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CHAPTER

1

The Money Merry-go-round

RAISON D'ÊTRE OF THE MARKETS

The beginning is always a good place to start. Let's go straight to the heart of the matter and ask the most fundamental question of all: What are financial markets *for*? What is their purpose? What is their *raison d'être*?

Financial markets are all about raising capital and matching those who want capital (borrowers) with those who have it (lenders). How do borrowers find lenders? With difficulty, clearly, but for the presence of intermediaries such as banks. Banks take deposits from those who have money to save and bundle the money up in various ways so that it can be lent to those who wish to borrow.

More complex transactions than a simple bank deposit require markets in which borrowers and their agents can meet lenders and their agents, and existing commitments to borrow or lend can be resold to other people. Stock exchanges are a good example. Companies raise money by selling shares to investors, and existing shares are freely bought and sold.

The money goes round and round, just like a carousel on a fairground (Table 1.1).

Lenders

Let's have a look at some of those who might be lenders.

Individuals

People may have savings in banks of various kinds. Individuals may not think of themselves as conscious savers but nevertheless pay monthly premiums to insurance companies and contributions to pensions. Regarding pensions, there are different traditions. The United States, the United Kingdom, the Netherlands, Switzerland and Japan have a strong tradition of pension funds and invest the money paid into either private pension plans or employers' pension schemes. In France, the state takes care of most pensions and pays them out of current taxation, not out of a fund. In Germany, company pensions are important, but the company decides on the investment, which may be in the company itself. Where pension funds exist, these funds, along with those of insurance companies, are key determinants of movements in the markets. Pension and insurance companies have to look ahead to long-term liabilities and will assist the borrowers of capital by buying government bonds (otherwise known as sovereign bonds), corporate bonds, corporate equities and so on. The shortage of such funds in many of the newly emerging economies was an important reason for the relatively slow growth of local securities markets in earlier years.

▼ **Table 1.1** *The money merry-go-round*

| Lenders | Intermediaries | Markets | Borrowers |
|----------------|-----------------------|------------------|---------------------|
| Individuals | Banks | Interbank | Individuals |
| Companies | Insurance companies | Equity market | Companies |
| | Pension funds | Money market | Central government |
| | Mutual funds | Bond market | Municipalities |
| | | Foreign exchange | Public corporations |

Companies

We think of commercial companies as borrowers of capital. However, even if a company is a borrower, if some of the money is not needed for a short period of time, the company will seek to make money by lending in the short-term markets, called money markets, that is, transactions of up to 1 year in duration.

There are also companies whose cash flow is strong and who tend to be lenders rather than borrowers.

Borrowers

Who, then, are the borrowers of capital?

Individuals

Individuals may have bank loans for domestic purchases or longer term mortgages to fund house purchases.

Companies

Companies need short-term money to fund cash flow. They need money for a longer term for growth and expansion.

Governments

Governments are typically voracious borrowers. Their expenditures exceed their receipts from taxes, so they borrow to make up the deficit. They may also borrow on behalf of municipalities, federal states, nationalized industries and public sector bodies, generally. The total is usually called the ‘public sector borrowing requirement’ (PSBR). The cumulative total for all the borrowing since a government started borrowing is called the ‘national debt’. The first surprise for many of us is that governments don’t pay off the national debt; it just gets bigger. If there are doubts about a country’s abilities to pay its debts – as in the case of Greece in 2011 – this can lead to a crisis. Of this, more in Chapters 3 and 10.

Municipalities and similar bodies

Apart from a government borrowing on behalf of various local authorities, these bodies may borrow in their own name. This would cover municipalities like Barcelona, counties in the UK, or federal states like Hesse in Germany.

Public corporations

These might include nationalized industries, like SNCF in France or the German railways and post office authorities, or general public sector bodies like Crédit Local de France or the German Unity Fund.

Within an economy, many of the above (individuals, companies and public corporations) will not be nationals, but foreigners, and therefore may need to borrow in foreign currency – this has implications for the foreign exchange market.

Securities

When the money is lent, it may simply be a deposit with a bank. Most of the time, however, the borrower will issue a receipt for the money, a promise to pay back. These pieces of paper are, in the most general sense, what we call ‘securities’. Unfortunately for the beginner, these have many different names – Treasury bills (T-bills), certificates of deposits (CDs), commercial paper (CP), bills of exchange, bonds, convertibles, debentures, preference shares, Eurobonds, floating rate notes (FRNs) and so on. At least we can console ourselves with the thought that they are essentially all the same – promises to pay back, which show key information:

- how much is owed,
- when it will be paid and
- the rate of interest to reward the lender.

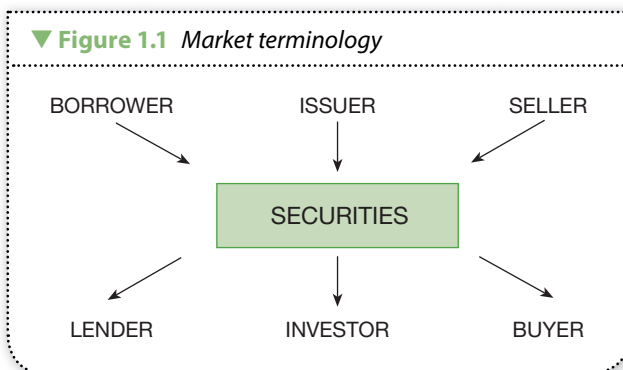
A major characteristic of the markets is that these securities are typically freely bought and sold. This makes life easier for the lender and helps the borrower to raise the money more easily.

For example, a young American wanting to save for old age spends \$5,000 on a 30-year government bond that has just been issued. After 5 years, he decides that this was not such a good idea and wants the money now. What does he do? He simply sells the bond to someone else. This is crucially important, as it means that he is more willing to put the money up in the first place, knowing that there is this escape clause. It also gives great velocity to the ‘money merry-go-round’, as the same security is bought and sold many times.

Let’s tackle the market jargon here. The first time the money is lent and changes hands, the first time the security is issued, is the *primary market*. All the buying and selling that takes place thereafter we call the *secondary market*. The secondary market is significant as the flexibility it gives makes the primary market work better – it’s the oil that helps the wheels turn round.

Let’s look at other terminology used (see Figure 1.1).

Suppose the government announces a new bond. We can say the government is *issuing* a new bond. We could just as easily say that the government is *selling* a new bond. We might see it as a sign of the government’s need to *borrow* more money. If you hear of the new bond, you may tell a friend that you’ve decided to *invest* in it. Alternatively, you might say that you’ve decided to *buy* the new bond. You probably won’t think of it that way, but you are effectively the *lender* of money to a government.



It may seem an obvious point, but all these terms might be used. Sometimes, newcomers need to be reminded that whoever buys a security is directly or indirectly lending money, unless it is equity.

RAISING CAPITAL

Let's look at an example outline in Box 1.1.

BOX 1.1

Examples of Raising Capital

Suppose a commercial company needs \$200m to finance building a new factory. We have just explained that the financial markets are all about the raising of money. What, then, are the choices?

Bank Loans

One obvious source of money when we need it is the bank. These days, when large sums of money are required, it may be a syndicate of banks in order to spread the risk. The banks take deposits lent to them and relend the money to the commercial company. It's their classic role as an intermediary. In the international syndicated bank lending market, based in London, the money will not be lent at a fixed rate, but at a variable rate, which changes from time to time according to market rates. This is called the floating rate. The banks may lend at a basic rate, such as the prime rate in the US or the interbank rate in Europe, plus a given margin, such as 0.75%. The bank will readjust the rate, say, every 3 months. The rate is fixed for 3 months but then changes for the next 3 months. Note that this creates *risk*. If rates fall, the lender loses income. If rates rise, the borrower pays more. Note, however, that in many European domestic markets, the banks' tradition is to lend to corporates at a fixed rate.

Bonds

Another choice would be to issue a bond. A bond is just a piece of paper stating the terms on which the money will be paid back. For example, it may be a 10-year bond, paying interest at 7% in two instalments per year. The word 'bond' implies that the rate of interest is fixed. If it's floating, then we have to find another name, such as floating rate note. The bond may be bought by a bank as another use for depositors' money, or it might be bought directly by an investor who sees the bond notice in the paper and instructs his agent to buy.

There is a strong obligation to meet the interest payments on the bond. If an interest payment is missed, the bondholders acquire certain rights and might even be able to put the company into liquidation.

Equity

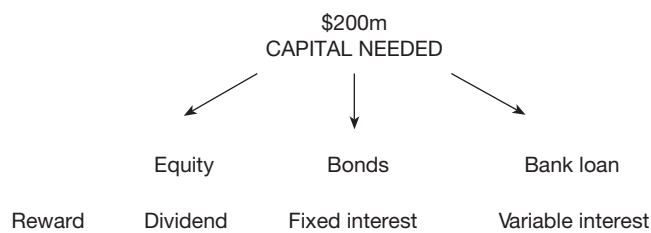
A final choice would be to raise the money by selling shares in the company. Shares are called *equity*. If it's the first time the company has done this, we call it a 'new issue'. If the company already has shareholders, it may approach them with the opportunity to buy more shares in the company, called a *rights issue*. This is because, under most but not

Examples of Raising Capital (*continued*)

all EU law, the existing shareholders must be approached first if any new shares are to be offered for cash. These rights are not protected as strongly in the US or in Germany.

The reward for the shareholders by way of income is the dividend. However, the income is usually poorer than that paid on a bond, and the shareholders look to capital gains as well, believing that the share price will go up as time goes by.

▼ **Figure 1.2** Raising capital



The three means of raising capital are shown in Figure 1.2. The way the world's financial assets have shifted between these methods over time is shown in Table 1.2, and the world's financial assets by market are shown in Table 1.3.

We must recognize that raising capital through equity is fundamentally different from the other two methods. The shareholder is part-owner along with the other shareholders. There is, therefore, no date for paying the money back (the shares may be sold on a stock

exchange to someone else, but that's quite different). The shareholders accept risk – they could prosper if the firm prospers, or lose some or all of their money if the firm goes into liquidation. If the latter sad event happens, the shareholders are the last to receive a share of any money left. In addition, if the firm hits trouble, the dividend can be cut or even missed altogether. However, if the company does this, the share price will usually fall – a reminder that, in issuing shares, the company generates a claim on its future earnings.

We should also note that capital raised by bank loans or issuing bonds is *loan* capital. That raised by issuing equity is known as share (or *equity*) capital.

In the case of bonds and bank loans, the money must eventually be paid back, and there are strong legal obligations to meet the interest payments – they are *debt*, not *equity*.

▼ **Table 1.2** Size of global financial assets

| | World \$ trillion | |
|------------------|-------------------|-------|
| | 2001 | 2013 |
| 1) Bank deposits | 79.0 | 93.2 |
| 2) Equities | 29.0 | 49.3 |
| 3) Bonds | 42.0 | 98.3 |
| Total (=1+2+3) | 150.0 | 240.8 |

Source: Data from Credit Suisse (2013) *Global Wealth Report* and own estimates.

Gearing/Leverage

There's nothing wrong in principle with borrowed money. It enables the company to do more trading than it could on the shareholders' equity alone. The danger comes when too much money is borrowed, especially if boom times are followed (as they usually are) by recession. The firm may be unable to pay the interest out of its reduced profits, quite apart from the problem of repaying the principal sum itself.

Stock market analysts, therefore, look at firms' balance sheets and look at the ratio of long-term debt to equity. However, let's note here that when we say 'equity', we don't just mean the money raised by selling shares originally and by subsequent rights issues.

▼ **Table 1.3** *The world's financial assets, by market*

| Market | Mid-2013 % |
|---------------|------------|
| Africa | 1.1 |
| Asia Pacific | 20.0 |
| China | 9.2 |
| Europe | 31.7 |
| India | 1.5 |
| Latin America | 3.8 |
| North America | 32.8 |
| WORLD | 100 |

Source: Data from Credit Suisse (2013) *Global Wealth Report*.

The firm (we hope) will make profits. Out of the profits, it will pay tax to the government and dividends to the shareholders. The remaining profit is retained for growth and expansion. This money also belongs to the shareholders. As a result, the term 'shareholders' funds' is used for the total equity of the shareholders:

$$\text{Original equity} + \text{Rights issues} + \text{Retained profit} = \text{Shareholders' funds}$$

Analysts, then, look at the ratio between the long-term debt and the shareholders' funds. This relationship is called *gearing* ('leverage' is the US term). The metaphor is from mechanics. A gear enables more work to be done with a given force. The lever is a similar idea. Remember Archimedes's saying 'Give me a fulcrum and I will lever the world'? The shareholders are doing more trading than they could with their money alone. How? By borrowing other people's money. The general idea behind gearing or leverage is to make a given sum of money go further. It can be summarized by the popular American expression 'more bang for your buck'. In this context, we do it by borrowing someone else's money. We shall also meet other contexts in this book.

The ratio between long-term debt and shareholders' funds is thus the gearing ratio. What ratio is safe? Frankly, this has become a matter of some controversy. Generally, people worry if the ratio reaches 100%, but that's only a crude guideline. For example, if the business is cyclical, analysts will worry more than if it is a steady business from one year to the next. They will also worry less if there are assets that can easily be realized rather than assets that may not be easy to dispose of, especially during a recession, for example property. In a low-interest-rate environment, corporate gearing will tend to increase – 2008 saw some companies flush with cash and not borrowing much (for instance, the FTSE 100 companies amassed £180bn in cash that year), although some firms availed themselves of the low interest rates, borrowing substantial amounts, especially for takeovers and private equity deals. At the end of 2008, the overall average gearing for the UK's top 100 companies was 38%. Of course, it is important to remember that since the onset of the credit crunch in 2007, the banks' ability to lend has been substantially curtailed, and markets have generally suffered a downturn.

Having looked at the three key choices for new capital – equity, bonds and bank loans – we should also be aware that, in Western financial markets generally, probably 50% of the money needed for growth and expansion comes from retained profits. 'Profit' can be a sensitive topic and, in some people's eyes, a pejorative term, for example 'they are only in it for the profit'. However, profit provides not only rewards for shareholders and taxes for governments, but funds for expansion, which create further employment and a more secure environment for the employees.

We shall look at the concept of international markets in Chapter 7. Briefly, we are talking about equity raised across national boundaries; bonds issued in, say, London in dollars and sold to international investors; and international banks getting together to syndicate a large loan. In addition to this, there is capital raised in purely domestic markets. Equity, bonds and large syndicated loans usually refer to long-term capital. There is also the raising of short-term capital for meeting cash flow needs rather than growth and expansion. Equity is not applicable here, but there are various securities and types of bank loan that meet this need.

International figures can be misleading, as the emphasis may be quite different in domestic markets. Each country has its own traditions. The US is a big market for company bonds, as well as a large equity market. German companies, however, have a long

tradition of close relationships with banks and the use of bank finance. Equity finance is strong in the UK, with a higher proportion of companies publicly quoted than in most other European countries.

CONCLUSION

We have seen that the *raison d'être* of the financial markets is the raising of capital. Our examination of the choices for finding capital shows us the financial markets in action and also the themes we study in this book, as shown in Box 1.2:

BOX 1.2

Book Content – What Is Ahead

Banking: In Chapters 2–5, we look at banking in all its aspects.

Regulation: Chapter 6 examines the role for regulation of the banking and financial sector, and highlights recent developments, particularly the reregulation of strategically important financial institutions (SIFIs).

Money and bond markets: In Chapter 7, we examine the domestic and international markets. We look at raising money for short term (money markets) and long term (bond markets).

Equities: Stock markets, brokers, market makers and institutions are explained in Chapter 8.

Hedge funds and private equity: Enormous funds are being invested in the markets today by these organizations, which is explained in Chapter 9.

Credit crisis: The credit crisis, which started with defaults in the US subprime market and culminated in the collapse of Lehman Brothers, the failure of large swathes of US, UK and other banking markets, and the resulting major state bailouts, are covered in detail in Chapter 10. We outline the causes of the crisis and the key events that occurred, noting features of the recent sovereign debt crisis and the ongoing policy response.

Foreign exchange: The international character of the markets today and gradual deregulation create strong demand for foreign currencies. This is considered in Chapter 11.

EMU: European Economic and Monetary Union and the introduction of the euro started on 1 January 1999 for 11 countries. This key development is discussed in Chapter 12, along with an overview of the role of the euro and characteristics of the recent eurozone crisis.

Derivative products: Interest rates, currency rates, bond prices and share prices fluctuate, creating risk. There are financial products that are, paradoxically, used to both exploit risk and control risk. These are called 'derivative products' and are, possibly, the fastest growing sector of the financial markets today. This complex but fascinating subject is looked at in Chapters 13–15.

Emerging and growth-leading economies: The role of various booming emerging economies is considered in Chapter 16. Particular focus is placed on the role of China and India, together with the increased influence of other emerging markets.

Key trends: Finally, in Chapter 17, we analyse the key trends in the financial markets today.

