

# Preface

This book, now in its ninth edition, reaches all the way back to the beginning of the 1990s. So much has happened in this interval of more than 20 years. War and revolution have marked many parts of the globe, especially the Middle East, with no end on the horizon. Natural disasters from earthquakes, hurricanes, floods and tsunamis, volcanoes, and more have unleashed devastation and death in critical regions of our planet.

Economic prosperity that marked so much of the 1990s turned into economic disaster in the opening decade of the new century. Jobs disappeared, living standards plummeted, homes were lost, and countless businesses failed. The worst economic recession in nearly 80 years led to anger and demonstrations in the streets and the most stringent belt-tightening among families and business owners and managers that has been experienced since the Great Depression of the 1930s.

Unquestionably, it is difficult to find and maintain a positive attitude and that most precious commodity, *hope*, under these circumstances. Yet that is what this book and many others like it are all about—how to turn trouble and turmoil into useful knowledge and from that knowledge hope that our world can be a happier and more fulfilling place.

This book does not presume to tackle the broadest spectrum of knowledge. No book can really do that, even in the modern digital age. Instead it focuses on a much smaller but nevertheless important slice of our world—the *financial-services sector* served by thousands of small and large financial firms that develop and market tools to manage risk, pursue financial opportunities, and supply information vital to the making of informed financial decisions, accompanied by the hope of favorable outcomes. Much of this book is devoted to the banking sector, but also to other important financial institutions—credit unions, mutual and hedge funds, pension plans, insurance companies, finance companies, security brokers and dealers, and thousands of other financial-service providers. We explore what these institutions do for us and the risks they present.

The heart of this edition, like those editions that have preceded it, is *risk management*. Managing risk has emerged into the dominant topic that most managers of financial-service firms must deal with in the modern world. Indeed, the taking on of significant risk marks the financial-services sector as much as any other sector of the economy. It is the fundamental task of banks and other financial firms to identify risk in its many forms and then develop and offer tools that are able to control that risk. Few activities are more important to us because the financial sector is, and always has been, continuously threatened by significant risks at home and abroad as well as inside and outside the individual financial firm. No better example can be found than the great credit crisis of 2007–2009 where large numbers of financial-service providers floundered and failed alongside others who somehow managed to survive.

Often today we distinguish between external and internal risks. For example, *external risks* to financial firms include wars, crime, poverty, environmental destruction, global warming, political revolution and strife, falling currency values, volatile equity markets, weakening economies, declining sales in key industries, inflation, increasing energy shortages, and a troubled home mortgage market. All of these external risks have had (and will continue to have) a profound effect on the services financial firms can offer and the profits and future growth they may hope for. Moreover, many financial-service providers today are caught in the middle of a geopolitical struggle as important countries like

China, India, Korea, Japan, and Russia are knocking on the door of global leadership and demanding a growing economic and political role.

If the foregoing external risks were not enough, numerous *internal risks* (some of them old and some relatively new) have surfaced inside financial firms. These include exposures to loss from such risk dimensions as credit risk, liquidity risk, market and price risk, interest rate risk, sovereign risk, operational risk, currency risk, off-balance-sheet risk, legal and compliance risks, strategic risk, reputation risk, and capital risk. Each of these types of risk is a major focus of attention in the pages of this book.

The successful manager of a financial-service institution today must understand the foregoing external and internal challenges and the strategies developed to deal with all of these threats. That is our purpose here—to examine the different risk exposures that confront financial-service providers today and to discover ways to deal with these challenges efficiently and effectively.

In addition to combating losses from risk exposure we must understand clearly the importance and key roles that financial institutions play in our lives and careers. These institutions are the principal means that we all draw upon to make payments for the goods and services we wish to buy. They are the vehicles through which we raise liquidity when emergency needs for cash arise. They are the principal repositories for our savings as we prepare for future spending and future financial challenges. They are the primary suppliers of credit which fuels spending and results in the creation of more jobs. These financial firms we will be studying are the principal sources for insurance protection and the purveyor of hedges to help us protect the value of the assets we hold and the income we receive. Finally, the financial-service providers we target in this book are major vehicles through which government economic policy (including monetary policy carried out by central banks) struggles in an attempt to stabilize the economy, avoid serious inflation, and reduce unemployment.

To be successful in our study we must learn about the key differences between one type of financial-service provider and another, and about the management principles and practices that can be used to help strengthen these firms, offering better service to the public. No longer is our world populated by one type of financial institution. There are thousands of these firms, some of which we still call banks, insurance companies, security dealers and brokers, mutual funds, and so on. But with increasing frequency these institutions have invaded each other's territory and taken on characteristics of their competitors. This so-called convergence trend leads to overlapping of services and confusion about what is actually happening in the financial sector.

Today larger banks control insurance and security affiliates. Many insurers own banks and serve as security brokers and dealers. Major security dealers have chartered banks and, in some cases, created insurance affiliates or departments. These convergences among different financial-service institutions make our study somewhat harder and raise questions about what is the appropriate business model in the financial sector today and for the future. Can all these financial-service providers succeed or are an increasing number doomed to disappointment and failure?

## Vital New Areas Covered in the New Edition

Among the most important new issues we confront in the ninth edition are:

- A study of some of the new policy tools being considered to measure and possibly counter *systemic risk in the economy*, and perhaps prevent a future debacle similar to the 2007–2009 credit crisis.

- An effort to explore and understand the continuing fight in the *home and commercial mortgage markets* to combat declining property sales and construction activity, slow home foreclosures, aid struggling borrowers, and reduce the threat of a prolonged economic recession.
- A discussion of recent *financial reform legislation* and *reregulation* as possible efforts to head off yet another financial crisis surrounding the banking and financial sector and restore public confidence in the financial system. (Illustrated in the United States by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.)
- A tracking of the rise of new *consumer protection laws and regulations* that offer defense for the welfare of consumers by promoting greater disclosure of contract terms, improved transparency in the information consumers are receiving, and better education of the public so that financial-service customers can make informed decisions (Illustrated by the creation of the new Consumer Financial Protection Bureau inside the United States).
- Helping to understand the battle over the *Credit Card Accountability, Responsibility, and Disclosure (CARD) Act of 2009* and its supporting regulations that seek to protect credit card users from excessive service fees and from the failure of card companies to adequately disclose changing contract terms, though the new rules may ultimately raise the cost of credit card services to card users.
- Exploring the current race to erect new international capital standards, known as *Basel III*, which propose heavier capital requirements and heavier use of equity capital, particularly by the globe's largest international banks, to avoid bank failures and disruption in public confidence in the most prominent financial institutions.
- Examining the growing trends in *branchless banking* and *mobile service delivery* that have encouraged financial firms to develop electronic delivery systems, allowing the customer to access financial services wherever and whenever he or she wishes, though financial firms run the risk of depersonalization of services offered to the public.

In addition to today's confusion over which financial firm does what, we will also discover the great size and performance differences among different financial firms, which have aroused major questions and issues. A key question in this field today centers on the future of the thousands of smaller financial institutions that exist in almost every country. Can these so-called small-fry institutions really survive in a land of giants (such as Citigroup, Bank of America, JP Morgan Chase, Barclays PLC, Prudential, and HSBC Holdings)? Can smaller financial institutions successfully face off against trillion-dollar financial-service companies? What is the optimal size and product mix for a financial firm, and how is that changing?

With all the sweeping changes that have dominated the financial world lately one must wonder at times: Why would anyone write a book about this daunting subject today? We must convey what we believe are the principles of sound financial management and what we think are the best practices for today's financial firms and financial-service industries. We must offer analysis and advice for a wide range of financial institutions, whether they be among the giants or among the smallest service providers.

We admit that writing a book about bank and nonbank financial firms and financial services is a hard job. However difficult, though, we must reveal that it is also an exciting adventure. We have come to realize that to ignore this sector of the economy places us at something of a personal and professional peril. We must discover everything we can about these institutions because all of us, whether we become banking and financial-service managers or not, must rely on the services financial firms provide. We ignore this sector of our system at considerable personal and business risk.

We should also remind ourselves that, had we never thought about it before, the financial-services sector represents a possible significant career opportunity down the road as the current credit crisis retreats. Financial services is becoming one of the more creative industries, less routine now that computer systems are available to handle most routine tasks. There is also a strong emphasis on sales promotion and serving the customers as fully as possible. A job in this dynamic, information-oriented sector poses a challenging and fascinating career possibility. The authors sincerely hope that the pages of this book will help you determine whether financial services just might be the exciting career opportunity you are searching for in the years ahead.

## Key Trends Unfolding in the Financial-Services Sector: Which Ones Does This Book Focus On?

This book unlocks the door to many of the major changes and events that are remaking the banking and financial services fields today. Among the key events and unfolding trends that lie out there waiting for us are:

- An analysis of the great battle for *financial reform* in the wake of the 2007–2009 credit crisis in which major new pieces of legislation—particularly the Credit Card Accountability, Responsibility, and Disclosure (CARD) Act and the Dodd-Frank Wall Street Reform and Consumer Protection Act (FINREG)—have passed into law, calling for comprehensive regulatory restrictions to avoid damaging consumers and creating another global credit crisis in the future. (See Chapters 1, 2, and 18.)
- An effort to explore the concept and possible presence of *systemic risk* in our financial system with several nations working to develop new methods of measuring and controlling this financial-systemwide threat to the welfare of consumers and jobs in the economy. (See Chapters 2 and 15.)
- A description of the worldwide fight for the proper design of international capital standards for banks under the terms of the developing *Basel III Agreement* in an effort to head off further disruptions in the banking system. (See Chapters 15 and 20.)
- A discussion of the changing face of financial institutions' regulation which appears to be moving away from deregulation of the financial sector (i.e., a loosening of the government's rules) which marked the 1960s through the 1990s, toward *reregulation* with whole new sets of tough government rules being crafted in the hope of preventing future financial crises. (See Chapters 1 and 2.)
- An examination of the *mortgage market debacle* which has resulted in many thousands of home foreclosures, declining home values, deteriorating neighborhoods, and frustrated public policy efforts to stop the mortgage market fall. (See Chapters 2 and 18.)
- A close look at *branchless banking* and *mobile financial services delivery*, emphasizing the swing from expensive brick-and-mortar expansion toward electronic networks so that consumers, rather than financial institutions, get to decide the time and place when they need to trade with a financial-service provider. (See Chapters 2, 3, and 4.)
- An expanded look at *ethics* in the financial sector with more examples of recent ethical dilemmas. (See Chapters 2, 3, 14, and 20.)
- A close look at the U.S. central bank, the *Federal Reserve System*, and how it dealt successfully with the 9/11 terrorist crisis and more recently has worked to battle against the troubled residential mortgage market amid a struggling economy. (See Chapters 2 and 11.)
- A look at the *mortgage market crisis* and its impact on financial-market conditions and the economy. (See Chapter 18.)

- An exploration of the *rise of China, India, Korea, Japan, and other leading nations* inside the global financial system to positions of increasing prominence and influence, offering competition to American and European bank and nonbank financial firms and an opportunity for international financial firms to enter vast new national markets. (See Chapters 2 and 20.)
- An *analysis of investment banking houses*, such as Bear Stearns, Lehman Brothers, and other firms (such as Countrywide Mortgage) that became victims of the most recent credit crisis and demonstrated once again that even the largest financial institutions are vulnerable to mistakes, in this case through dealing heavily in the subprime residential mortgage market. (See Chapters 1 and 18.)
- A more detailed look at leading financial firms, led by *commercial and investment banks, security brokers and dealers, mutual funds, hedge funds, finance companies, mortgage banks*, and several others. *Investment banking* is a particular target of our study because it is often among the most powerful financial industry members because of the higher returns these companies may achieve and the vital services they provide. (See Chapters 1, 2, 3, and 14.)
- Coverage of the *ongoing battle between industrial and retailing firms trying to get into the financial sector and existing financial-service providers*. A key discussion point concerns “walls”—regulatory barriers between financial services and other industries that the United States and other leading countries have put in place, presumably to protect the safety of the public’s funds. (See Chapters 1, 2, and 20.)
- A look at the strengths and the weaknesses of the *securitization* process and an examination of the use of *interest-rate and currency hedging instruments*, including the risks these instruments and techniques create for themselves and for the financial system as a whole. (See Chapters 7, 8, 9, and 20.)
- A continuing discussion of the controversial *Bank Secrecy and Patriot* acts which have appeared in one form or another in several nations, particularly following the terrorist attacks of 9/11, and the widening use of monetary penalties for banks that have had problems in trying to trace the financial activities of some of their customers. (See Chapter 2.)
- A look at the *Grameen Bank and other microlenders emerging around the globe*—what they do and what impact they have had. (See Chapter 20.)
- An increased recognition of the many (and expanding) *types of risk* that surround and threaten financial firms and an explanation of *how risk can be measured and managed*. (See Chapters 6, 7, 8, 9, and 15.)
- An exploration of recently *new financial instruments* and their impact, including option mortgages, trust preferred securities, exchange traded funds, and range notes. (See Chapters 10, 14, 15, and 18.)

## Teaching and Learning Tools surrounding the Ninth Edition

The new ninth edition offers several tools to promote learning and understanding and make this book an effective resource for the teacher. Among the most useful are likely to be:

- *New and newly revised problems to solve* (including problems suitable for Excel) along with an extensive battery of challenging, quality problems from earlier editions.
- A *continuing case problem* that runs through most of the chapters and encourages the development of analytical techniques while acting as a useful exercise for those who like to assign term papers or semester projects.

- *Video clips* in a variety of chapters that visually bring the reader up-to-date about new developments in the financial-services marketplace (such as Toyota opening a bank in Russia), provide tutorials on various financial topics (such as construction of the yield curve and calculations of yields to maturity using Excel and financial calculators), offer explanations of how financial services are delivered (such as through ATMs and portable phones,) and broadcast an exploration of the history of financial institutions (such as the recent rapid expansion of credit unions and payday lenders).
- As in previous editions, a series of *topics boxes* devoted to *E-Banking and E-Commerce*, *Real Banks Real Decisions*, *Insights and Issues*, and *Ethics in Banking and Financial Services*. These boxed features sharpen the focus surrounding controversies in the financial institutions field, explore the most recent developments, analyze management decisions, and discuss ethical issues in the field.
- *Key URLs* that appear in every chapter and offer to carry the reader into supplemental material that could be useful for class presentations and to help those who want to dig deeper and master the subject.
- *Factoids* that offer pertinent and interesting facts and ideas that supplement what the text is saying and excite readers.
- *Filmtoids* mention movies of the recent past that provide unique insights about the development of the banking and financial-services sectors of the economy.
- *Key Video Links*, referenced in the margins, offer the reader video presentations on recent financial-service developments and provide tutorials on key topics to supplement text material.
- *Concept Checks* that pose questions and brief problems to allow the reader to see if he or she understood what they have just read in each part of a chapter.
- *Chapter Summaries* that present an outline of what the chapter has discussed, summarize the key points presented, and offer an avenue of review to help prepare the reader for an exam.
- *Key Terms* that are listed at the conclusion of each chapter's narrative along with the page numbers indicating where these terms appear and are defined.
- *Problems and Projects* that offer a challenge to the reader and explore the reader's depth of understanding, giving him or her an opportunity to solve problems and make numerical calculations.
- *Internet Exercises* that request the reader to dig into the vast reservoir of the World Wide Web to discover information sources pertinent to the most important aspects of each chapter.
- *Real Numbers for Real Banks*, which offer the reader (including both students and teachers) the opportunity to dig into the data resources available on the Internet (including the financial statements of financial-service providers) and use the information to analyze real banking firms.
- *Selected References* that are arranged by topic and appear at the conclusion of each chapter, helping the reader decide where to inquire further on any major topic presented in the foregoing chapter.
- A *Dictionary of Banking and Financial-Service Terms* appearing at the back of the book following the last chapter in which the key terms that appeared in each chapter are defined. These definitions help the reader more clearly understand the language of the banking and financial-services sector.

## Supplementary Tools to Promote Learning and Understanding

A number of supplementary learning and information tools accompany this text. The most significant of these educational materials are:

- *Instructor's Manual and Testbank*, which supplies a topic outline of each chapter, makes available hundreds of questions to answer for study and for the construction of lectures and exams, and presents problems to work out.
- *PowerPoint Presentation System*, which aids teachers in putting together classroom presentations, facilitating discussion in class and over the Internet, and grants readers study notes helpful in completing assignments and preparing for tests. The PowerPoint slides contain lecture outlines, charts, graphs, numerical examples, outlines of key topics, and repetition of key points addressed in the text. Teachers and other presenters electing to use these slides can rearrange and edit these PowerPoint materials to more sufficiently satisfy their instructional and presentation needs.
- *Text website*, [www.mhhe.com/rosehudgins9e](http://www.mhhe.com/rosehudgins9e), which can be accessed by class members, teachers, and other users of the text. Periodically the authors develop updated material for insert into the website in an effort to keep the text up-to-date.



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### Electronic Textbook Option

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## Acknowledging the Important Contributions of Reviewers and Commentors

The authors wish to express their gratitude to the many readers, teachers, financial managers, professional editors, and other talented reviewers who have criticized the text in an effort to improve it and have suggested new features that might aid those who plan to

read and study from this text. As the book passes into its ninth edition, the list of significant contributors has grown beyond the capability of the authors to successfully acknowledge all of these valuable contributions. However, among the talented and well-informed teachers who have helped significantly are the following professionals in the field:

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|---|--|
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## A Special Note Addressed to the Readers of *Bank Management and Financial Services*

Beginning a new term or semester of an educational program is always challenging and suffused with an air of uncertainty. Did we take the right course or choose the most talented and effective teacher? Do we have the background needed to learn everything that's written and discussed in this class? Is there content in this course that may change our lives for the better? Or is all of this just a big waste of time?

Unfortunately, answers to these important questions usually do not arrive until the formal educational experience is coming to an end. Sometimes we still do not know how valuable a particular course was even years later as we work our way into the middle of a career. At the start of this venture most of us simply have to take a "leap of faith" that our educational journey will ultimately turn out to be worthwhile. But the opening of this particular book and the taking on of a course of study in this particular field come with one reassurance: Few courses focus on material that is likely to be as important to us as this one, whether we ultimately become financial-service managers or follow some other career path. Our lifestyles and living standards for years to come will depend, in part, on the financial decisions we make and upon the willingness of financial-service businesses to give us access to credit, protect and successfully manage our savings, supply us with insurance coverage to protect our assets and income, and execute payments on our behalf to the thousands of businesses and stores we enter and with which we transact purchases of goods and services during our lifetime. In short, this is a field of study about which we cannot afford to be ignorant.

This book, now entering its ninth edition, is designed to help you explore this important, fascinating, and often trouble-prone sector of our world. As the recent mortgage credit crisis has reminded us: if the financial sector starts to fall apart, much of the economy will be crippled along with it. When businesses and consumers cannot obtain the credit they need to purchase the goods and services they desire, businesses close, jobs are lost, governments lose tax revenues, some people have to surrender their homes, and educational dreams may be suppressed. All of us need to learn how and why this can happen and understand what it could mean to us if we are ill-prepared.

The authors have endeavored to make this book, and supporting informational materials, a powerful educational tool—one that will assist you in mastering the techniques and ideas fundamental to this important field of study. We hope to aid in your efforts to deal with and understand the myriad of changes—alterations in risk, regulation, technological change, and competition—that confront the financial sector and financial-service managers everyday.

This book is structured with multiple learning aids to help you. For example:

- Each of the 20 chapters begins with an *Introduction* that sets the stage for what is to follow and emphasizes and explains why each chapter is important.
- The Internet is closely intertwined with this text, as evidenced by *Key URLs* in the margins that suggest fertile fields on the Web you can explore, going beyond what the text itself provides.
- Interesting background information and ideas show up in many page margins under the labels *Factoids*, *Filmtoids*, and *Key Video Links* with the first posing challenging questions and answering them on the spot, the second asking if you have seen a particular movie or film that touches on the financial-services sector, and the last directing the reader to audio/video presentations on new financial developments and visual tutorials to reinforce learning of key points. Some instructors have brought portions of these films and video clips into their classrooms.
- Interspersed among the pages of each chapter are *Concept Checks*, posing questions and short problems just to see if you understand the material in the sections you have just read or if you have missed something important. If you cannot answer the questions in

a Concept Checks section about what you have just read, it's time to go back and fill in the knowledge gap.

- Every chapter closes with a bulleted *Summary* that lists the key points raised, offering you a quick refresher before you close the book. Often these chapter summaries turn out to be helpful as you approach an exam or get ready for a presentation.
- The *Summary* portion of each chapter is followed immediately by a list of *Key Terms* designed to help you understand the language of the banking and financial-services marketplace. A page number stands beside each key term so you can more easily find a chapter's key terms and uncover a definition and explanation. The key terms represent yet another educational aid when you face an exam or are preparing a report.
- At the close of this book, following Chapter 20, is a *Dictionary of Banking and Financial-Service Terms* that supplies definitions for the key terms that appear in each of the chapters. You can doublecheck your understanding of text material by examining the list of chapter key terms and then thumbing through the dictionary to make sure you know what they mean. This step may be particularly useful as exam time approaches—sort of a quick review to see how much you really know at this point.
- Several problem statements and issues to resolve show up in the final portions of each chapter. These sections are named *Problems and Projects*, *Internet Exercises*, and *Real Numbers for Real Banks*. There is also a *Continuing Case Problem* that spans many chapters and that may be assigned as a semester or term project by your instructor. You may find that these problems and questions can be useful in making sure you have digested each chapter and in introducing new ideas that you would benefit from knowing.
- *Informational boxes* appear throughout the text, in most of the chapters, focusing in on ethics issues in the field, on developments in E-commerce, on controversial financial management and public issues, and on challenges that financial-service managers have confronted and responded to in the past. These appear under several different labels, including *Insights and Issues*, *Real Banks*, *Real Decisions*, *E-Banking and E-Commerce*, and *Ethics in Banking and Financial Services*.

While it is true that this book supplies many different ideas and tools in the financial-services field, it is, like any textbook, locked in time until the next edition appears. It provides us with a snapshot of this field at a particular moment in time. However, banking and financial services is an industry undergoing great changes—something new every day. Accordingly we are obligated to reach beyond a single book in order to stay abreast of the ever changing financial-services scene. Our sincerest hope is that we can awaken your interest in this field and encourage you to reach further. If we can accomplish that, then this text will have done its job.

The financial-services marketplace is one of those fields of study where the effort you put into understanding this field may well pay large dividends in the years ahead. Indeed, an old saying we have quoted over the years says: “Chance favors the prepared mind.” Sure, it's an old idea that most of us have heard before and shrugged off. However, in this field it tends to be dead on! Mastery of the financial-services sector will build up your personal and professional confidence and is likely to reward you in the long run, no matter how your life and career unfold.

We offer you congratulations on your choice of an important and significant field of study. We extend our best wishes for your success as you learn about the financial-services field. And we wish for you a rewarding personal and professional journey wherever your path leads.

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