former Associate Editor of the *Journal of Financial Research*.

**DAVID A. WHIDBEE**

Dr. David A. Whidbee is an Assistant Professor of Finance at Washington State University. He received his Ph.D. in Finance from the University of Georgia and his MBA and B.Sc. in Finance from Auburn University. After receiving his MBA, he worked as a financial analyst in the Chief Economist's Office at the Federal Home Loan Bank Board and, subsequently, the Office of Thrift Supervision. While on the staff at these regulatory agencies, he performed research and analysis on the thrift industry and prepared congressional testimony concerning the problems the industry faced in the late 1980s.

In 1990, Dr. Whidbee left the OTS to begin the Ph.D. program in Finance at the University of Georgia where he wrote his dissertation on corporate governance in the banking industry and began teaching financial markets and institutions. His other teaching interests are in the areas of commercial banking, financial institutions, and corporate finance. Upon completing the Ph.D. program, he joined the faculty at California State University, Sacramento, where he taught commercial banking and financial markets and institutions. In 1997, he left Cal State Sacramento to join the faculty at Washington State University, where he continues to teach commercial banking and financial markets and institutions. Dr. Whidbee's research interests are in the areas of financial institutions and corporate governance. His work has been published in several outlets, including the *Journal of Business*, the *Journal of Banking and Finance*, the *Journal of Corporate Finance*, *Financial Management*, and the *Journal of Financial Services Research*. In addition, he has presented his research at numerous academic and regulatory conferences.

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