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FINANCIAL MARKETS, INSTRUMENTS,
AND INSTITUTIONS

Financial Markets, Instruments, and Institutions

Anthony M. Santomero

David F. Babbel

both of The Wharton School, University of Pennsylvania

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Preface

Financial markets, instruments, and institutions have undergone substantial change over the last decade. There has been a proliferation of financial instruments as well as an explosion in trading volume. The once staid institutions involved in the creation and trading of financial assets have transformed themselves in response to these changes. In light of this revolution in the financial market, teachers of this material constantly have had to modify and adapt their course outlines. To aid in this process of change, the present volume attempts to update the textbooks in this area in order to respond to the dynamics of the financial markets. It develops more fully the approaches used to price financial instruments; it presents a more up-to-date description of the markets; and offers more current insight into the evolution of financial sector institutions.

The Underlying Philosophy

The study of financial markets has traditionally been taught either as a money and banking course or as an institutionally based money and capital markets course. The former begins with the role of money in society and moves to the macroeconomic implications of diversified financial markets. It does not address the wide range of individual financial instruments, nor does it examine the structure of financial markets and institutions in any detail. The latter avoids issues of valuation and pricing methodologies in favor of descriptive material with an institutional focus.

In today's dynamic financial environment, the knowledgeable participant requires a more firm grounding in financial theory, a greater exposure to the diversity of financial instruments, and an appreciation of the role of institutions within these markets. Choosing to concentrate strictly on the monetary sector or

the descriptive elements of the market does not allow the student to appreciate the key concepts of theory and how they are incorporated into financial markets. Rather than forcing the instructor to choose between these two approaches, the current textbook offers a perspective that centers more on the function, pricing, and institutional structure of the financial markets. While neglecting macro-economic apparatus, it develops more fully the pricing of various financial instruments and the differences between instruments and institutions that operate in the financial markets.

Organization of the Text

In Section I the textbook opens with a discussion of financial markets' role in the economy. It integrates both the markets and institutions into an overall view of how the economy works and how its activity is measured.

Section II begins with a discussion of the determination of financial market interest rates. It explains both the level of interest rates and reasons for interest rate movements over time. Next, it uses current market interest rates to value cash flows of different kinds. Starting from simple present value, it develops the more modern techniques that are currently in use in financial markets.

Section III explores the main instruments of the money and capital markets. Starting from short-term money market instruments, it explores the bond, mortgage, and equity markets. It then introduces futures and options, floating rate securities, and other more esoteric derivatives. In each case, the institutional features of the market are presented, key characteristics of the instrument reviewed, and the valuation techniques developed in Section II employed to determine market prices for the instrument in question.

Section IV has two parts. In the first three chapters (17, 18 and 19), the nature of markets is reviewed and the role of markets in facilitating new issues and ownership transfer discussed. Next, this section reviews the major institutions in the financial markets. The section ends with a discussion of financial structure changes and how these institutions use the techniques developed in this textbook to manage their own financial performance.

The textbook concludes with Section V, where the role of the Federal Reserve and the money supply is discussed. Given the important role that the money supply plays in the financial sector, these chapters review how the Federal Reserve affects this quantity and how it interrelates with other parts of the financial markets.

Intended Audience

This textbook is designed for a one-semester course in money and capital markets taught within a finance department of a business school. By design, the course does not require nor does it overlap with monetary economics or finance topics

taught elsewhere in the curriculum. It is designed to be used in the first financial markets course. After completing this course, students will be well prepared for the more advanced material in courses such as investments, speculative markets, international finance, and fixed income. On the other hand, if the student chooses to take no further courses in finance, the textbook can be used to offer a broad overview of financial markets, pricing, and institutions.

Ancillary Support

The following supplementary materials are available for instructors who use this book to support them in their teaching efforts:

Instructor's Manual/Test Bank

The manual for this textbook includes solutions to all end-of-chapter review questions. These are supplemented by additional questions and problems that can be used as a test bank for each of the 27 chapters. In addition, the Instructor's Manual includes chapter outlines/transparency masters designed to assist in the chapter-by-chapter presentation of the material. In these outlines, key subjects are indicated and pertinent formulas presented for in-class discussion.

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We are indebted to the many colleagues who gave us their insight and guidance while we were writing this textbook. Their careful work was a major factor in our creating a book that is current, accurate, and fresh in its approach. Among all who helped in this endeavor:

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We welcome any comments and suggestions for enhancement. Please let us know of your experience with this text, either through Irwin or at our E-mail addresses below.

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As a consultant for leading financial institutions in the United States and abroad, Dr. Santomero has addressed issues of financial risk management procedures, the pricing of risks of various kinds, and credit risk evaluation and management. He has advised the Federal Reserve Board of Governors, the FDIC, and the General Accounting Office on a wide range of issues relating to capital regulation and structural reform. Internationally, he has been a consultant to the European Economic Community in Brussels, the Inter-American Development Bank, the Kingdom of Sweden, the Ministry of Finance of Japan, the Treasury of New Zealand, the Bank of Israel, the National Housing Bank of India, the Saudi Arabian Monetary Agency, and the Capital Markets Board of Turkey. In addition, he currently serves as a permanent advisor to the Swedish Central Bank.

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A former vice president and director of research in the Pension and Insurance Department at Goldman, Sachs & Co., and economist at the World Bank, Dr. Babbel is a financial consultant for several of the largest financial institutions. He has published prolifically in academic and professional literature on asset/liability management, insurance, fixed income investments, and foreign exchange risk management. He is coauthor of a 1996 monograph entitled *Valuation of Interest-Sensitive Financial Instruments*.

He received his undergraduate training in economics at Brigham Young University, and his graduate training at the University of Florida in finance. His postdoctoral education in insurance was undertaken at the University of Pennsylvania's Wharton School.

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