

# Study Guide

for use with

## **Financial Markets and Institutions**

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*A Modern Perspective*



*Saunders / Cornett*

5-62

Prepared by  
William Lepley

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for use with

# Financial Markets and Institutions

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## CHAPTER 0

Chapter 0? ...as in *Chapter Zero*? Yes, this chapter doesn't even get the respect of having a *positive number* in its title.

This is the only part of the *Study Guide* that's *not* matched up to a chapter in *Financial Markets and Institutions, A Modern Perspective*, by Anthony Saunders and Marcia Millon Cornett. You might say this is the only *original* thing here. And, it's certainly the *shortest* part. (By the way, a normal title for this page, like "Preface," was given due consideration. But calling it a "Preface" would guarantee that *no one* would ever read it.)

What exactly does the *Study Guide* aim to accomplish? Just three things:

- 1) Some practice with *word stuff*: the terminology and descriptions.
- 2) Some practice with *number stuff*: the problems.
- 3) To have some fun in the process.

The first two things are pretty typical, in any study guide. You'll find questions and problems. You'll also find answers (let's hope they're right).

But the third goal above may not be so typical. Studying is not always "fun and games." It can be hard work. But, the inhabitants of financial markets and institutions are human beings. And, they try to have fun while working in markets and institutions. So, why not have a little fun when studying about them?

Each chapter in the *Study Guide* has been organized with the general outline below. And, we'll just have to wait.... and listen... to find out if the approach serves the three goals listed above. I suspect that readers will let me know.

- I. Surveying the Territory: An Aerial View
- II. Digging in the Dirt: A Subterranean View
  - A. Getting it on your terms
  - B. Any questions?
  - C. Do we have a problem here?
  - D. Care to cruise... on the web?
- III. Washing Up... And a Few Awards
  - A. The EASIEST THING in the chapter
  - B. The HARDEST THING in the chapter
  - C. The FUNNIEST THING in the chapter... or not
- IV. Checking the Answers... For Section II

William Lepley

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Study Guide for use with  
**FINANCIAL MARKETS AND INSTITUTIONS**  
Anthony Saunders and Marcia Millon Cornett

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## CHAPTER 1 INTRODUCTION

### I. SURVEYING THE TERRITORY: AN AERIAL VIEW

Let's start by putting down the major topic headings for Chapter 1. In other words, let's see where Professors Saunders and Cornett are taking us.

*Why Study Financial Markets and Institutions?: Chapter Overview*

*Overview of Financial Markets*

*Overview of Financial Institutions*

*Globalization of Financial Markets and Institutions*

Now, that was simple enough. Markets...Institutions...okay, we've just read the title of the book again...after all, this is *Chapter 1*, right? There can't be much going on here, right? The authors are just telling us what will happen *later*, right?

Well, *yes*... they do tell us what's coming later on. But *no*...there's some real *stuff* here. You know what I'm talking about—the kind of stuff that can show up on an exam. So, don't dismiss it so quickly.

### II. DIGGING IN THE DIRT: A SUBTERRANEAN VIEW

To learn this stuff, you've got to dig. Let's go play in the dirt.

#### A. *Getting it on your terms*

There's a whole bunch of financial *lingo* in this chapter, and more in the chapters that follow. In fact, there's so much of it, let's start a list:

**financial markets**  
**primary market**  
**firm commitment underwriting**  
**initial public offering**  
**tombstone**  
**secondary market**  
**money market**  
**over-the-counter market**  
**capital market**  
**spot foreign exchange transaction**  
**forward foreign exchange transaction**  
**financial institutions**

direct transfer  
 liquidity  
 price risk  
 indirect transfer  
 monitoring costs  
 delegated monitor  
 asset transformers  
 diversify  
 economies of scale  
 etrade  
 maturity intermediation  
 denomination intermediation  
 transmission of monetary policy  
 credit allocation  
 intergenerational wealth transfers  
 time intermediation  
 payment services  
 Eurodollar bond

Now, if you want to get picky about it, we *could* come up with even *more* terms. But if you can understand this set, you'll be in decent shape.

### ***B. Any questions?***

Better yet, how about some *answers*? For the initial set, find the *term*—from the list above—which best fits the description. Then you can try writing a few *essays*. And yes, answers will be provided in a later section. But *you* try them first. (By the way, there are just a handful of descriptions here—not one for each term in the list—so don't run back to the bookstore, insisting that you've been cheated out of a page!)

#### **Terms:**

1. This is the market for longer-term funds. The key issue is the *time* for which the funds are provided. We “draw the line” at one year. So, if a security will pay back for a term greater than a year, it's in this market.  
This is the \_\_\_\_\_.
2. This is the market for “used” securities—i.e., like the used car market. So, the securities in this market are probably not being offered for sale by their original issuers.  
This is the \_\_\_\_\_.
3. This is the first offer of a company's securities to the public. These are brand-spanking-new securities.  
This is a \_\_\_\_\_.



4. Let's say a whole bunch of folks deposit, on average, \$100 per week in the bank. Then, the bank periodically "bundles up" the money and lends it out in \$10 thousand or even \$100 thousand increments. (Clue: think about "size" here.)  
The bank is engaged in: \_\_\_\_\_.
5. When a bank lends out funds (as in the preceding question), it is performing a "surveillance" function on behalf of the depositors. After all, sometimes borrowers need to be "checked on," don't they?  
When the bank performs this function, it is acting as a \_\_\_\_\_.
6. With this market, *time* is the key characteristic of interest. Suppose a security is scheduled to be paid off in the short-term—let's say less than one year.  
The security is trading in the: \_\_\_\_\_.
7. Suppose you are a Federal Reserve economist—worrying about how money supply changes will influence the financial world, and ultimately, affect things like paychecks, inventories, and inflation.  
You are worried about the: \_\_\_\_\_.
8. Our friend Laura handles the chickens and eggs on her farm. When she collects the eggs, she is careful *not* to "put all her eggs in one basket." And, when she invests the money from selling the eggs, she tries to follow the same principle.  
Laura has chosen to: \_\_\_\_\_.
9. Think of a general term for businesses like commercial banks, credit unions, or insurance companies... but *not* including firms like Microsoft, Walmart, or Home Depot.  
We are talking about examples of: \_\_\_\_\_.
10. Jack's National Bank has a loan portfolio of \$200 *million*. Jill's National Bank has a loan portfolio of \$2 *billion*. Jill's average operating cost (say, per dollar of assets) is lower than Jack's average cost of operating.  
This demonstrates the phenomenon of: \_\_\_\_\_.
11. Bernie doesn't deal with banks. But he sometimes lends a few bucks to his friend Barney, who pays Bernie back on payday. This kind of transaction is a:  
\_\_\_\_\_.

**Essays:**

12. Consider this statement: "Secondary market transactions have no consequences for the original *issuers* of securities, because the issuers receive no funding from such transactions." Do you agree or disagree? Explain.
13. Distinguish a *forward* foreign exchange transaction from a *spot* foreign exchange transaction.

14. Contrast a *commercial bank* with a *thrift institution*. Also, how important have they been in the U.S.—in terms of their size *relative to* the overall financial institution sector?
15. Which seems most important in the U.S.: *direct transfers* or *indirect transfers*? Why?

**C. *Do we have a problem here?***

You will probably be happy to know that we *don't* have a problem to demonstrate here. After all, this is still Chapter 1. If you *are* disappointed, relax. There's more to come. The textbook is a big one.

**D. *Care to cruise... on the web?***

Even though we're in the introductory chapter, it's not a bad idea to get your fingers limbered up—and start clicking around to see what's available on the World Wide Web.

1. The New York Stock Exchange has an extensive web site. The home page is:

<http://www.nyse.com/>

2. One of the specific areas at the NYSE site is related to market information. Try this page:

<http://www.nyse.com/marketinfo/marketinfo.html>

Here, you can access the latest market pricing information, but there are also hot buttons for other data, as well as research. (You might be able to uncover some research papers that would help you with *your* research papers.)

3. The text's Table 1-7 shows some money supply data, and it comes from the Federal Reserve. Table 1-10 shows data from the Federal Reserve's "Flow of Funds" accounts. As with so many things these days, you can retrieve up-to-date information on the web. For example, you can find money supply data at:

<http://www.bog.frb.fed.us/releases/H6/Current/>

Can you find the "flow of funds" data, as well?

### III. WASHING UP... AND A FEW AWARDS

Hey, my hands are downright filthy... so let's wash up and shoot the... well you know....

#### A. *The EASIEST THING in the chapter*

**Table 1-4**, listing different types of financial institutions. I'm guessing most readers already understand at least three-quarters of these. If not, then you probably just arrived from another planet. Still, it's useful to look them over—and, see if you can determine where the various institutions around you “fit in” on the list.

#### B. *The HARDEST THING in the chapter*

I'd say its all those darn risks, as listed in **Table 1-8**. How *anybody* could *really* understand—and distinguish among—all those risks at this point is beyond me. But remember: this is Chapter 1. Study **Table 1-8**, and know this: you *will* visit these risks again!

#### C. *The FUNNIEST THING in the chapter... or not*

Ever notice the human capacity for coming up with a high-minded term to describe what might be a rather unpleasant activity? Here are two, related ones: **monitoring costs** and **delegated monitor**. Now the “monitoring” implied here is an absolute necessity in the financial world. What goes on? Well, when I use *other people's money*, those *other people* are going to be snooping around, trying to determine exactly what I'm up to. They're checking up on me. They might have to get downright *nosey*, in fact. And that's the point: **monitoring** does sound a whole lot better than **snooping**—and maybe a bit more professional, too. (How would *you* like to be known as Senior Vice President for Snooping Activities, at Last National Bank?)

### IV. CHECKING THE ANSWERS... FOR SECTION II

#### Terms:

1. capital market
2. secondary market
3. initial public offering (and, you can also say this is a *primary market* transaction)
4. denomination intermediation
5. delegated monitor
6. money market
7. transmission of monetary policy
8. diversify
9. financial institutions
10. economies of scale
11. direct transfer

**Essays:**

12. It is true that secondary market transactions do not generate funds for the issuers. Secondary market transactions occur *after* the primary market transactions. However, secondary market transactions *are important* to security issuers. The mere *existence* of secondary market activity can make it easier for issuers to sell their securities in the primary market. Investors value liquidity, and if they see an active secondary market, they will be more willing to purchase securities in the primary market. In addition, secondary market activity useful provides *pricing* information. The prices allow the issuers to gauge how investors are evaluating or “grading” their decisions on allocating the funds. The pricing information is also useful if the issuer is considering the sale of more securities.
  
13. Both transactions obviously involve the trade of one currency (say U.S. dollars) for another currency (say Japanese yen). The difference has to do with *when* the currencies will change hands. With a *spot* transaction, the dollars and yen change hands at the time of the agreement—you might say it changes hands “on the spot.” In contrast, with a *forward* transaction, the dollars and yen will change hands some time *after* the deal has been struck. The deal has been made *in advance* of the actual money flow. A delivery date will be specified in the forward transaction, indicating when the currencies will change hands.
  
14. Both thrifts and commercial banks are *depository institutions*—meaning that issuance of *deposit* liabilities is a primary way of raising funds. But thrift institutions have been more specialized in terms of where they invest their funds. Savings institutions, for example, direct their funding towards home mortgage lending. Credit unions, another type of thrift, have a consumer loan focus. Commercial banks have typically been involved in a broader array of lending—business loans, consumer loans, and mortgage loans. Both thrifts and commercial banks have been very significant in terms of asset size, although in recent years, their relative shares have fallen. In 1948, for example, combined assets of thrifts and commercial banks amounted to about 68 percent of overall financial institution assets. By 1999, their share had fallen to about 45 percent (see Table 1-5 in the text). Commercial banks, by themselves, have shown a dramatic, long-term fall in relative asset size—from a 60-plus percent share in the early 1900s to 35 percent in 1999. Both of these institution classes remain important, but other institutional types have been growing.
  
15. A *direct transfer* occurs when a supplier of funds deals *directly* with someone who wants to use the funds (for example, a loan from you to your brother-in-law). With *indirect transfers*, a financial institution is involved in the process—linking up suppliers and users of funds, who never even have to see each other. John deposits his paycheck in Rock Solid Savings Bank. Then, Mary goes to Rock Solid and borrows the funds (along with funds from other suppliers), to finance a home purchase. In the industrialized world, *indirect transfers* seem clearly to be the dominant type. The reasons relate to the costs and risks of direct transfers. Liquidity and default risks can loom large, but financial institutions can become very good at dealing with these risks. The *transactions costs* involved in bringing supplier and

demanders together—and, in particular, the *monitoring costs*—provide an important rationale for financial institution existence. Financial institutions can economize on these costs.



## CHAPTER 2 DETERMINANTS OF INTEREST RATES

### I. SURVEYING THE TERRITORY: AN AERIAL VIEW

In this chapter, we see *interest rates* from over, under, sideways, and more. But to start, just remember a couple of basic things. First, *interest*—whether it’s in dollars, yen, pounds, or even some *real* asset—is just a sort of payment or “bribe” designed to get one person to willingly *do without* something for a period of time. I give someone \$100, thereby foregoing the opportunity to spend it now. In return, I hope to get back my \$100, *plus interest*, next year.

The person who “does without” is the *lender* (although, in some contexts, that lender might be called an *investor*, or a *saver*). The person who gets the “something”—for a while—is the *borrower*. Finally, an *interest rate* merely expresses the interest payment as a percentage of the amount loaned.

Here are the chapter’s main topics. (And yes...in case you were wondering... this list, when coupled with 79 cents, will buy you a *really bad* cup of coffee.)

*Interest Rate Fundamentals: Chapter Overview*

*Time Value of Money and Interest Rates*

*Loanable Funds Theory*

*Movement of Interest Rates Over Time*

*Determinants of Interest Rates for Individual Securities*

*Term Structure of Interest Rates*

*Forecasting Interest Rates*

### II. DIGGING IN THE DIRT: A SUBTERRANEAN VIEW

#### A. *Getting it on your terms*

- nominal interest rate
- time value of money
- compound interest
- simple interest
- present value
- lump sum payment
- annuity

future value  
 equivalent annual return  
 discount yield  
 single payment yield  
 loanable funds theory  
 supply of funds  
 demand for funds  
 flight to safe haven (or flight to safety)  
 equilibrium interest rate  
 inflation  
 real interest rate  
 Fisher effect  
 default risk  
 liquidity risk  
 special provisions, or covenants  
 taxability  
 convertibility  
 callability  
 term structure of interest rates  
 yield curve  
 unbiased expectations theory  
 liquidity premium theory  
 market segmentation theory  
 preferred habitat theory  
 forward rate

**B. Any questions?**

**Terms:**

1. Linda is thinking about buying a bond. But a primary concern is the bond's limited marketability. If she buys it, she may not be able to turn it back into cash in a hurry.  
This risk is called: \_\_\_\_\_.
2. Larry bought a house, financing it with a 30-year mortgage loan. The loan allows Larry to "pre-pay"—paying off the full balance—without penalty. The loan has an interest rate of 10%. If Larry had instead taken a loan that *could not* be paid off early, the lender would have charged an interest rate of 9.5%. The interest rate on Larry's loan has a premium based on: \_\_\_\_\_.
3. Sphinx Corp. Bond is a straight bond, and was issued today with an interest rate of 10%. King Corp. Bond was also issued a straight bond today, at an interest rate of 10.5%. The Sphinx Bond and the King Bond have the same *default risk*. Also, the two bonds are the same in terms of their special provisions and covenants. The difference in interest rates is probably attributable to the:  
\_\_\_\_\_.



4. A dollar received *today* is worth more to me than a dollar received *a year from now*.  
This is the essence of the: \_\_\_\_\_.
5. As businesses foresee increasingly profitable investment opportunities, they desire more financing. They may offer securities in the marketplace to raise money.  
This is an important factor behind the: \_\_\_\_\_.
6. Suppose the quantity of funds demanded is equal to the quantity of funds supplied.  
The resulting interest rate would be the: \_\_\_\_\_.
7. Today, we observe and record the yields on bonds of *different* maturity—but sharing the same credit risk, taxability, and special provisions or covenants.  
The graph of the yields against corresponding maturities is the: \_\_\_\_\_.
8. Julie has \$1,000 to put in the bank. Given the bank's interest rate, she will have \$1,050 in exactly one year. In “time value of money” jargon, the \$1,050 amount is a: \_\_\_\_\_.
9. To lease his new car, Mark will be paying \$475 per month for 48 months. This flow of payments is an example of an: \_\_\_\_\_.
10. A municipal bond's yield will typically be *lower* than the yield on a corporate bond even if the default risk and callability are identical. The yield difference is most likely due to: \_\_\_\_\_.

**Essays:**

11. Describe the phenomenon called the “flight to safe haven.” Who's flying where? And why are they flying there?
12. Suppose the business outlook turns gloomy. We aren't exactly sure what started it, but consumers are not eager to buy new products. Retailers see their inventories build up, so they postpone orders for new items. Producers cut back on orders for raw materials. In the context of the “loanable funds theory,” what happens to the *demand for funds*? From this, explain what would happen to the level of interest rates.
13. As we look at some actual interest rates from *different* parts of the financial markets—as in the text's **Figure 2-9**—what sort of relationship seems apparent?
14. Use the loanable funds framework to explain what happens if market participants perceive *higher* default risk for bonds.