PETER MOLES AND NICHOLAS TERRY

THE HANDBOOK OF INTERNATIONAL FINANCIAL TERMS

OXFORD

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PREFACE

For many people, the picture that they have of a financial market-place is provided by television and cinema. In such forms, the world of finance can appear exciting, glamorous, and almost totally incomprehensible. The commonest images comprise rooms hidden away from the public gaze, filled with people at desks crammed with computer screens and telephones. The lack of comprehension comes from not only the language being used but also the purpose of all this activity and the working practices of those involved. Life in this environment seems complicated and fast moving. A place where individual careers and incomes, and the fortunes of entire institutions, can be won and lost.

The Handbook of International Financial Terms is designed to provide a ready reference to these financial markets. Its scope is both broad and international, covering a very wide range of activities undertaken by the major global financial centres. To this extent, it can be seen as an extension of the *Oxford Dictionary of Finance*. It will have appeal to both formal and informal finance students, and help them to a better understanding of what financial markets do, how they do it, and the particular language that is used. *The Handbook of International Financial Terms* has been written with the purpose of assisting those students following courses in finance as both a free-standing introduction, and a handy refresher or decoder to accompany standard finance textbooks. It is with this group in mind that some entries contain suggestions for further reading.

For the practitioner, this handbook should be a ready reference and, possibly, a source of inspiration as well as providing definitions of items. Such professionals will be able to save on search time and draw confidence from having their existing understanding confirmed. It is written with the intention of providing one of the most comprehensive and technically advanced collections of terms currently available in a single volume. As such, *The Handbook of International Financial Terms* represents a convenient reference work suited to the needs of practitioners. The notion of the practitioner here is intended to be inclusive in its coverage. For example, practitioners could be: traders, analysts, money and fund managers, bankers, advisers, corporate treasurers, lawyers, accountants, and related professionals.

The authors have the strongly held conviction that there is a place for one book which contains information ranging from the fundamental to the highly sophisticated. Unlike a textbook which works thematically, *The Handbook of International Financial Terms* is a source book for looking up specific items and definitions in a quick and efficient manner. The logic behind this approach is to provide readers with an understanding of the use of the term, and how and where it is used in the market concerned. Once this is achieved, the reader has the awareness to expand the search thematically using cross-references. For those less familiar with the subject, or for those wishing a contextual approach, there is the next section entitled 'Getting Going with the A—Z of Entries'.

The Handbook of International Financial Terms features up-to-date terminology from the different markets around the world. Particular attention is given to derivatives (futures, options, and other risk management products), which is an area that has grown significantly in recent years. Consequently, there has been an explosion in new terms and concepts. The authors have sought to do justice to the modern practice of financial risk management as well as financial innovations. Therefore, the handbook contains a large number of foreign terms, details about how these different derivative products are interrelated, and indications of why they are used.

How to use the Handbook

The main text of the Handbook contains the entries listed alphabetically. Clear definitions for each of the individual terms are provided together with formulae, where appropriate. If warranted, examples or illustrations are also given in order to aid understanding. Other related terms (for example, opposites are denoted by opp.) are indicated, as well as other referenced terms which may be of interest (denoted by 'see'). Items which appear elsewhere are denoted using semi-bold. A typical entry would appear as follows:

> **Finance** (i) The study, specialization in, or use of money. Hence, *financial officer*, and *financial economics*. (ii) The markets, activities, and businesses involved directly with money rather than with real assets (cf. **financial institution**). This is an economy's *financial sector*. (iii) **Funds** or a **loan** (cf. **capital**). See **financial instrument**. (iv) Those persons who have specific responsibility for advising about or managing money (cf. **finance director**). Hence a *financial expert*. (v) Alternative term for **capital** (cf. **liabilities**).

Finance is a generic term and is therefore not market or activity specific. Where a term is used in a particular market, or refers to a particular activity, or location this is also shown (in parentheses). For example: **collateralized mortgage obligation** (CMO) (Bonds; USA). Thus the instrument is a collateralized mortgage obligation, the acronym for which is CMO, and it belongs to the bond markets or traded term debt markets in the United States of America. If the reader had wanted to know the meaning of CMO, this is found by looking in the List of Abbreviations and Acronyms, which gives the meaning of the letters, allowing the term to be looked up in the alphabetical section. This follows the section entitled 'Getting Going with the A to Z of Entries', which is provided to assist the less knowledgeable reader by setting the entries in context and is designed to give a short overview of the main entries.

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Finally, as is usual in these matters, all errors and omissions remain entirely the responsibility of the authors. Although great care has been taken over the detail in this work, mistakes can occur with a project of this type. The authors would greatly appreciate learning of any such mishaps, and any more general comments on the structure of the book and suggestions about the future.

Peter Moles and Nicholas Terry

Edinburgh University Management School
University of Edinburgh
7 Bristo Square
Edinburgh EH8 9AL
Scotland
United Kingdom

Tel.: Int + 44 (0) 131 650 8065/3823
Fax: Int + 44 (0) 131 650 6501

e mail: P.Moles@ed.ac.uk
e mail: J.GOLDRING@ed.ac.uk

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GETTING GOING WITH THE A TO Z OF ENTRIES[1]

Finance specialists should find it possible to explore the main body of entries comprising *The Handbook of International Financial Terms* (*THIFT*) without too much difficulty. The large number of definitions provides an opportunity to enhance and confirm their existing knowledge and understanding, as well as to become more aware of the wide implications of international finance. What follows is a descriptive overview of financial markets and instruments intended to offer the non-specialist several ways into the A to Z listing. By gaining access to the entries (highlighted in bold), the non-specialist should be able to demystify much of the behaviour of modern financial markets. In particular this *Handbook* provides a guide to what is traded; why it is traded; where, how, and by whom it is traded. The domestic/regional markets and sectors which comprise the international or global financial market-place share, to a varying degree, common problems, organizational structures, and regulations and, in different ways, these shared and separating characteristics also influence the behaviour of the individual markets.

Financial markets trade what are called financial claims or instruments, and markets are interested in 'Who is doing the issuing?' and 'Who is doing the buying?', and 'Why?' in both cases. That is, how do individuals, households, companies, governments, and countries pay for what they do; are any of these groups spending more than they receive (often referred to as deficit units or net borrowers); or receiving more than they spend (surplus units or net lenders). This is best seen in terms of the flow of funds between different sectors of an economy shown in Figure 1. The flow of funds within a country will see borrowing and lending between the different sectors: the state sector, the personal sector, and the industrial and commercial sector. This will take place either directly or be channelled through the financial markets. In addition, in an open economy, the domestic sectors and the domestic financial markets are connected to the international financial markets whether to borrow or lend.

A major question of interest is how, if they are borrowers, are they raising funds in the financial markets? For example, is it via loans or overdrafts from **intermediary** institutions who specialize in finance, or by issuing various kinds of financial

[1] Note this section is designed to provide an introduction to the main text and is not meant to provide a rigorous framework for the alphabetical list of entries. The coverage of topics is highly selective and designed to put the financial markets in context. As a result many areas of importance have had to be omitted, or not given true prominence. A reader wishing for a rigorous discussion of issues in international finance should consult one of the many excellent books on the subject.

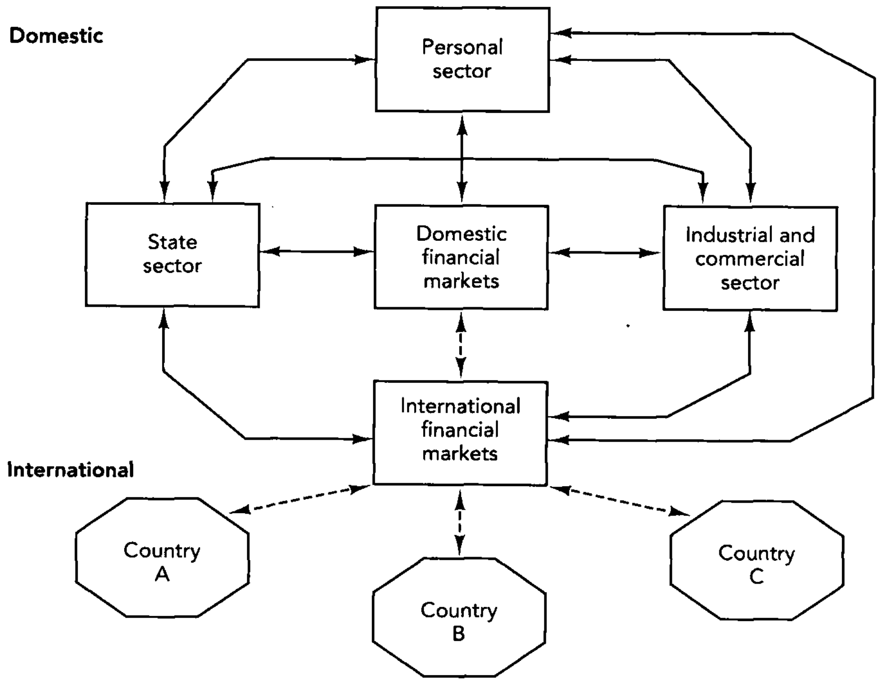

Figure 1. Flow of funds and financial markets

instruments or claims directly to surplus units, usually with the help of institutions which act to facilitate transactions. Or if they are lending, what sorts of claims and promises from borrowers or intermediary institutions are they prepared to accept? To obtain a basic understanding of the different nature of these claims, see **equity, debt, instrument**, and **loans**, and for an example of how the lender–borrower relationship is priced, see the **term structure of interest rates**. From a market perspective, perhaps the most important part of this lender–borrower relationship is how these financial claims are priced or valued. Moreover, participants are exposed to changes in value as market prices change and seek to know and benefit from or protect themselves from these changes in the relative valuation of assets over time and under varying economic conditions.

The different categories of financial instrument within this flow of funds are linked with a common concern about money and how it circulates (e.g. between the personal sector and private sector industrial and commercial **companies**). This is done in such a way as to satisfy the functions of **money**. These functions reflect the ability of particular forms of money (e.g. gold pieces, notes, coins, and credit cards) to: act as a payment in settlement of a transaction or debt; act as a unit of account; and act as a store of value. Different economies, and therefore the markets located within individual countries, have used differing institutional arrangements in an attempt to ensure a smooth flow of funds between sectors. Differences in culture and country specific requirements also help explain why a variety of financial markets and agents have emerged. Collectively, this array of disparate markets and institutions is often referred to as the international monetary system. Within this system, we can distinguish basic functional categories such as the **capital markets**, the **money markets**, the **currency markets** or **foreign exchange markets**, and the **commodities** markets.[2] In order to assist in the flow of funds in the **cash markets** or the **physical markets**, markets in **contingent claims** have been developed. These **derivative** markets have emerged to manage and transfer the various risks inherent from financial exposures.[3]

Within a single country or economic system, individual arrangements are normally associated with specific customs and practices. For example, the **London Stock Exchange** and the **Bank of England** for the UK are at the core of the **City**, and the **New York Stock Exchange** and the **Federal Reserve** for the USA make up **Wall Street**. When combined, these markets and institutions provide the basis for the creation of a domestic financial system, within which **financial institutions** operate. As well as existing to fulfil the functions of money, these systems provide a valuation for financial assets (or equivalently, the required rate of return), markets in which such claims may be traded, and efficiencies that reduce transaction costs. These aspects of the flow of funds reveal the **opportunity costs** of using money in one way, rather than another, and the relative values of different assets, and the choice of instruments, thus effecting the process of saving and investing. One important function of markets is **price discovery**, where the continual revaluation process provides signals to economic agents as to how funds should be allocated to financial assets and, as a result, helps in the efficient allocation of resources.

At the heart of the domestic financial systems that go to make up the global system are **financial institutions**. They help ensure that the flow of funds works in an efficient manner. Their role is to act either as facilitators or intermediators (or occasionally both). Facilitators help smooth transactions between surplus units and deficit units. They help structure, sell, advise, and generally assist in completing transactions for borrowers and lenders. Intermediators have a more complex function in that they transform claims from borrowers in ways that make them more attractive to lenders. For example, they attempt to overcome situations where more wish to borrow than wish to lend; such a situation is often called a **liquidity** crisis. Where the reverse situation arises, a market could be described as being over-funded. Financial institutions exist in part to reconcile such imbalances, which can

[2] Commodities are in principle a separate factor of production, being consumption assets. However, they share some characteristics with money and financial assets, notably that trading in major commodities is carried out on organized exchanges and commodities are treated as an investment class. One only has to look at the financial pages of a newspaper to see that the gold and crude oil price are placed alongside the stock market indicators, the cost of money, and exchange rates.

[3] It is interesting to note the growth of derivatives as a transfer mechanism and their absolute necessity as an overlay to the cash markets. In those countries that have recently made the transition from a command to a market economy, the financial sector has started with the establishment of a stock exchange and a debt market, but then have moved rapidly to establish derivatives markets.

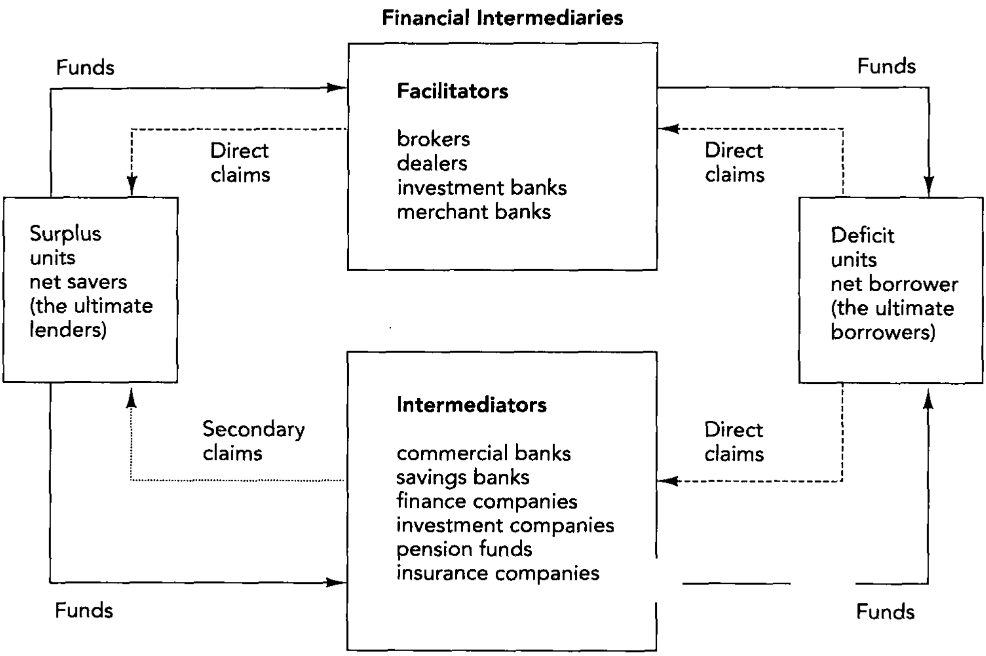

Figure 2. Flow of funds II—the role of financial intermediaries

be caused by the straightforward timing differences in the availability of funds from lending units and the demand for funds from borrowing units. The imbalance in the demand and supply of loanable funds can also be as a result of the **mismatch** in the quality of potential borrowers, and the expectation of lenders. Hence, the importance of **credit ratings** and the existence of **quality spreads**. In such cases, financial institutions may act on behalf of borrowers and lenders in markets, using their name and resources to overcome such difficulties. This process is referred to as financial **intermediation**.

A more familiar transaction might involve a financial institution, such as a **bank, building society, savings and loan association**, or a **savings bank**. Depositors place funds into a bank in return for a promise to repay the amount on demand, a rate of interest, and the provision of certain services, such as a **current** or **checking accounts**. In order to justify paying interest and providing services, the bank must make its deposits work in some profitable way. One way would be for the bank to lend money to a business in order to enable it to invest in, say, new products. The bank will charge **interest** on the loan at a rate above that paid to the depositor; this difference in interest rates is called the **margin**. Margins in general reflect the perceived **risk** associated with the **debtor** firm. The amount at risk or **exposure** can, in part, be offset by the bank accepting a claim on the firm's assets via a **lien** which can be exercised if the firm fails to meet the interest charges, or fails to repay the original sum borrowed, the **principal**. When assets are pledged in this manner, the loan would be called a **secured loan**. Negotiable claims upon a borrower which are transferable to third parties are known as **securities**.[4] A situation in which a borrower breaks some or all of the borrowing terms attached to the debt is usually called **default**. What happens thereafter will depend upon the precise terms of the loan agreement and certain provisions within that contract called **covenants**.

Although financial intermediation is carried out in a variety of different ways, there are many shared characteristics, especially in relation to the overall structure of the markets in which they operate, and the products and services that they issue, offer, and trade. Intermediators provide surplus units with immediate **diversification** and the benefits from the pooling of deposits and the creation of **portfolios**.[5] Correctly undertaken, diversification reduces risks and therefore the required return to lenders. Facilitators do not lend directly but assist in finding investors, in structuring the resultant transactions, and, in many cases, in providing a secondary market where existing claims can be transferred between surplus units. Since the requirements of borrowers and lenders do diverge radically, the ability to resell financial claims in the market is of paramount importance. Facilitating institutions, known variously as **agents**, **brokers**, **broker-dealers**, **dealers**, or **traders** (for example, **stockbrokers** who handle various kinds of stocks, or commodity brokers who specialize in commodities markets) act to match up buyers and sellers. Trading in financial assets is either arranged through an **organized exchange** or is carried in the **over-the-counter** (OTC) markets.

Financial markets involve financial claims based either on borrowing and lending or represent ownership rights (these two categories of claims are shown at the top of Figure 3). Differences in these contractual positions lead to **debt** claims which have known monetary or contractual payoffs or various types of **equity** or **share capital** where the payoffs involve varying degrees of participation in the profits or value of the firm, asset, or instrument. Debt instruments may be either provided by intermediating institutions when it is usually non-negotiable (variously known as **loans**, **advances**, or **credit facilities**) or issued directly to lenders as transferable **securities**. These money claims may also vary according to factors such as the frequency and type of interest payments, their repayment date or **maturity**, and the type of contract. Such claims can be also backed by physical assets, as with **asset-backed** or **mortgage-backed securities**, or the borrower's **credit worthiness**. The credit worthiness, credit standing, or financial solidity is effectively a promise to repay based on the current and future **cash flow** or **earnings** of the issuer, or a third-party **guarantor**. There are also **hybrid** instruments which combine features of

[4] **Securitization**, one of the major trends of the capital markets, involves the substitution of negotiable claims for bilateral contracts. As such, it has led to a number of intermediate stage instruments, such as **sub-participation of loans**, or asset sales where the legal basis is still a loan, but the lender's rights can be transferred.

[5] It should be noted that they also provide administrative services, such as valuation, payment, money transfer, and so on.

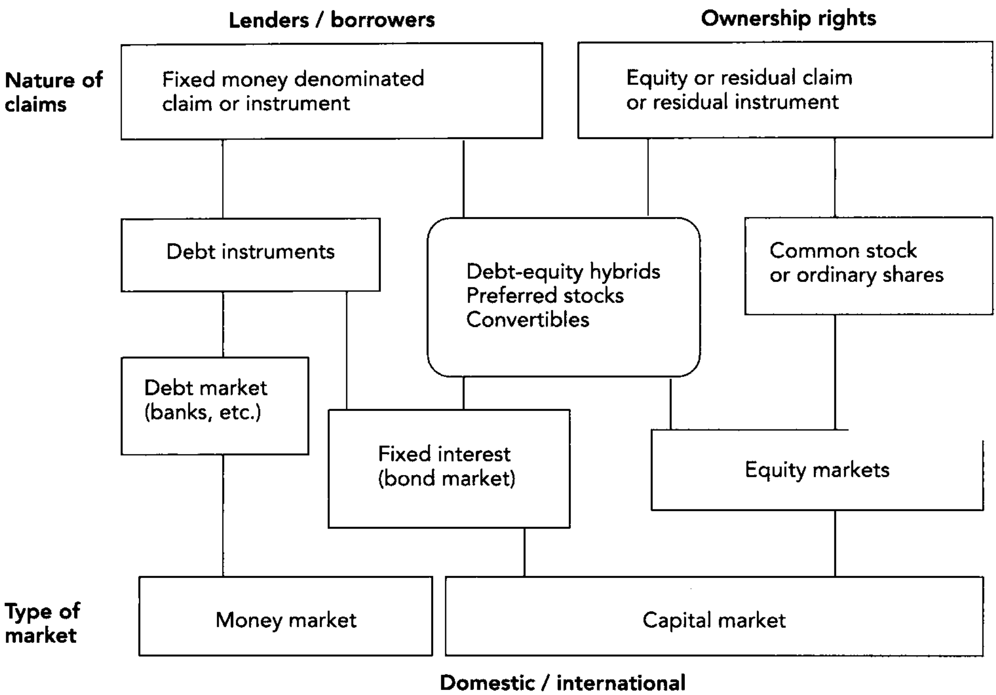

Figure 3. Classification of financial markets by type

more than one class of claim, such as **convertibles**. The equity of a firm comes in various forms, including: **common stock** or **ordinary shares**, alternatively known as **equities**; and **preferred stock** or **preference shares**. These differ according to factors such as contracted or expected **dividends**, **capital appreciation**, and their priority and share of assets in **liquidation** or when sold.

The financial markets are also characterized by the **maturity** of the claims being traded. The **money markets** involve transactions where the financial claims are typically of twelve months or less in maturity, or **duration**. Money markets trade, for example, **banker's acceptances**, **certificates of deposit**, **commercial paper**, **treasury bills**, **bills of exchange**, **loan notes**, **repurchase agreements**, **foreign exchange**, and, internationally, **eurocurrencies**. Where the time involved exceeds one year, or thereabouts, the transactions are grouped under the heading of **capital markets**. These provide **new issue** and **secondary markets** in both **fixed income** (or **notes** and **bonds**) and in **equities**. It is rare (but not unknown) for the **bond markets** to trade fixed claims beyond thirty years until **maturity**.[6] Many financial institutions

[6] Government bond markets in the USA and the UK offer 30-year bonds; those of France, Germany, and Japan tend to have shorter, 10-year maturities, although longer-dated issues exist. On the whole, corporate bonds tend not to exceed the maturity of the government debt markets in the country of issue.

are participants in more than one type of market, although individual organizations may specialize in particular instruments, sectors, or classes. The rationale for the existence of different instruments is to provide the most appropriate means to meet the requirements of those needing to satisfy **liabilities** in the near or distant future, and to appeal to those with funds available over a roughly equal period. The surge in financial innovation, in the form of new instruments, derivatives, and trading methods, has been a direct response to questions of **asset-liability management** and gaps in the available instruments. These gaps come about due to, amongst other factors, legal and regulatory constraints, unfavourable or undesirable risk-reward characteristics, and taxes.[7] Innovations which address a wide economic need can themselves become established instruments (for example, **interest rate swaps** and **cross-currency swaps** which were developed in the early 1980s have become established as a fourth type of derivative); other innovations, which address more specific economic or individual requirements, have been seven-day wonders.[8]

The financial markets in which these claims are traded operate either to recycle existing claims between surplus units in the **secondary market** with the help of financial institutions or by creating new claims or **new issues** via the **primary market** (see Figure 4). An **initial public offering** (IPO) is one of the ways a company can first offer its shares to a wide range of investors. Once the company has received its funds in exchange for its shares, they become **listed** or **quoted** on an exchange and can be bought and sold in what is termed the **secondary** or **after-market**. Investors, or more correctly **speculators**, that anticipate an increase in the value of shares between the time that they are first issued, and when they are traded in the secondary market are called **stags** in the UK. The analogy to animals continues as market participants who are optimistic about future asset values are known as **bulls**; and those who are pessimistic are known as **bears**. Hence expressions such as 'the equities bull market of the early to mid-1980s'.

The formalities associated with organized stock markets can differ; for example, the London Stock Exchange has at the time of writing a **quote** or **price-driven** dealing system; whereas, the New York Stock Exchange (NYSE) is **order-driven** using **specialists** to handle the flow of **orders**. Moreover, the **Big Board** (NYSE) located on **Wall Street** maintains a physical **trading floor**, as compared to London's screen-based trading system. Derivatives exchanges have tended to favour **open outcry** in **pits** where **floor brokers**, supplemented by **locals**, provide a frenzied trading atmosphere shouting offers or signalling frantically between buyers and sellers. This results in differences in the way financial instruments are bought and sold, and the procedure for establishing the prices at which trades take place. Regardless of the technical methods used, these represent formal, or not so formal, **auction** systems designed to establish the market (or fair) price to both buyer and seller, and are as a result, therefore, often referred to as a **double-auction** process. The

[7] At the operational level, the key role of information technology as a means of processing ever larger volumes of data should not be underestimated.

[8] For instance, the **leveraged swap** and the **wedding band swap** do not appear to have become established as a new type of instrument.

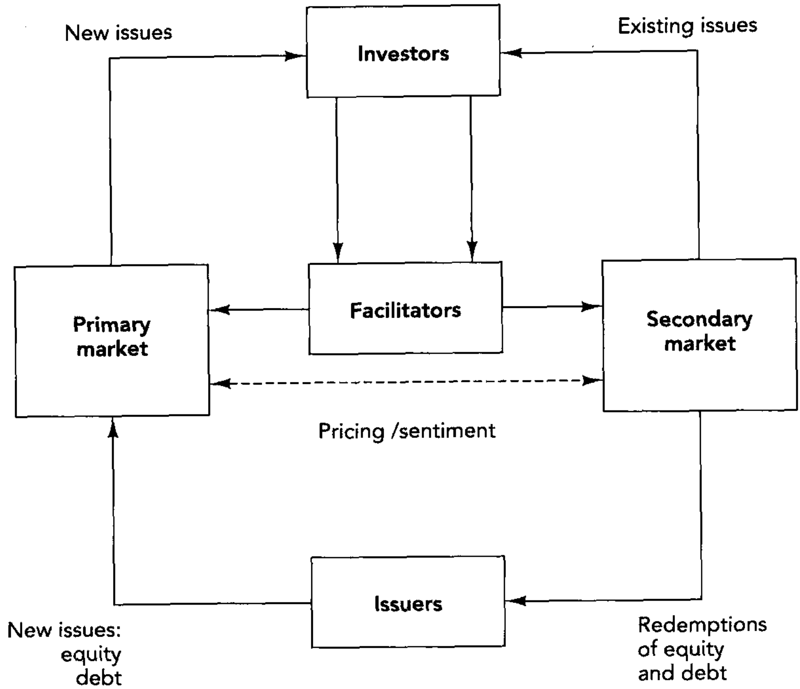

Figure 4. Primary and secondary markets

two-way prices provided by intermediaries comprise both **bid** and **offer** quotes. The market price can be established by **specialists** whose function is to smooth transactions and in so doing may trade on behalf of themselves and also operate a **book** in which customers' unexecuted orders are maintained. Alternatively, markets allow in a **dual capacity** under which **intermediaries** can act either **principal**, or **agent**, or both. The names given to **traders** and instruments may also differ; for example, in the USA, shorter-term company debt issues are called **commercial paper**, and in the UK the same sort of issue would be called commercial **bills**.

As a result of the nature of their claims, equity and bond markets have a separate identity within the capital markets and they often have distinct dealing and settlement systems. This, in turn, has produced specialist traders and specific methods for assessing each market. Another difference is the importance of government issues in the bond markets which act as a **benchmark** for the pricing and **terms and conditions** of non-government debt issues. When large amounts of debt are sought by governments **auctions** or **tenders** are used. For other issuers, several financial intermediaries may act together to establish the basis of the funding under an arrangement called **syndication**. Such a process may well include the introduction of additional parties to provide **underwriting** or **distribution** capabilities based on the intermediary's **placing power**. In the international markets, the **eurobond market** is now the principal source of cross-border, debt-based transactions rather than **foreign bonds** in domestic markets. A recent innovation has been the introduction of **global** debt issues and equity offerings where the securities are distributed and traded both internationally and in the major domestic markets.

Financial institutions such as **investment banks**, **commercial banks**, or **money center banks** perform functions and offer products and services that are recognizable around the world. The differences emerge with regard to their specialized functions and often unique solutions to particular operations demanded by the individual domestic financial and regulatory systems. For example, the UK has particular money market institutions known as **discount houses** and **accepting houses**. The capital markets in the UK are dominated by the **London Stock Exchange** for both equities and bonds while the **London International Financial Futures and Options Exchange** (LIFFE) handles **exchange-traded** derivatives. The financial services sector includes institutions which are **financial conglomerates** or **universal banks**, **securities houses**, often with specialist in-house **investment banks**, **merchant banks**, **investing institutions**, and **international banks**. Serving the domestic and international markets are a number of specialized institutions such as **leasing** companies, **finance houses**, and **venture capital** firms. The extent to which these businesses are carried out by separate institutions has been eroded by the emergence of **financial conglomerates**, **universal banks**, or **allfinanz**. The trend towards **globalization** has ensured that in the world's three main financial markets, of New York, Tokyo, and London, the same relatively small number of world-class **bulge bracket** financial institutions can be found, together with a larger number of specialized, **boutique**, national, or regional institutions that undertake similar functions.

The operations of these markets are divided into three core businesses: banking, investment, and insurance. The banking industry can take several different forms, as previously mentioned, and is influenced by regulatory and legal restrictions, such as the **Glass–Stegal Act** in the USA, and by a desire for individual institutions to be differentiated in order to gain comparative advantage. The differences between, say, commercial banks and investment banks are most visible when comparing the products and services offered, which reflects how they generate **earnings**. Clearing banks which accept **deposits** and create **loans** and **credit** do so in return for a **margin**; whereas investment banks offer more specialized products and services for which they receive fees and **commissions**. Commercial banking is therefore often considered a **spread**-driven, relationship business, as compared to the fee-driven, **transaction**-orientated investment banking business.[9] **Universal banks** that operate in both businesses have, therefore, opportunities for the cross-selling of services. For individuals, the merging of, insurance, investments, and banking has led to the idea of **bancassurance**, the one-stop provider of all customers' retail financial services needs. For the wealthy individual, the **private bank** provides a personalized full range of services.

[9] This simplistic asset-building intermediation versus transaction facilitating distinction ignores the increasing fee-based activities of commercial banks.

Commercial banks prosper and grow according to how well they attract deposits, using interest rates, product diversity, convenient location, and quality of service. Simultaneously, they must be prudent in creating credit and accepting lending opportunities based on **credit worthiness, credit rating**, or **credit scoring**. Investment banks thrive by increasing the number and size of transactions, selling financial products, and providing advice to firms and governments. Examples of the sort of help on offer include: valuation; drawing up a **prospectus** which accompanies a share or debt issue; and producing an **offer document** in pursuit of a corporate **merger** or **acquisition**; and structuring the finance in a **project**. Investment bankers not only offer advice about the timing and pricing of proposed transactions, they can be essential in arranging the financing of the deal. This would be the case in transactions called **leveraged buy-outs** or LBOs. In addition to such single-purpose deals, investment banks offer a range of ongoing dealing and advisory services that are aimed at the **chief financial officer** and treasury departments of larger firms. These products include tailor-made: **options, caps, floors and collars, forward rate agreements, interest rate swaps, foreign exchange transactions and cross-currency swaps, swaptions, commercial paper, banker's acceptances, medium-term notes, floating rates notes** and **repurchase agreements**, and **commodity swaps**.

The rationale for many of these relatively complex financial arrangements give them special appeal to large, multinational organizations because they are likely to be exposed to significant **interest rate risk** and **currency risk**. These, and other, sources of risk need to be managed or **hedged**, otherwise changes in the **macro-economic** factors outside the control of the individual organization may cause otherwise profitable operations to be uneconomic. The mechanism by which firms and banks get together to do deals, or put in place **risk management** strategies, is not provided by a formal and recognizable market-place (as is the case with the buying and selling of equities). Instead, it is based on institutional reputation. How such reputations are established often appears unclear, although past success with similar transactions seems to be important. It is common for particular departments within institutions to be known for certain things, for example, correctly analysing stock market sentiment, or accurately predicting trends in economic variables like inflation, and growth rates. Such activities rely extensively on **forecasting** techniques based on **models**. This may help explain why the representatives of such institutions participate in television and radio programmes and are regarded as 'experts'.

Risk is central to financial markets, it arises either from the nature of the contract, as it does with **interest rate risk** if it is a debt claim, for instance, or the risk might arise from the **counterparty** on the other side, whose ability to perform their contractual obligation may be impaired. The relationship between the risks taken by investors, either surplus units or via financial institutions such as banks, and the returns that they expect is normally explained within something called the **risk-return trade-off** or **risk-reward**.

In other words, the way in which banks, for instance, price money is made according to how they view the relationship between the risk of the borrower and