**CHAPTER SUMMARIES**

CHAPTER 1 SUMMARY

* *Chapter 1 explains what financial markets are* for*? their purpose? and their raison d’être? The main features of money and capital markets are discussed.*
* Chapter 1 explains what financial markets are, their purpose and raison d’etre. The main features of money and capital markets are discussed.
* The purpose of the markets is to facilitate the raising of capital and match those who want capital (borrowers) with those who have it (lenders).
* Typically, the borrower issues a receipt promising to pay the lender back – these are securities and may be freely bought and sold.
* Money may be raised by a bank loan (commercial banking) or by the issue of a bond or equity (the capital markets). The first two represent debt. The relationship between debt and equity on a balance sheet is known as gearing.
* There are domestic markets and international (cross-border) markets.

**CHAPTER 2 BANKING BACKGROUND**

* Chapter 2 provides an introduction to banking business covering the historical evolution of the business right through to contemporary developments such as shadow banking. The chapter outlines the main banking institutions, terminology and regulatory factors impacting the banking business.
* Supervision of banks may be carried out by the central bank (as in the Netherlands and in the UK) or by other supervisory bodies (as in France, Germany, Japan and the US).
* Central banks, commercial banks and investment banks are the main types of bank. There are also savings banks, cooperative banks and mortgage banks but, with increasing deregulation, the differences are generally weakening. Finally, there are credit unions.
* Islamic banking is managing money in accordance with *Sharia* (Islamic) law.
* On a bank’s balance sheet, the *liabilities* are shareholders’ equity, deposits and borrowings. The *assets* are cash, money market deposits, securities, loans and fixed assets like buildings.
* The shareholders’ equity (including retained profits) is at the heart of the bank’s *capital*.
* Bank regulators have set up a committee (the *Basel Committee*), which lays down rules that suggest the capital required not only for the credit risk in bank lending but also the market risk of the financial instruments it holds and the operational risk inherent in a bank’s activities. The latest capital rules are stipulated in Basel III which will come into force in 2019. These rules are implanted into EU law via Capital Requirements Directives (CRDs) – CRD IV implements the features of Basel III into EU law in January 2014 and has the same 2019 full bank compliance date.
* The Second European Banking Directive allows banks in the EU to open branches anywhere in the EU under license from their *home* central bank.
* In an era where money is no longer tied to gold or silver, the ease with which a bank can advance money is called the *creation of credit*. It is limited by liquidity rules, capital ratio rules and central bank monetary policy.
* Excessive credit creation and lax monetary policy have been identified as major culprits of the recent credit crisis. Lax policy fuelled a mortgage lending boom, particularly subprime mortgages funded via securitization techniques, which led to a property price bubble in the US, the UK and elsewhere. When the bubble burst during 2007 and into 2008, banks that were heavily exposed to property lending (and investments in mortgage-backed securities) suffered losses. Banks’ capital strength and liquidity position came under investor and depositor scrutiny. The first bank to fail as a result of the crisis was the UK mortgage lender Northern Rock. There then followed a wave of collapses, the largest being RBS and Citigroup. The US, the UK and other European governments had to engage in providing massive financial support to save their banking systems. The system experienced its largest financial collapse since the Great Depression of the 1930s and states now play a major role in reconfiguring the world’s largest market-based economies. Since the crisis there have been massive moves to inject capital and liquidity into European and US banking systems. Pressures have mounted in the light of the eurozone crisis during 2011 and 2012, with substantial liquidity injections into the banking systems of Europe via the ECB, the US and the UK.
* The European Commission has set-out a roadmap for the creation of the European Banking Union, this establishes the **Single Supervisory Mechanism**(SSM) and a**Single Resolution Mechanism**(SRM) (dealing with the financing and restructuring of troubled institutions) for banks. It also establishes a single European Deposit Gurantee Scheme. The new regulator, will be the European Central Bank based in Frankfurt and will oversee all the largest banks operating in the 18 Eurozone countries (for the ten non-euro EU countries they can opt to join the new system). The main objective of the Banking Union is to break the link between weak banks and sovereign risk.

**CHAPTER 3 ROLE OF THE CENTRAL BANK**

* Chapter Three outlines the history, role and functions of central banks. The chapter covers recent contemporary monetary policy issues including Quantitative Easing (QE).
* Banco Central do Brazil, the Brazilian central bank, was established in 1964; the People’s Bank of China was founded in 1948; the Bank of France was founded in 1800; the Bundesbank in 1957; the Reserve Bank of India was founded in 1934; the Bank of Japan in 1885; the Central Bank of the Russian Federation (Bank of Russia) was established in 1990; the Bank of England in 1694, the Federal Reserve in 1913; and the European Central Bank in 1998. Worldwide, there are 160 central banks.
* Central bank activities include:

 -Supervision of the banking system: Here it will play a key role even if legally there is a separate supervisory body.

 -Monetary policy: This includes controlling interest rates and the money supply. The main monetary policies used focus on inflation targeting; price targeting; monetary aggregates; and foreign exchange rate targeting. The most common policy is inflation targeting.

 -Printing of banknotes and minting of coins: This must be linked to growth in the economy or inflation will follow.

 -Banker to the other banks: Domestic banks must leave sums of money with the central bank for various clearing and settlement systems. In some countries, for example the eurozone, the central bank imposes minimum reserves as part of monetary policy, although these do not apply in the UK.

 -Banker to the government: In raising money for the government, the central bank controls the account into which the money is paid. As taxes are paid, the government balance increases and the commercial banks’ balances fall. When the government spends money, the opposite happens.

 -Raising money for the government: This usually involves the sale of short-term T-bills and medium- to long-term government bonds. The cumulative sum of money owed for all borrowing not yet repaid is the national debt. It is usually shown as a percentage of GDP to see if the situation is worsening or improving. Over time, however, inflation erodes the burden of the debt. Debt burdens have increased dramatically as a consequence of the cost of financial system rescue packages resulting from the credit crisis.

 -Controlling the nation’s reserves: From time to time, central banks will buy or sell their country’s currency to influence the rate. If they buy it, they will use the nation’s reserves of gold and foreign currencies to do so.

 -Acting as LLR: Sometimes this refers to the rescue of banks in trouble but, more generally, it is the willingness of the central bank to assist banks with liquidity problems. Usually, this means their inability to meet the necessary balance levels at the central bank (as a direct result of central bank policy). The rate of interest involved in the transaction gives the central bank control over interest rates. While LLR actions were relatively uncommon prior to the credit crisis, they have become widespread since then, as central banks have had to inject billions into banks and economies overall to prop up failing banking systems, particularly in the UK and the US.

 -International liaison: This involves cooperation with bodies like the IMF, the World Bank and the BIS. It also involves supporting international meetings of the G7 and the G10. With the addition of Russia, the G7 is now the G8.

**CHAPTER 4 COMMERCIAL BANKING**

* Chapter 4 outlines the main features of commercial banking, covering both retail and wholesale banking activities.
* Commercial banks are in the classic business of accepting deposits and making loans. The business is both retail (the general public, shops and small businesses) and wholesale (other banks, corporates and institutions).
* Retail banking covers current accounts, cheque facilities, savings accounts, credit cards and loan facilities, like overdrafts, personal loans and mortgages. Increasingly, internet developments are leading to the spread of home banking.
* Clearing of payments may involve cheques or electronic payment systems. Cheques are expensive and banks have been trying to reduce their use through internet banking, the use of debit cards and, in some countries, e-money.
* Key issues in retail banking today relate to the need to raise capital and liquidity, executive pay, how to manage risks better, growing competition, cost control, sales of non-banking products and the use of IT. Growing links between banks and insurance companies have led to the term bancassurance.
* Wholesale banking covers bank lending to larger entities than those met in retail banking, and to activities described in other chapters – money markets and foreign exchange.
* Loans may be uncommitted or committed.Uncommitted facilities include overdrafts, lines of credit and bankers’ acceptances.Committed facilities include term loans, standby credit, revolving credit and project finance.
* Syndicated loansare common for large value domestic and cross-border business. There are arranging banks, co-managers, participating banks and agent banks.
* Various *fees* are involved – facility or front end fee, underwriting fees, agents fees and commitment fees. Finally, there is the loan margin.
* The loan agreement covers the amount of the loan, its purpose, draw down facilities, interest calculations and provisions.
* Among the provisions will be covenants. These are designed to protect the bank if the financial position of the borrower worsens. They include interest cover, net worth, total borrowing, gearing and current ratio.
* Other provisions cover *events of default*. There will also be a negative pledge – the client undertakes not to offer security against a loan from another party.
* A bank may assign or transfer part of the loan to another bank or it may be a less formal sub-participation.
* Falling profit margins on corporate loans have led many commercial banks into riskier lending. In addition, growing overlaps between wholesale banking and capital market activity through the trading of loans and related securitized products led to a boom in syndicated lending that peaked in 2007, and then collapsed with the onset of the credit crisis. Pricing has increased and maturities have shrunk. This increased overlap between banks and markets, and the wider range of services that could be offered, encouraged the largest commercial banks to become much more involved in investment banking, with disastrous consequences.

**CHAPTER 5 INVESTMENT BANKING**

* Chapter 5 provides an insight into the investment banking business
* Investment banking activities can be summarized as:

 -Accepting:This is putting the bank’s signature on a bill of exchange to give it a better credit quality. The bill of exchange is a promise to pay a trade debt. If the bank is on the central bank’s list for this purpose, the bill is a *bank bill*. Others are *trade bills*. The bill is frequently sold at a discount. Commercial banks will also accept bills, but historically, it is an investment bank activity.

 -Corporate finance:This covers new issues of equities and bonds, rights issues, mergers and acquisitions and research.

 -Securities trading:The trading includes money market instruments, equities, bonds and derivative products.

 -Investment management: The funds managed are those of high net worth individuals, corporates, mutual funds and (especially) pension funds.

 *-Loan arrangement:* While the bank may not lend the money, it may help to assemble a syndicate for large-scale financial products.

 *-Foreign exchange:* The large foreign exchange dealers are commercial banks but investment banks will still need to run a foreign exchange section.

* In the US, investment and commercial banks were separated by the *Glass- Steagall Act*, but actions by the Federal Reserve weakened its provisions, and the legislation was repealed in 1999.
* The old Japanese restrictions of *Article 65* of the Exchange and Securities Code regarding commercial banking, investment banking and insurance have been swept away.
* Across Europe, banks that carry out both commercial and investment banking are called *universal banks*.
* *Deregulation* encouraged commercial banks to become more involved in investment banking activity. Banks became much more reliant on securities market activity to generate income and this fuelled the securitization trend – particularly for mortgage-backed securities products. This, in turn, fuelled property prices, which encouraged more mortgage lending funded by the issuance of increasingly complex mortgage-backed securities (including collateralized debt obligations). When the crisis in the subprime market hit and property prices started to fall, the love affair between banks and securitization was over.
* Bear Stearns and Lehman Brothers failed in 2008, Merrill Lynch merged (also to avoid collapse) with Bank of America, and Goldman Sachs and Morgan Stanley converted into commercial banks in order to diversify their funding bases. The industry suffered its largest losses on record and has become subject to increased regulatory oversight that seeks to limit activities, including restrictions on proprietary trading (the so-called Volker rule) encompassed in the US Dodd-Frank 2010 Act, and ring-fencing of investment from retail banking as recommended by the UK’s Vickers Commission.
* Many of the firms involved in the asset securitization business – hedge funds, private equity firms, structured investment companies and money market funds – all fell outside traditional banking sector regulations and therefore could operate in an unregulated environment. This is now known as the shadow banking system that grew up in parallel with the securitization business.

**CHAPTER 6 REGULATION**

* Chapter 6 examines banking and financial sector regulation, particularly in the light of the global financial crises of 2007-8.
* The financial crisis and the sovereign debt crisis present serious challenges to the preservation of financial stability of the banking system and the eurozone itself.
* Large-scale banking rescues have raised serious concerns about the social and economic costs of *too big to fail* (TBTF) or ‘too systemically important to fail’.
* An important question for policy makers is whether limits should be placed on bank size, growth or concentration, to minimize the *moral hazard* concerns raised by banks having achieved TBTF or related status.
* Between 1970 and 2007, there were 124 systemic banking crises in 101 countries.
* Banking crises can have very large fiscal costs, for example Argentina, 75% of GDP; Chile, 36% of GDP; China, 18% of GDP; Korea, 31% of GDP; Indonesia, 57% of GDP; Mexico, 20% of GDP.
* There are three purposes of regulation: limiting monopoly power; safeguarding welfare; and dealing with externalities.
* *Asymmetric information* causes problems of moral hazard and adverse selection. When sellers of securities/borrowers know more than buyers/lenders about their own characteristics, it can result in *adverse selection*. The riskiest individuals/institutions will be the most eager to borrow, but lenders are aware of this and may not lend to low- and high-risk borrowers because they cannot distinguish between them.
* After borrowers receive funds, they know more than the lenders about their use of the funds, which produces moral hazard. The risk arises that borrowers take actions that harm lenders, which means that lenders may not lend because they cannot monitor borrowers effectively.
* Too big to fail is a problem if governments care more about the largest institutions, as banks have an incentive to become large and then take on too much risk.
* *Systemic risk* refers to all events capable of imperiling the stability of the banking and financial system.
* The main regulatory responses to the crisis have been the US *Dodd-Frank Act 2010*, recommendations made by the UK *Vickers Commission* in September 2011, *Basel III* (to be implemented by 2019), and, in Europe, the establishment of the *ESFS, EBA and Europen Banking Union*.
* European Banking Union aims to break the banking sector / sovereign debt (country finances) link – by providing broader support across the Eurozone (all Euro area government will stand behind a failing individual country’s banking system), supervision will be uniform, and resolution of poor performaing banks (how you restructure them or shut them in the event of a crisis) will become similar throughout the Euro area.
* As part of European banking Union, their will be a Single Supervisory Mechnaism, with the ECB as the main supervisor. It assumed supervisory responsibility in November 2014. Prior to this it under too a Comprehensive Assessment of the asset quality and capital strength of the Eurozones largest and/or systemically most important 130 banks. This comprise two parts, an Asset Quality Review (AQR) – looking at asset quality, and second, stress tests on bank capital strength. 25 banks failed the tests with a capital shortfall of €25bn, although only 12 had to raise more capital. The worst affected banks was the Italian Monte De Paschi di Siena (the worlds’ oldest bank founded in 1472!)
* All seek to recapitalize the banks, boost liquidity and constrain activity.
* Recent stress tests still reveal capital shortages in the banking sector, and more pessimistic scenarios regarding sovereign debt *haircuts* suggest that many European banks in particular will have to continue to keep on capital raising into the foreseeable future.
* An overhaul of current regulatory structures will inevitably continue to take place. New rules place a greater emphasis on: simple leverage and liquidity ratios; the curtailment of opaque business models; and minimizing the distortions caused by TBTF and/or SIFIs. A new supervisory architecture will gradually be put in place.

**CHAPTER 7 MONEY & BOND MARKETS**

* Chapter Seven examines the key features of money and bond markets.
* The rate of interest is the price of money. It varies with risk, maturity and liquidity. There is, finally, supply and demand.
* Bonds have a par or nominal value. They may sell at below or above par value and the resulting return to the investor is yield. If we ignore the profit or loss at redemption, it is interest yield. If we do not, it is gross redemption yield. As interest rates go up, bond prices go down and vice versa. This volatility is most marked for long-dated bonds. If the bond is sold before going ex dividend, the buyer pays accrued interest.
* *Credit ratings* (such as AAA or BB) are assigned to bonds to guide investors as to the risk and, hence, the necessary yield.
* Money markets cover transactions whose maturity is one year or less. They include:

 -Money at call and short notice: Liquid funds lent for very short periods.

 -Interbank market:The rate at which one bank will lend money to another is the offer rate for money, hence London Interbank Offered Rate (LIBOR) or Tokyo Interbank Offered Rate (TIBOR).

 -T-bills, local authority and public sector bills: These represent the short-term borrowing of these entities, say, 3, 6 and 12 months.

 -Certificates of deposit: Short-term borrowings by banks.

 -Commercial paper: Short-term borrowing of corporates, very big in the US.

 -Bills of exchange: Discussed in Chapter 5.

* Central banks control short-term interest rates using key rates such as Lombard rate, discount rate, repo rate and similar terms.
* Bonds are transactions in excess of one year. The face rate of interest is called the coupon and they may be short-, medium- or long-dated. They may be sold through an offer for sale or a private placing.
* Government and public sector bonds are usually the most important. Frequently, they are sold at monthly auctions on set dates to specialist dealers.
* Mortgage and other asset-backed bonds use the flows of interest and capital to back bond issues – these are asset-backed securities(ABS). Other terms used are collateralized mortgage obligations (CMO), commercial mortgage-backed securities(CMBS), covered bonds and structured bonds*.* The growth in structured products and other securitized instruments has been stratospheric since 2000, it peaked in 2006/07 and then activity collapsed. The growth of these instruments has been widely cited as the main cause of the property price boom and bust and the credit crisis that followed.
* Debentures (in the UK) are corporate bonds secured on assets.
* Convertibles are bonds that may be converted to another bond or equity. The right to buy equity later at a set price may be contained in an attached warrant.
* Preference shares usually pay the dividend as a fixed rate of interest. They are preferred to other shareholders for dividends and in the event of liquidation and are non-voting.
* Hybrid bonds have the characteristics of both bonds and equity, being perpetual, deeply subordinated and noncumulative. They are growing fast in popularity.
* Foreign bonds are those issued in the domestic market by non-residents.
* Junk bonds are bonds below investment grade, offering high yields.
* Islamic bonds are issued to conform with Islamic law and do not pay interest in the conventional way. They are known as sukuks.
* Internationalor euromarkets refer to primary market activity (loans, bonds or money market instruments) outside the domestic market of that currency, for example a dollar loan raised in London or a dollar bond issued in Singapore. London is the major centre for these activities.
* Coupon stripping refers to detaching the coupons from a bond and selling the principal and the coupons all separately. They are all now zero coupon bonds.
* Medium-term notes are flexible programmes for issuing paper in any currency, any maturity, any quantity and fixed or floating.
* Repos stand for sale and repurchase agreements. These are used either to borrow bonds for short positions or finance long positions.

**CHAPTER 8 EQUITY MARKETS**

* Chapter Eight presents a detailed insight into the main fetaures of global equity markets.
* Strictly speaking, *stocks* are fixed interest securities and shares are equities.
* *Share indices* are usually based on market capitalization and calculated every minute.
* In most economies, the major shareholders are investment institutions (pension funds, insurance companies and mutual funds) rather than private shareholders. The world’s ageing populations will lead to a growth in funded pensions.
* Mixed pools of shares are popular investments. They may be *closed-ended* (for example UK investment trusts) or *open-ended* (for example US mutual funds).
* *Order-driven dealing systems* are those where orders of buyers and sellers are matched. *Quote-driven systems* are those where market makersquote firm bid and offer prices. Hybrid systems, like New York, involve elements of both types.
* Dealers with *long* positions can lend stock to gain collateral to fund their position and those with *short* positions can borrow stock (offering collateral) to match their sales. This is *stock borrowing and lending*. Very large deals are *bought deals* or *block trades*.
* Sometimes firms buy their own shares back in order to cancel them and enhance dividends and earnings per share.
* Settlement systems are usually *rolling settlement*, although settlement of all deals in a given trading period still exists (for example France).
* With new issues, shares may be a *public offer for sale* (or *initial public offering*). The alternative is the *private placing*, although sometimes a mixture of both is used.
* An offer of more shares to existing shareholders is a *rights issue*.
* A *scrip issue* offers shareholders free shares and a *split* divides the par value of the existing shares. The objective in both cases is to lower the price to improve liquidity. A *consolidation* replaces a number of existing shares by one new one to enhance the price. A *scrip dividend* is an offer of shares instead of cash dividends (optional).
* As well as the normal market for shares, there may be a secondary market for newer companies who do not meet the requirements for a full listing. There may also be dealing outside the exchange – *over the counter* (*OTC*).
* When a firm goes public, we look at the relationship between the price of similar shares and the profit per share to guide us as to the correct offer price of the new share. This is the *price/earnings ratio* (*p/e*). We also look at the likely dividend as a percentage of the share price to calculate the *gross dividend yield*.
* To check if the latter is achieved by giving away all the profit, we compare the profit per share to the net dividend to calculate the *cover ratio*. Finally, analysts look at the *earnings per share*.
* The Markets in Financial Instruments Directive (MiFID) came into effect on 1 November 2007, and replaced the existing Investment Services Directive (ISD), introducing new rules for a wider range of EU investments firms, covering transparency of trades and increasing reporting requirements. It is being updated by MiFID II, which should come into force by late 2016 or early 2017 Investments firms also have to adhere to the EU Capital Adequacy Directive.
* In the US, the NYSE acquired Archipelago, the electronic exchange, and then Euronext, creating *NYSE Euronext*, which covered trading in New York and various European capital and derivatives markets. NYSE was acquired by Intercontinental Exchange (ICE) in November 2013 so now NYSE and Euronext operate as divisions of ICE. NASDAQ has merged with the AMEX and acquired Instinet, the electronic exchange.
* Over recent years, there has been rapid development of *dark pool* trading systems that allow the trading of large blocks of shares to be carried out away from the public, or order book of an exchange or other type of publicly available share trading platform. In Europe, there are 45 dark pools operated by either exchanges, smaller platforms such as Chi-X (commonly referred to as ‘multilateral trading facilities’) and independent operators, such as US-based Liquidnet.
* In general, the future for traditional exchanges is under threat from internet trading and the growth of *electronic communications networks* (ECNs).

**CHAPTER 9 HEDGE FUNDS & PRIVATE EQUITY**

* Chapter Nine outline important features of the hedge fund and private equity business.
* A *hedge fund* is an actively managed investment that seeks an attractive *absolute* return, that is, a return whether the market goes up or down. To achieve this, a wide variety of strategies are used, especially *short selling* of securities – the selling of borrowed assets in the hope of buying them back at a lower price.
* *Private equity* is a mixture of venture capital for early stage companies and management buyouts. The company that is bought out may be refloated on the stock market later to achieve a profit or sold to a trade buyer.
* Both activities seek to enhance profits by heavy borrowing, known as *leverage.*
* Hedge funds use a wide variety of strategies, many of them very complicated. They are similar to those used by the proprietary trading desks of investment bankers, but with much greater freedom for risk and leverage since the funds are not regulated in the way that investment bankers are. As a result, it is claimed that they often account for 30% to 40% of trading of bonds, equities, foreign exchange and credit derivatives.
* Around 9% of hedge funds closed in 2008 as a consequence of the economic slowdown and particularly the collapse of banks and their prime brokerage arms in late autumn. The industry’s reputation has also suffered from the collapse of the fraudulent Bernard Madoff investment firm that operated as a Ponzi scheme and embezzled $50bn from clients. The performance of the sector has improved modestly since then.
* The US Dodd Frank Act of 2010 introduced more regulations for the hedge fund industry. Funds with more than US$150 million in assets are to be registered with the SEC, and they have to disclose detailed information about their trading strategies and funds under management. Those with under $100 million have to register with state supervisors and offshore funds with more than US$25 million and if doing business with US clients also have to register. Part of the Dodd Frank legislation known as the "Volcker Rule," limits bank business with hedge funds and prohibits proprietary trading.
* In Europe, the 2010 EU’s Directive on Alternative Investment Fund Managers (AIFMD) requires hedge funds to be registered with their home regulatory authorities. It provides for a single passport, and also has new capital and leverage requirements. Rules on hedge funds are country specific and vary from one jurisdiction to another but they all have requirements on licensing, leverage, short-selling and report requirements.
* UK hedge funds have to obtain a license and are subject to regulation by the Financial Conduct Authority.
* Investors in hedge funds were originally high net worth individuals but now the various institutions are big investors – fund of funds, pension funds, banks, endowments and foundations.
* The investment institutions are also heavy investors in private equity companies. They have a disadvantage for private investors due to the inability to withdraw money quickly, as these companies will be prepared to wait three to five years for a return. There are, nevertheless, private equity investment trusts, private equity funds of funds and venture capital trusts. Private equity companies are so called because they are usually private companies as this gives them greater freedom of action.
* The high leverage used by private equity groups has drawn attention – up to as much as seven times profit before tax, interest, depreciation and amortization.
* Both hedge funds and private equity groups have attracted investment in view of the large profits apparently being achieved, with returns of the order of 20% p.a. being claimed. However, no academic studies have been able to verify high *average* profits over the whole range of activity. While there are, without doubt, spectacular successes, there are also many wind-ups and failures.

**CHAPTER 10 FINANCIAL CRISIS**

* Chapter Ten focuses on the causes and consequences of the global financial crisis.
* The *credit crisis* ran from June 2007 through to early 2009. The main causes of the crisis were macroeconomic and microeconomic.
* Macroeconomic causes included the build-up of global financial imbalances and low real interest rates. The latter fuelled a credit boom, especially in mortgage lending.
* *Microeconomic causes* were that consumers failed to understand the risks they were taking, managers of financial firms sought higher returns via increased leverage, compensation schemes were geared to encourage financial professionals to take on more risk, skewed incentives of credit rating agencies, and the substantial limitations in risk measurement, management and regulatory oversight.
* The BIS identified five stages of the crisis: *Stage 1* (June 2007 up to mid-March 2008) – losses in US subprime market starting in the summer of 2007; *Stage 2* (mid-March to mid-September 2008) – events leading up to the Lehman Brothers bankruptcy; *Stage 3* (15 September to late October 2008) – global loss of confidence; *Stage 4* (late October 2008 to mid-March 2009) – investors focus on the global economic downturn; and *Stage 5* (from mid-March 2009) – signs of stabilization.
* The rapid growth in *securitization* was a major cause of the crisis. This activity has had a major impact on the funding of residential property markets but also on the flexibility with which banks can manage their loan books. The collapse of subprime mortgage lending in the US and related securitized products is seen by many as the start of the credit crisis.
* Securitization involves the process where banks find borrowers, originate loans but then sell the loans (repackaged as securities) on to investors. This is known as the *originate-to-distribute* model in contrast to the traditional *originate and hold* approach.
* Securitization relates to the pooling of credit-risky assets, traditionally residential mortgage loans (but nowadays other types of credits such as car loans, credit card receivables or any credit generating some form of predictable cash flow), and their subsequent sale to an SPV, which then issues securities to finance the purchase of the assets.
* The securities issued by the SPV are usually fixed income instruments – known as MBSif backed by mortgages or ABS if backed by a variety of different types of loans – which are then sold to investors where the principal and interest depend on the cash flows produced by the pool of underlying financial assets.
* The first major securitization activity in the US was by the S&Ls that moved mortgage loans off their balance sheet and sold them on to investors. The *government-sponsored enterprises* (GSEs), such as Fannie Mae and Freddie Mac, were major operators in the US mortgage securitization business and they held an estimated $5 trillion in mortgage-backed securities by mid-2008 (federal authorities had to step in and bail them out in September 2008).
* *Subprime* refers to loans to higher risk borrowers – those that are not prime borrowers. Mortgage lending to subprime lenders grew rapidly from around $200bn in mid-2003 to more than $500bn by mid-2004, peaking at around $600bn in 2005/06. At this time, they accounted for about 20% of all new US residential mortgages. Around 80% of subprime mortgages were securitized.
* The attraction of subprime mortgage lending for banks was that it offered higher interest rates than prime mortgages – typically 2% more. The use of subprime loans in the underlying collateral allowed MBS and CDO packagers to enhance their profit margins while offering competitive returns on their securitizations.
* Most securities issued by SPVs were rated by credit rating agencies – S&P, Moody’s and Fitch – to make them more attractive to investors. While the credit quality of individual loans in the underlying pool of assets may be low, the credit quality (and therefore the credit rating) of the overall portfolio held in the SPV can be increased by pooling the portfolio of credit-risky assets so as to gain various diversification benefits.
* In addition, the risks of the portfolio could further be improved by *various credit enhancement techniques* such as *third-party guarantees* (insurance from *monoline insurers* to protect the value of assets), *overcollateralization* (holding a larger pool of assets than securities issued) and by something known as *excess spread* (originators, namely banks, inject cash into the SPV that will bear certain early losses). All the aforementioned practices, getting the ABS or MBS rated and the various credit enhancement techniques, were put in place to increase the attractiveness of the securities issued to investors.
* From early to mid-2007, a wave of defaults accumulated in the US subprime mortgage market and property prices began to fall. As the value of the collateral declined, investors realized that their investments were rapidly evaporating. Also, the complexity of the structures meant that it became well-nigh impossible to value the securities as it was also virtually impossible to accurately value the underlying collateral. Securities that had been rated as low risk and investment grade by the rating agencies became speculative and even unsaleable. This prompted the meltdown in the subprime (and other) mortgage-backed securities markets. Banks stopped lending to each other as they did not know the exposure of each other to securitized assets held on and off their books. The interbank market dried up and central banks had to inject short-term funding into the markets by the end of 2007. The situation was made more complex by a new wave of securitization including CDOs and asset-backed commercial paper (ABCP).
* At the end of 2008, Bloomberg reported that bank losses stemming from the meltdown in the US subprime market amounted to $744.6bn – Wachovia had the biggest loss of $96.5bn, followed by Citigroup with $67.2bn, and Merrill Lynch with $55.9bn.
* The credit crisis spread rapidly, having a particularly disastrous impact on the financial systems of the UK, Ireland and Iceland. No major European system was immune from its effects as banks failed or had to be supported via capital and liquidity injections. Japanese banks appeared less affected by the crisis than most, although they have had a poorly performing domestic economy to worry about for over a decade. Governments and various international organizations have *introduced major reforms to the financial system*, such as the Dodd-Frank Act in the US, covering the cleansing of bank balance sheets, increased capital and liquidity requirements, increased oversight and regulation of securitization business, hedge funds (as discussed in Chapter 9) and credit rating agencies.

**CHAPTER 11 FOREIGN EXCHANGE**

* Chapter Eleven examines the features of the foreign exchange (FX) market
* The foreign exchange market is huge, trading $5,345bn ($5.3 trillion) a day in 2013, with London the biggest market.
* The demand for foreign exchange arises from trade, tourism, government spending, international security trading and speculation.
* Interbank business in London accounts for over two-thirds of the market by value and the top 5 banks dominate.
* One economic theory for explaining exchange rates is purchasing power parity (PPP). Pricing the same basket of goods in two countries should result in the exchange rate. If a country consistently has higher inflation than another, its currency will tend to weaken compared with that of the country with lower inflation. The high inflation country will have to offer higher interest rates to persuade non-nationals to hold its currency. The theory that investors will shift assets according to factors like these is the portfolio balance model.
* The postwar period of fixed exchange rates was agreed at a meeting at Bretton Woods in 1944. This also set up the IMF and the World Bank.
* Foreign exchange risk for corporates has three elements – transaction risk, translation risk and economic risk.
* Spot rates are today’s exchange rates with settlement in two days. Forward rates are fixed rates for a transaction at a later date. They are determined by the difference in interest rates in the two currencies concerned. Worldwide, 42%% of deals by the volume of turnover are FX swaps, 38% spot and 13% forwards .
* The forward rate, being fixed, protects against the currency moving to the buyer’s/seller’s disadvantage, but they cannot benefit if it moves in their favour. This can be achieved by currency options. Options can be dealt on an exchange or over the counter (OTC).
* Foreign exchange quotations are shown as a bid/offer rate. The dollar lies at the heart of foreign exchange dealing, as most transactions involve moving in and out of the dollar. Sterling and currencies that were linked to sterling quote so many dollars to the domestic currency. Other currencies quote a quantity of that currency to the dollar. A rate between two currencies, neither of them the dollar, is called a cross-rate.
* The purchase of a currency spot accompanied by its simultaneous sale forward is the foreign exchange swap.
* Brokers are active and link buyers and sellers on an anonymous basis. Electronic broking systems like Reuters and EBS’s spot matching systems are widely used.
* A bank’s foreign currency holdings with banks abroad are its nostro accounts. The foreign banks’ balances with it in the domestic currency are vostro accounts.

*Multilateral netting* is now used to reduce settlement risk and the main system is CLS, which settled $2 trillion daily transactions in August 2013. Recorded daily settlements in value terms was on 19 March 2008 when 1,113,464 payment instructions were settled to a value of $10.3 trillion.

* Arbitrage is taking advantage of an anomaly in rates to make risk-free profit.
* Central banks carry out a foreign exchange survey every three years (2013 was the last occasion), with the results coordinated by the BIS.

**CHAPTER 12 EUROPE & THE EUROZONE**

* Chapter 12 focuses on the evolution of the Eurozone, highlighting EU regulatory developments particularly in the financial services area. The chapter also covers the 2011 (onwards) Eurozone sovereign debt crisis.
* The origins of the EU as it is today lie in the European Coal and Steel Community in 1952, a pooling of coal and steel resources in Belgium, France, Italy, Luxembourg, the Netherlands and West Germany. These six countries signed the Treaty of Rome in 1957 and began the concept of a common market and the European Economic Community. The motives were economic and political.
* Enlargement of membership came later with the addition of Denmark, Ireland and the UK in 1973, Greece in 1981, Spain and Portugal in 1986, Austria, Finland and Sweden in 1995, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia in 2004, Bulgaria and Romania in 2007 and Croatia in 2013
* The Single European Act of 1987 (which came into force in January 1993) aimed to eliminate all final barriers to trade within Europe, and to establish a genuinely efficient and competitive single market.
* The European Economic Community (EEC) had already been shortened to European Community (EC). With the Single European Act, it became the European Union (EU).
* The first moves to a single currency and monetary union were suggested in the Werner Report of 1970, proposing a single currency by 1980. Upheaval in the 1970s (the collapse of Bretton Woods and oil price inflation) prevented any progress.
* The next move was the European Monetary System in 1979. This set up the use of the ECU as a common unit of accountancy, and also the Exchange Rate Mechanism (ERM) tying currencies to bands around a target rate against other currencies. The bands were ± 2.25% or ± 6%. By the end of 1990, 11 of Europe’s 12 countries were members of the ERM.
* Attacks on currencies in the ERM in 1992 and 1993 led to a revision of the band to ± 15% (except for the guilder/deutschmark rate, which remained at ± 2.25 %).
* In 1989, a report by Jacques Delors, the Commission president, set out steps towards economic and monetary union. The Maastricht Treaty laid down convergence conditions, the setting up of a European Monetary Institute (EMI) in 1994 to precede the European Central Bank and the possibility of Economic and Monetary Union (EMU) beginning in 1999. It was later decided to call the new currency the euro.
* Following detailed plans laid down by the EMI, economic and monetary union began on 1 January 1999. Initially, the euro was used for interbank and other wholesale purposes, with notes and coins following on 1 January, 2002. In the meantime, the relevant currencies were locked together in fixed exchange rates.
* Eleven countries joined the new system in 1999 – Austria, Belgium, Finland, France, Ireland, Italy, Germany, Luxembourg, the Netherlands, Portugal and Spain. This left Greece, Sweden, the UK and Denmark outside. Greece joined in 2001. Membership expanded to the current 18 countries; Slovenia (joined on 31 December 2006), Cyprus (1 January 2008), Malta (1 January 2008), Slovakia (1 January 2009), Estonia (1 January 2011) and Latvia (1 January 2014)
* The European Central Bank (ECB) began operations in June 1998. It has six executive members who form the executive board. They meet with the 18 governors of the member states to form the governing council. This grouping of the ECB together with the 18 governors is usually called the European System of Central Banks (ESCB). However, the ECB has pointed out that legally this includes the governors of the non-EMU states, even though they play no part. It prefers to use the name Eurosystem.
* To prevent excessive budget deficits, there is a Stability and Growth Pact, which limits budget deficits to a maximum of 3% in relation to GDP, although over time, at least half of the member countries in the eurozone have exceeded the limit. It now has little credibility in the light of the eurozone crisis.
* Those countries wishing to join EMU are expected to have spent two years in the successor to the ERM, known as ERM II.

The EU economy is larger than the US in PPP terms with a GDP of €12.9 trillion compared to €11.8 trillion, respectively.

* According to IMF figures for 2013, the EU now accounts for 23% of global GDP compared with around 22% for the US. Within the eurozone itself, the market is dominated by Germany, France and Italy, who together account for 66% of the total GDP – Germany alone accounts for 29%. In contrast, China’s nominal GDP stood at over $9.5 trillion in 2013, making it the second largest single country economy after the US (nominal GDP of $16.8 trillion)$.
* The new interbank payment and settlement system for the euro is TARGET2.
* The objective of EMU is to produce a range of benefits:
	+ price transparency leading to more competition
	+ a logical completion of the move towards a single competitive market
	+ a saving in foreign currency transactions
	+ a reduction of the cost of capital through more efficient capital markets – bonds, equities and derivatives
	+ more integrated retail and wholesale banking systems.
* Critics, however, point to the problems of a ‘one size fits all’ policy in interest rates and currencies:
	+ differences in business cycles
	+ the strains on fiscal policy that will emerge
	+ the lack of labour mobility
	+ some weaknesses in the structure of the ECB
	+ the fact that full price transparency will not exist due to tax differences and weakness in Europe due to high social costs, inflexible labour markets and a large public sector.
* The major EU country not in EMU is the UK. Prior to the eurozone crisis, those in the UK who wished to join:
	+ wanted to continue to encourage foreign investment in the UK
	+ wanted to enjoy lower forex costs
	+ wanted greater stability of the currency
	+ believed that the UK outside would lose influence and the City of London lose ground to Frankfurt.
* Those who disagree believe that:
	+ the threat to foreign investment is exaggerated
	+ the lower forex costs are modest compared to the total picture
	+ there will still be currency instability against the dollar, yen and Swiss franc
	+ the London dominance in financial markets will not be affected
	+ the UK will suffer from the ‘one size fits all’ policy and fear greater political integration.
* The European/eurozone sovereign debt crisis relates to the financial crisis faced by various countries concerning their inability to finance their spending due to their excessive levels of previous borrowings. The crisis emerged during 2009 as a consequence of the increased debt levels (partly because of banking system bailouts in 2007/08) and also because of the downgrading of various government debt by the rating agencies which made new borrowing and the financing of existing debt more expensive.
* Countries in the eurozone have been most affected, namely Greece, Ireland and Portugal, and there has been a wave of rescue packages coordinated by the European Commission, ECB and IMF aimed at stemming the crisis
* The policies needed to bring an end to the eurozone’s sovereign debt crisis have been fairly clear for some time, especially to observers of debt crises in emerging markets and developing economies. These policies are a combination of:
	+ sovereign debt write-offs
	+ bank recapitalizations
	+ medium-term commitments to fiscal discipline
	+ cuts in labour and other business costs to restore competitiveness and
	+ growth (euphemistically called ‘structural reform’).
* In September 2012 plans for a European Banking Union were established, the main features of which relate to setting-up a:
* single European banking supervision (Single Supervisory Mechanism - SSM)
* common resolution framework (Single Resolution Mechanism - SRM)
* common deposit insurance (Single Deposit Guarantee Mechanism - SDM)
* single rulebook (common legal framework, EBA single rulebook)

The Single Supervisory Mechanism (SSM) gives to the ECB new supervisory powers aimed at maintaining the stability of euro area banks. Under the SSM, the ECB will directly supervise "significant" credit institutions and it will work closely with the other national regulators. Typically the ECB will only supervise banks deemed as systemically important. This will be around 125 to 130 banks that account for 85%+ of Eurozone banking sector assets. As part of the ECBs new supervisory role it undertook an Asset Quality Review and Stress Tests of these banks in October 2014. Supervisory powers commenced on 1 st November 2014.

* The European Commission has pressed on with a series of other initiatives including The *Markets in Financial Instruments Directive* (MiFID 2) and the *single euro payments area* (SEPA) are the most important recent moves in this direction. There is some evidence that London, as Europe’s major financial centre, has benefited from MiFID, as it has reduced securities trading costs and boosted cross-border trading in wholesale areas.

**CHAPTER 13 TRADED OPTIONS**

* Chapter 13 present key features of the options market.
* The users of derivative products are speculators, hedgers and arbitrageurs. The key products are options and futures. All the rest are simply variations on the same theme.
* An option gives the buyer the right, but not the obligation, to buy or sell financial instruments or commodities at an agreed price and at an agreed future date or time period.
* Options can be purchased on a trading exchange or over the counter. The exchange has the advantage of the protection of the clearing house, but the OTC market will more easily tailor a product to suit the user’s needs.
* Options to buy a given product at a later date are calls. Options to sell are puts. There are buyers and writers (sellers) of options.
* The price of the option is the premium, the price of the product at which the option buyer can exercise is the exercise or strike price. Options can also be traded.
* The option buyer cannot lose more than the premium, the option writer cannot gain more than the premium.
* To protect against default, the clearing house asks option writers for initial margin and, each day, variation margin.
* If the option to buy or sell is at a price more favourable than the market price, the option is said to have intrinsic value. The balance of the premium is time value, which will fall as the expiry date approaches.
* Trading the option will be more profitable than exercising if the option has time value.
* A small percentage change in the price of the underlying asset leads to a large percentage change in the premium. This is gearing.
* The premium is based on the past performance of the share price. The more volatile the performance, the higher the premium.
* Options at a price more favourable than the market price are said to be in the money. If the price is less favourable than the market, they are out of the money, and if the price is the same as the market, they are at the money.
* There are options on equities, equity indices, bonds, currencies, interest rates and commodities.
* Combining option positions leads to options strategies such as a straddle, bull spread or butterfly.
* Other non-standardized options are referred to as exotic options, for example barrier options, lookback options, digital options, and so on.
* The market in Europe for options and futures has seen an upheaval in Europe’s exchanges, such that these products are primarily now handled by just two bodies – Eurex and Euronext (including Liffe).

**CHAPTER 14 FINANCIAL FUTURES**

* Chapter 14 presents key features of the financial futures market.
* Futures trading began with crops, which were only available once per year and whose price fluctuated.
* Buyers and sellers might seek to reduce the risk of an adverse price movement by a hedge.
* A futures contract is an agreement to buy or sell a product at a set price at a later date. Unlike options, however, it is a commitment. Speculators, therefore, are exposed to unlimited risk but hedgers can offset losses with profits on their physical positions.
* Usually, futures contracts do not go to delivery. An opening contract to buy is closed by a later contract to sell; an opening contract to sell is closed by a later contract to buy. The position is cash settled. In contracts like equity indices and interest rates, delivery is not possible anyway.
* Forward relates to buying or selling for actual delivery at a future date at a price set now. Forwards are OTC and can be specified as being physical or cash settled. With forwards being OTC, holders generally have to take on counterparty credit risk. Typically, there are no margin calls on forwards, although it is possible for margin calls to be written into OTC contracts to mitigate credit risk.
* Futures are similar to forwards, but usually there is no intention to take or make delivery; later, the position will be closed with the opposite contract and settled in cash. Futures are exchange traded and can be cash or physically settled. They are traded on futures exchanges with set contract sizes, set expiry dates and the protection of the clearing house. The credit risk of futures is to the exchange on which they are traded and there are margin calls to reduce this risk. Futures exist on the same range of products as options, although futures on equities are rare.
* Many options contracts on futures exchanges are options to have the future.
* Some exchanges use a trading floor and open outcry. Others use systems of order matching by computer. Order matching is now increasing at the expense of open outcry.

**CHAPTER 15 OTHER DERIVATIVE PRODUCTS**

* Chapter 15 covers a variety of derivative products including FRAs, interest rate products and various swap instruments including CDS.
* *Forward rate agreements* (FRAs) are a way of fixing a rate of interest for a date in the future and for a given period of time (*forward/forward*).
* The buyer is compensated by the seller if market rates on the given date exceed the given strike rate. The buyer, however, must compensate the seller if market rates fall below the strike rate.
* Borrowers seeking protection will *buy* FRAs, investors will *sell* them. Banks make a profit through the use of a bid/offer spread.
* Essentially, the FRA is the equivalent of the exchange traded interest rate futures contract in the OTC market.
* The FRA is for one forward period only. *Swaps* are agreements for many forward periods, for example one per year for the next 10 years. Again, the market rate of interest (usually LIBOR) is compared with a given strike rate, leading to a compensatory payment from one party to the other.
* The buyer in the case of the FRA is usually called the *payer* in the swap, that is, the payer of the fixed rate. The seller in the FRA is usually called the *receiver* in a swap, that is, the receiver of the fixed rate.
* The above are interest rate swaps; there are also currency swaps.
* Profit may arise for both parties from the application of the theory of *comparative advantage*. Banks will make a profit through the bid/offer spread.
* Swaps for those borrowing money are *liability swaps*; swaps for investors are *asset swaps*.
* Swaps are essentially a series of FRAs. A swap starting at a future date is a *forward swap*; an option to have a swap is a *swaption* and a swap of two floating rates is a *basis swap*.
* A borrower can be protected from an interest rate rise but still benefit from a fall using an interest rate *cap*; an investor can benefit from an interest rate rise but still be protected from a fall using an interest rate *floor*.
* The combination of a cap and floor leads to a range of interest rates for future transactions called a *collar*. Caps, floors and collars are variations on options.
* The BIS initial estimate of the notional value outstanding of the OTC derivatives market in June 2014 was $691 trillion. The cash flows associated with this activity are much lower as many participants in the market buy and sell contracts to hedge their positions – typical cash flows are around $15 to $20 trillion. The BIS estimates for the notional value outstanding of exchange traded contracts in June 2014 was $73 trillion.
* Interest rate derivatives accounted for much the largest category for both OTC and exchange traded derivatives.
* *Credit default swaps* (CDS) are an arrangement by which the risk of default on a bond issue, or a basket of bond issues, is sold for a given premium. This is part of the market for *credit derivatives* generally, which had been the fastest growing sector of the market until the onset of the credit crisis. The rescue of AIG in September 2008 was primarily motivated by regulatory concerns about the collapse of a business that had $440bn of (unhedged) notional outstanding CDS contracts.
* Provisions in the Dodd Frank Act and similar EU legislation will force a large volume of OTC contracts (particularly interest rate swaps) back onto organized exchanges by the end of the decade.

CHAPTER 16 EMERGING GROWTH-LEADING ECONOMIES (EAGLES)

* Chapter 16 focuses on the future economic prospects of emerging and growth leading economies.
* China and India undoubtedly remain important global economies but nowadays there is greater discussion of other countries, including the so-called BRIC (Brazil, Russia, India and China) countries, as well as what BBVA Research (2012, 2014) has identified as the EAGLEs (emerging and growth-leading economies).
* EAGLEs are particularly interesting as they are defined as economies whose contribution to world economic growth over the next decade is expected to exceed the average of the leading industrialized nations (according to BBVA Research, the G7 minus the US).
* Seven countries achieved EAGLE status: namely China, India, Indonesia, Russia, Brazil, Turkey and Mexico.
* The seven EAGLEs are forecast to contribute 51% of world economic growth between 2013 and 2023, compared to 19% for the slow-growing G7 countries (and 27% for the developed world in total).
* There are also the so-called EAGLEs ‘nest’ countries, a watch list of countries with expected incremental GDP in the next 10 years to be lower than the G6 average (G7 minus the US) but higher than the smallest contributor of that group. The 19 nest countries are Egypt, Chile, Thailand, Argentina, Nigeria, Colombia, Poland, Vietnam, Pakistan, Bangladesh, Malaysia, South Africa, the Philippines, Peru, Saudi Arabia, Iraq, Iran, Kazakhstan and Qatar. They are forecast to contribute around 14% of GDP growth over the following decade, and may be part of the EAGLEs in the future.
* China and India “play in another league” compared to all other countries as they are expected to contribute 30% and 11%, respectively, to global growth between 2013 and 2023. Other revealing forecasts suggest that Turkey will contribute more than Germany, and Mexico will add more to global growth than the UK, France and Italy over the aforementioned ten year time span.
* The population of China is 1.36 billion and that of India 1.25 billion.
* The IMF reports that China’s nominal GDP was $9.5 trillion for 2013; India’s was $1.9 trillion.
* China’s economy has been growing by around 9% annually and India’s by 7% over the past decade or so although the IMF is suggesting only 4.6% for 2014. The National Bureau of Statistics in China reported growth in 2011 at 8.8% and this has declined to around 7.5% by the end of 2014.
* China is the world largest exporter, with $2.2 trillion of goods and services exported during 2013, more than the whole EU ($2.1trillion) and the US ($1.6 trillion). Export growth has been around 20% annually over the past five years, but has recently slowed to around 11% in 2014. India is ranked 17th in exporting countries, trading around $313b
* China is a large manufacturing economy and its growth has led to substantial imports of raw materials including oil and also imports of components from neighboring Asian economies. Exports are not just of low-cost, low-tech goods but computers, digital phones and similar products, although the bulk of high-tech exports are assembled from high-tech imports (like iPhones).
* India is an entrepreneurial economy with skilled English-speaking graduates and has a high reputation in the field of IT. It has become a major centre for outsourcing. It is also a young economy. China will face major future problems as a result of its one-child policy.
* Both economies have massive rural populations and face the problem of the contrast between the growing prosperity of the middle classes and the extreme poverty in rural areas.
* Hong Kong retains some autonomy. When people speak of China, they usually mean mainland China.
* Banking in both economies is dominated by state sector banks and this has led to much wasteful lending to local enterprises. Foreign ownership is carefully controlled. China’s state banks are gradually going public, using the Hong Kong Stock Exchange and releasing only a minor percentage of shares for sale.
* There are a large number of rural and urban cooperatives in China and India and also many thousands of post offices, which both countries would like to see playing a larger role in providing banking services.
* The renminbi is kept within a tight band in a basket of currencies, while the rupee floats; but both countries impose tight capital controls. The strength of the renminbi has been criticized by the US and the IMF as a key factor in promoting global financial imbalances.
* Capital markets are relatively underdeveloped in both countries. China’s stock market is highly volatile, driven by speculative domestic investors. China’s top companies float in Hong Kong. India’s Mumbai Stock Exchange is more developed but also subject to wild swings. Bond markets are dominated by state bonds in both economies and the corporate bond market is weak. Banks are far too dominant as a source of finance and stronger capital markets are badly needed in China and India.
* Derivative markets in China primarily exist for commodities, although other financial derivatives are emerging. In India, financial derivatives are well established.
* Insurance is growing rapidly in both markets and many foreign insurers are represented. Financing pensions for the rural poor is a major future challenge for both countries.
* The growth of China and India can be seen as a threat to employment in the US and Europe. At the same time, the influx of low-cost goods reduces inflation and raises living standards. The opportunity is there to sell services, general and financial, to the fast-growing, prosperous middle classes.

**CHAPTER 17 TRENDS IN THE GLOBAL FINANCIAL MARKETS**

* Chapter 17 covers various trends in global financial markets that cover:
* Challenges faced by banks and financial markets in dealing with major ongoing regulatory reforms
* Creation of the European Banking Union
* Developments in social, environmental, ethical and trust (SEET) issues
* Alternative energy investments
* Search for yield, including (high) dividend paying stocks
* Prospects for further consolidation in the financial sector.