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FINANCIAL MARKETS AND INSTITUTIONS

FOURTH EDITION

JEFF MADURA

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Preface

Financial markets facilitate the flow of funds in order to finance the investments by corporations, governments, and individuals. Financial institutions are the key players in financial markets because they serve as the intermediaries that determine the flow of funds. This text describes the various financial markets and the financial institutions that serve those markets. It provides a conceptual framework that can be used to understand why markets exist. Each type of financial market is described with a focus on its utilization by financial institutions, its internationalization, and recent events that have affected it. Each type of financial institution is described with a focus on its sources and uses of funds, regulatory aspects, management, use of financial markets, and performance.

INTENDED MARKET

This text is suitable for both undergraduate and masters level courses in financial markets, financial institutions, or the combination of markets and institutions. Some courses may attempt to maximize the comprehension level by assigning the more difficult questions and problems, the special exercises at the end of each chapter, and the Comprehensive Project.

ORGANIZATION OF THE TEXT

This text is organized as follows. Part I (Chapters 1 to 3) introduces the key financial markets and financial institutions, explains interest rate movements in the financial markets, and explains why yields vary among securities. Part II (Chapters 4 and 5) describes the functions of the Federal Reserve System and how the Fed influences interest rates and other economic conditions with its monetary policy. Part III (Chapters 6 through 9) covers the major debt security markets, Part IV (Chapters 10 and 11) describes equity securities markets, and Part V (Chapters 12 through 15) covers the derivative security markets. Each chapter in these three parts focuses on a particular market. The integration of each market with other markets is stressed throughout these chapters. Part VI (Chapters 16 to 20) concentrates on commercial banking, while Part VII (Chapters 21 to 27) covers all other types of financial institutions.

Courses that emphasize financial markets would focus on the first five parts (Chapters 1–15). Some commercial banking chapters would still likely be assigned. Courses that emphasize financial institutions would focus on Parts I, II, VI, and VII although some background on securities markets (Parts III, IV, and V) could be helpful. Finally, some courses that are designed to emphasize financial markets and institutions may attempt to focus on particular markets and institutions, depending on other available courses. For example, if a course on derivative securities is commonly offered, Part V of this text may be ignored. Alternatively, if an available Investments course provides a thorough background on various types of securities, Parts III and IV can be avoided. A final alternative is to use most of the class time on the conceptual problems and allow students to read the more descriptive chapters on their own.

Regardless of the sequence of chapters desired, it is highly recommended that the special exercises be assigned in each chapter, along with selected "Questions." These exercises serve as a focal point for class discussion.

COVERAGE OF MAJOR CONCEPTS AND EVENTS

Numerous concepts relating to recent events and current trends in financial markets are discussed throughout the chapters, including:

- forecasting interest rates
- inflation-indexed Treasury bonds
- shareholder activism by institutional investors
- development of the global bond market
- emerging stock markets
- option pricing
- forecasting stock volatility
- regulatory reform in the banking industry
- the use of junk bonds to finance acquisitions
- the measurement and use of duration
- the use of interest rate swaps and currency swaps by bond portfolio managers
- the use of collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs) in the mortgage markets
- the use of portfolio insurance strategies to reduce risk
- the increasing importance of mutual funds
- the underfunding of pension funds

Each chapter is self-contained so professors can use classroom time to focus on the more complex concepts and rely on the text to cover the other concepts. Chapters can be rearranged without a loss in continuity.

APPROACH OF THE TEXT

The approach of the text is to reinforce the key concepts in the following ways:

1. **OPENING DIAGRAM:** A diagram is provided at the beginning of each part to illustrate in general terms how the key concepts to be covered in that part are related. This offers some intuition about the organization of chapters in that part.
2. **OBJECTIVES:** The key concepts are identified within a bulleted list of the objectives at the beginning of the chapter.
3. **EMPHASIS:** The key concepts are thoroughly described in the chapter.
4. **SUMMARY:** The key concepts are summarized at the end of the chapter in a bulleted list that corresponds to the list of objectives at the beginning of the chapter.
5. **QUESTIONS AND PROBLEMS:** Many of the Questions and Problems at the end of each chapter test the students knowledge of the key concepts.

6. **WSJ EXERCISE:** A section at the end of each chapter called WSJ exercise enables students to apply information provided in *The Wall Street Journal* to specific concepts explained within the chapter.
7. **MANAGING IN FINANCIAL MARKETS:** At the end of each chapter, an exercise called “Managing in Financial Markets” places students in a position where they must make decisions about specific situations related to the key concepts in that chapter.
8. **MONITORING WALL STREET:** At the end of each chapter, a section called “Monitoring Wall Street” provides quotes about the chapter’s key concepts and asks students to interpret these quotes. This gives students practice in applying what they have learned to interpret announcements by the financial media.
9. **INTERNET APPLICATIONS:** At the end of each chapter, a section called “Internet Applications” explains how the Internet can be used to access financial data and obtain more information on the chapter concepts. It also contains an exercise that enables students to personally experience the application of the Internet to key concepts discussed in that chapter.
10. **INTEGRATIVE PROBLEM:** The Integrative Problem at the end of each part integrates the key concepts across chapters within that part.
11. **COMPREHENSIVE PROJECT:** A Comprehensive Project is contained in Appendix A at the end of the text, which requires students to apply several key concepts described in various chapters to actual data.

The concepts in each chapter can be reinforced by one or more of the text’s features described above. Each professor has his or her own method to help students get the most out of the text. Each professor’s use of the features will vary with the level of students and the focus of the course. A course that focuses mostly on financial markets may emphasize projects such as taking positions in securities and derivative instruments, and other related projects that involve *The Wall Street Journal*. Conversely, a course that focuses on financial institutions may emphasize projects such as reviewing recent annual reports to fully understand how a particular financial institution’s performance is affected by its policies, industry regulations, and economic conditions.

CHANGES IN THIS EDITION

- The organization of the text has been revised so that the relationship between interest rates and bond prices is contained in a new chapter called “Bond Valuation” and is placed next to the “Bond Markets” chapter. In addition, a new chapter called “Stock Valuation” has been added and is placed next to the “Stock Markets” chapter.
- Relevant information from the “Point of Interest” and “Applied Research” boxes in the previous edition has been infused directly within the text.
- A section called “Managing in Financial Markets” has been added to the end of each chapter, which places students in a position where

they must make decisions about specific situations related to each chapter.

- A section called “Monitoring Wall Street” has been added to the end of each chapter, providing three quotes by Wall Street analysts, which students must attempt to interpret. This gives students practice in interpreting announcements by the financial media about financial markets and institutions.
- A section called “Internet Applications” has been added to the end of each chapter. This section explains how the Internet can be used to access financial data and obtain more information on the chapter concepts. It also contains an exercise that enables students to personally experience the application of the Internet to chapter concepts.
- A Comprehensive Project has been inserted (see Appendix A) which requires students to directly apply several concepts described in various chapters to actual data.
- All chapters have been updated to incorporate recent trends and events.
- The chapters have been revised to place more emphasis on the key concepts, while removing other, less useful, material.
- Where appropriate, major regulatory changes that affect various financial markets and institutions are discussed.
- Many of the key conceptual relationships discussed are supported by graphs containing the most recent data available.
- The “Global Aspects” sections have been expanded in many chapters to incorporate the continuing globalization of financial markets.
- An end-of-text Internet Appendix introduces students to using the World Wide Web for Finance. This guide will help students locate the information needed to solve the Internet Applications at the end of each chapter.

SUPPLEMENTS FOR THE PROFESSOR

The following supplements are available for the professor.

1. An Instructor’s Manual, which contains the chapter outline, a summary of key concepts for discussion, answers to the end of chapter questions and problems, answers to the exercise called Managing in Financial Markets, and answers to the exercise called “Monitoring Wall Street.”
2. A Computer diskette (attached inside the Instructor’s Manual) that contains the data bank that is provided in the back of the text.
3. A Test Bank.
4. A computerized Test Bank, WesTest, which is a microcomputer test generation program for IBM PCs and compatibles.
5. Transparency masters that reflect many of the exhibits illustrated in the text.
6. A PowerPoint presentation package is available to qualified adopters and has been prepared by David R. Durst, University of Akron.

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