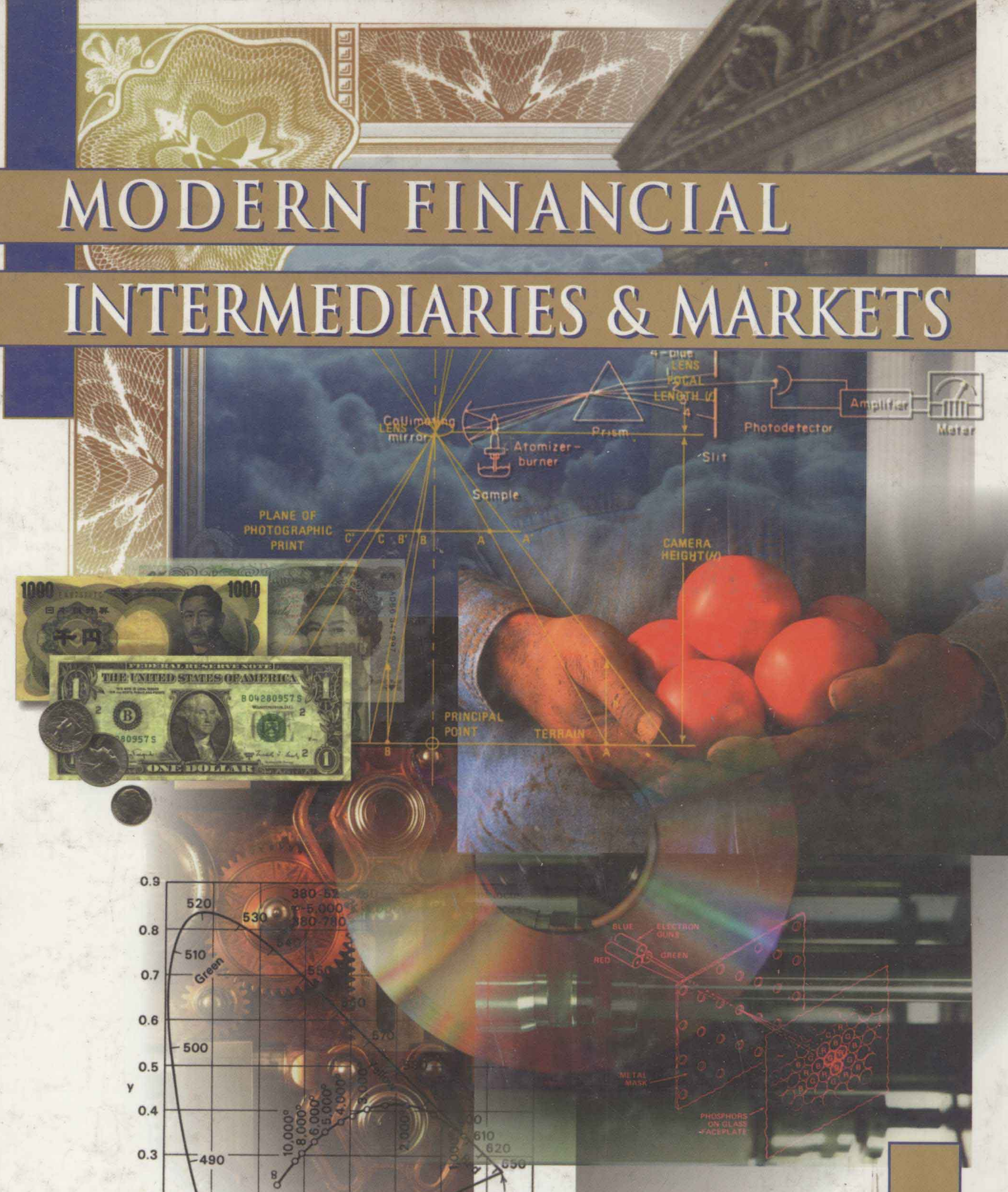
MODERN FINANCIAL INTERMEDIARIES & MARKETS



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GORDON V. KARELS

Modern Financial Intermediaries and Markets

Nasser Arshadi
University of Missouri–St. Louis

Gordon V. Karels
University of Nebraska–Lincoln

Prentice Hall, Upper Saddle River, NJ 07458

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Modern Financial Intermediaries and Markets

PREFACE

Most of the available textbooks dealing with financial markets and institutions introduce a collection of topics that have no clear theoretical connection with one another. As a result, students simply memorize a set of institutional details that often become obsolete due to changes in regulatory structure, advancements in technology, and the intensification of competition in domestic and international markets. Furthermore, students faced with a list of seemingly unrelated topics have difficulty in prioritizing particular facts and in comprehending and retaining the material for subsequent coursework and employment. In the end, this seemingly straightforward pedagogical methodology only complicates the subject matter. Not surprisingly, students find such texts tedious.

The existing descriptive books have generally shied away from the coverage of modern theoretical and empirical research under the assumption that such topics are too difficult for students to comprehend. Indeed, the very institutional nature of these books does not allow for a thorough integration of theoretical findings and their empirical tests. A decade of teaching such material, however, has proven to us in both undergraduate and graduate courses that students are eager to learn truly relevant theories and related evidence. The challenge for an effective finance instructor is to present complex theories and empirics in a manner that is comprehensible to students. Academics equally dissatisfied with material found in existing texts have settled, as we have, for a compilation of journal articles and special-topic books. We intend to integrate these topics into a single volume through a unified treatment.

As advances in information technology rapidly change the composition of financial instruments and intermediaries, education must also adapt to the new environment by teaching students the nature of the intermediation process, the unique features of intermediaries and instruments, and the trends in the development of new instruments in financial risk management (e.g., derivatives). Understanding the economic foundation of the intermediation process, in addition to the institutional details of today's intermediaries and instruments, will prepare students not only for today's job market but will also help to increase their educational flexibility in adapting to future changes.

Modern Financial Intermediaries and Markets examines firms, intermediaries, financial market instruments, and financial risk management. Advancements in the theory of capital markets and financial intermediation in the last two decades have significantly improved our understanding of these topics and altered traditional perspectives on the roles of capital markets, financial intermediaries, and regulatory structure. We develop the intermediation process as a broad theme which extends beyond the nature and purpose of financial intermediaries to include their influence over the financial instruments and markets in which they operate. For example, we examine the reasons behind commercial bank dominance in the swap market by evaluating the unique features of swap contracts, their primary functions, and the financial positions of customers who demand swaps. This analysis requires us to build a unified framework through which we can explain how a bank is uniquely qualified to produce customer credit information before the bank participates in a swap agreement, bears the risk, and facilitates the customer's sale of stocks and bonds in the capital market.

We wrote this text primarily for financial markets and institutions courses at both the undergraduate and MBA levels, taken either as a general business requirement or as a finance or economics elective. The text will also work well in related courses on money and banking or bank management. Since the book is self-contained, students need no prior knowledge of financial intermediation or capital markets, but may find an introductory economics course useful as a prerequisite.

To assist instructors in teaching, we provide an instructor's manual consisting of solutions to all questions and problems in the book, lecture notes, and overhead transparency masters. We also supply a test bank consisting of multiple choice questions and problems, essays, and word problems. A computerized version of the test bank is also available. We also intend to set up a Web Site to discuss current issues related to subjects discussed in the book. Like most instructors, we have been dissatisfied with the auxiliary material provided by most of the textbooks in the market. Our supplements are carefully prepared to provide detailed teaching and test material, with the intention of reducing instructors' preparation time.

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ABOUT THE AUTHORS

Nasser Arshadi is an Associate Professor of Finance at the University of Missouri–St. Louis. His areas of research interest include financial intermediation, capital markets, and corporate finance. His papers have appeared in the *Journal of Money, Credit, and Banking, Journal of Banking and Finance, Journal of Financial Services Research, Journal of Financial Research, Financial Management,* and *Financial Review.* He has published a prior book entitled *The Law and Finance of Corporate Insider Trading: Theory and Evidence,* coauthored with Thomas Eyssell. He has served as a Visiting Scholar at Board of Governors of the Federal Reserve System in Washington, DC, and as a consultant to the American Bankers Association and the Treasury Management Association.

Gordon V. Karels is the Nebraska Bankers Association Professor of Banking at the University of Nebraska–Lincoln. He is currently serving as Associate Dean of the College of Business Administration and has previously served as Graduate Programs Coordinator and MBA Program Director at UNL. He received his doctorate from Purdue University in 1979 and joined the UNL faculty in 1986. Prior to joining the UNL faculty, he served as Chairman of the Economics Department at the University of Nebraska at Omaha and on the faculty at Florida International University. In 1993, he had the distinction of serving as the first Visiting American Business Professor at Technical University Chemnitz (Germany). He has also served as a Visiting Professor at Bayreuth University (Germany).

Dr. Karels has teaching and research interests in the areas of bank management, financial institutions, managerial economics, competitive bidding, and managerial finance. He has published over 25 refereed journal articles, a textbook in financial mathematics, supplemental textbook material in microeconomics, and several cases in bank management. He serves as a consultant on asset-liability management to Information Technology Incorporated and has consulted for the Goodyear Tire and Rubber Company. He has taught numerous management development seminars on financial budgeting and forecasting.

Modern Financial Intermediaries and Markets

BRIEF CONTENTS

C O N T E N T S

PART TWO: FINANCIAL MARKETS

PART THREE: FINANCIAL DERIVATIVES

PART ONE: FINANCIAL INTERMEDIARIES

CHAPTER 1

A Framework for Studying Modern Financial Intermediaries and Markets

OBJECTIVES

This chapter presents a brief introduction to the intermediation process. We begin with a discussion of transaction costs, because their role is central to establishing markets, firms, corporations, financial intermediaries, and financial and derivative instruments. After introducing transaction costs, we describe the intermediation process, and conclude with a synopsis of each chapter.

TRANSACTION COSTS AS THE UNIFYING THEME

Advances in technology and intensified competition in domestic and global markets have led to drastic changes in the intermediation process, requiring a new approach to the study of financial institutions and markets. Since most activities in the intermediation process involve information, the impact of innovative technology on the financial services industry is significant. The ability to collect, process, and analyze large quantities of information quickly and cheaply has expanded market opportunities (e.g., mutual funds, derivatives) and has altered the way traditional markets operate (e.g., home mortgage securitization).

Technology has also contributed to the unbundling of the traditional loan into origination, risk-bearing, funding, and servicing functions, which, in turn, has increased competition in the financial markets for each function. Separating funding from the remaining loan services develops new lines of business for intermediaries in the form of fee-based activities. Securitization, loan sales, and off-balance-sheet activities are examples of fee-based ventures that do not require funding. Fee-based activities are on the rise, while traditional activities such as intermediary loans are on the decline. Whereas corporations once relied on bank loans for a major part of their external financing, they now raise a significant part of their funds through the direct sale of securities in the capital market, facilitated by standby letters of credit obtained from commercial banks.

In market-oriented economies there is an economic rationale for the existence of each and every institution and instrument. The surviving institutions and instruments are those that have the lowest transaction costs. ***Transaction***