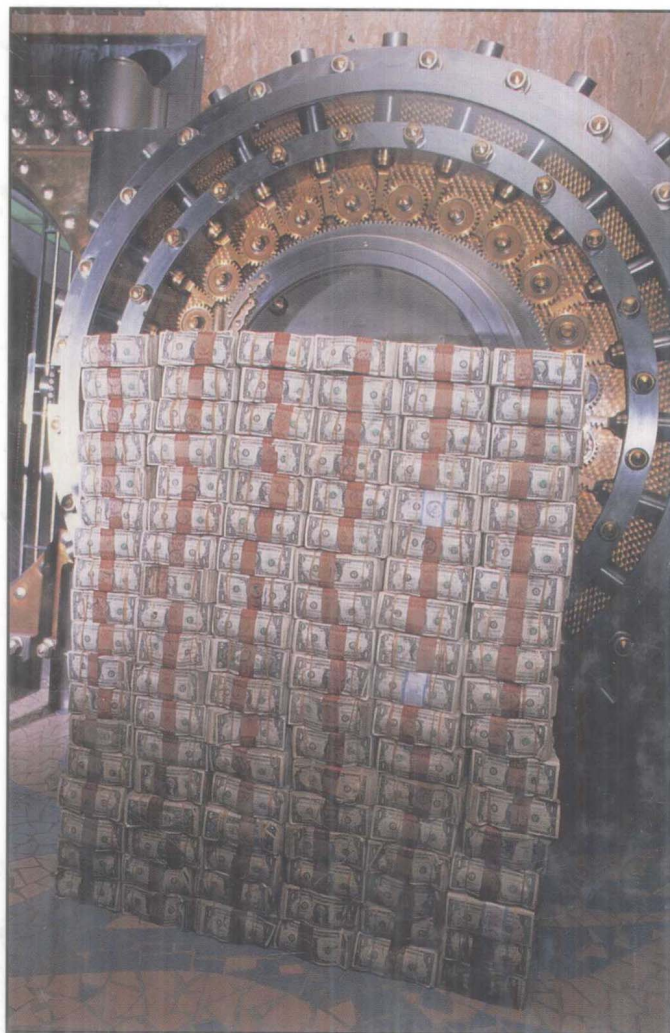


COMMERCIAL BANK FINANCIAL MANAGEMENT

Fifth Edition



JOSEPH F. SINKEY, JR.

Fifth
Edition

COMMERCIAL BANK FINANCIAL MANAGEMENT

In the Financial-Services Industry

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Preface

“Bank financial management” and “financial-services industry,” the two major themes of this book, are captured by the title: *Commercial Bank Financial Management in the Financial-Services Industry*. First, the book’s approach to bank management is financial in the sense that it reflects modern corporate financial management as opposed to simply describing what banks do. This means that maximizing shareholder value, risk-return tradeoffs, and risk management are key concepts. Second, because banks operate in the *financial-services industry* (FSI) and not in the more narrowly defined banking industry, they must have an expansive view of (1) where they are going and (2) how they are going to get there. A prerequisite is to know where the bank is today, especially in terms of its profitability, liquidity, and comprehensive risk-based capital requirements. With declining franchise value in the traditional business of funding loans with deposits in order to be competitive in the FSI of the twenty-first century, banks must have strategic, technological-based visions of ways to add value.

Several centuries B.C., Heraclitus, the Greek philosopher, achieved literary immortality and aptly anticipated *modern banking* in the FSI when he said:

All is flux, nothing stays still. Nothing endures but change.

The sources of flux in banking, which have been numerous and sometimes volatile, include

- *Competition*
- *Consolidation*
- *Information technology*
- *Product and geographic expansion*
- *Re-regulation* (including deposit-insurance reform)
- *Volatility of interest rates, exchange rates, and commodity prices*

Combined with rational self-interest, these driving forces of change generate financial innovation. Schematically,

Forces of Change + Rational Self-Interest → Financial Innovation

where rational self-interest refers to the pursuit of *profitable investment opportunities*. This model represents a framework for analyzing change and the important role of financial innovation in banking and the FSI.

One of the most important innovations in banking has been the development of *tools for managing risk*. Because risk management is arguably the critical component

of bank financial management, it is a major focus of this book. Risk-management techniques range from traditional methods such as *asset-liability management* (ALM) and borrower *credit analysis* to more sophisticated *on-* and *off-balance-sheet* techniques such as *duration* analysis, the use of *derivatives* in the form of *futures*, *forwards*, *options*, and *swaps* for *hedging*, and the removal of risk through *securitization*. Securitization, which is the process of packaging loans for sale as securities, reflects one of the important “-izations” that is fundamentally changing banking and the FSI. Other important “-izations” include the *globalization* of world financial markets, which because of the domination of U.S. financial-services firms can, without too much exaggeration, be called *Americanization*; the *institutionalization* of savings into pension and mutual funds; and the *privatization* of formerly state-owned enterprises.

The ability to adapt to change will determine who survives in the financial-services industry. For some large U.S. banks, adaptation in the early 1990s took the form of corporate restructurings including dividend cuts, reorganizations, and major charges against earnings (e.g., for losses on commercial real-estate loans). The consolidation trend in banking and the FSI, which has been going on for years, accelerated during the mid-1990s marked by the megamerger of Chase Manhattan Bank and Chemical Bank in 1996 to form the largest bank in the United States.

Corporate restructurings and mergers are designed to make firms into the “lean, mean fighting machines” that we so often hear about; corpulent banks will be gobbled up by competitors. Banks that take on too much risk and miscalculate their downside vulnerability will find that market forces and *prompt corrective action* by regulators (as required by the FDIC Improvement Act of 1991) will prevent them from becoming “zombies”—the antithesis of the 1980s when numerous savings-and-loan associations (S&Ls) and commercial banks failed. Also, banks that sell their products without *full disclosure*, whether they be mutual funds sold to consumers or derivatives products sold to corporate clients, will find limitations on *caveat emptor* (“let the buyer beware”).

Dealing with commercial banking from a finance perspective and applying principles of financial management to banking in the rapidly changing financial-services industry, as this book does, is an approach that is crucial today because of the dramatic changes occurring in the competition for financial services. To be successful, bank managers must be able to respond quickly and rationally to these changes. Former principles, like the “3-6-3 rule” (i.e., money in at 3%, out at 6%, and on the golf course by 3 P.M.), do not apply in today’s dynamic environment. The theory and practice of financial management provide a framework that highlights the importance of making decisions that add value creators and eliminate value destroyers. Banks that achieve these objectives will thrive.

Structure of the Fifth Edition

Just as downsizing has affected the corporate world, it has affected the size of the fifth edition. Down from 25 chapters to 20, the book is more efficient. Following two introductory chapters that provide an overview of banking and its risks, the book continues in six parts and 18 chapters:

- Bank performance and financial management (chapters 3–5)
- The risks of banking and their management (chapter 6–9)
- Managing the lending function and securitization (chapters 10–12)
- Managing bank capital (chapters 13–14)

- The federal safety net and ethics in banking (chapters 15–17)
- Financial innovation, information technology, and corporate restructuring in banking (chapters 18–20).

The Brief Contents on page v provides a structural overview of the book; whereas the Contents, beginning on page vii, provides detailed information for each chapter.

Major Changes in and Themes of the Fifth Edition: A Top-Ten List

In the spirit of David Letterman’s top-ten list and as a device for keeping the description of changes and themes manageable, consider the following top-ten items for the fifth edition of this book:

10. Chapters—and fewer of them—designed to be more user friendly by including Learning Objectives, a Chapter Theme, and *two* lists of Key Concepts, Ideas, and Terms (one at the beginning of each chapter and a more detailed one at the end).
9. An acronym glossary to make the arcane world of ALM, LIBOR, CAMEL, and FDIC less confusing.
8. Author and subject indexes to make it easy to find who, what, where, and when.
7. New end-of-chapter questions, problems, cases, and projects to test learning comprehension and challenge research, writing, and analytical skills.
6. A complete analysis and description of the role of bank regulation, deposit insurance, and the federal safety net.
5. The interweaving throughout the book of the critical role that financial innovations such as information technology, securitization, and derivatives play in bank financial management.
4. A clear treatment of the important distinction between accounting and market measures of bank performance.
3. Understanding that a comprehensive measure of a bank’s capital adequacy must take account of all of a bank’s risk exposures, including credit risk, interest-rate risk, liquidity risk, foreign-exchange risk, and sensitivity to market risk.
2. Understanding that maximizing shareholder value requires bankers to develop strategic plans and policies, risk-management techniques, and corporate checks and balances that are designed to add value creators and eliminate value destroyers.

And, drum-roll, please

1. The addition of a new chapter on ethics in banking—not by accident the thinnest chapter in the book, because the thinnest book in the world is: *Ethics for Bankers, Lawyers, and Regulators*.*

What Banks Do and How They Are Special

Are commercial banks special or different from other business firms? To be a player in the financial-services industry, a company needs a different mix of assets from those of a nonfinancial corporation. Banks have very few tangible assets like

*in Letterman-wit fashion

factories and machinery. Offices, furniture, computers, and software programs are the “hard” assets of banking. In contrast, banks use lots of intangible assets, like reputational capital, technical expertise, customer relationships, market presence, trade names, and deposit-insurance guarantees.

Banks use their real and intangible assets to produce such financial products and services as loans and checking accounts, items that appear on a bank’s balance sheet. In addition, they produce items that do not appear on their balance sheets (e.g., loan commitments, letters of credit, and interest-rate swaps); these are known as off-balance-sheet activities or OBSAs. These activities generate “contingent claims” on a bank’s balance sheet. The interest and fees paid for these products and services, whether on or off the balance sheet, are the “sales” of banking. Like any other business, banks expect to make a profit by having sales exceed costs. In addition, because business success is usually judged by value, banks strive to maximize their equity or net asset values by undertaking only positive net-present-value projects. Unlike most other businesses, however, banks are heavily regulated and have access to deposit insurance and the discount window. If anything makes banks special, regulation and deposit insurance do.

For Whom the Bell Tolls

This book is designed for both academic and practitioner markets and for anyone interested in the financial management of commercial banks in the financial-services industry. As a college textbook, upper-division undergraduates and MBA students are the intended audiences. In addition to bank management courses, the book can be used in courses dealing with the management of financial institutions. Doctoral students and practitioners will find the book to be both a good background text and a useful reference.

Auxiliary Teaching Materials

The *Instructor’s Manual and Test Bank* that accompanies this book has answers to all of the end-of-chapter questions and problems and a comprehensive test bank of objective and other questions. In addition, it contains chapter outlines, transparency masters, pedagogical suggestions, and updated chapter information if available. My preferred approach to teaching a bank-management course is to supplement it with a bank-management simulator. The one I have used for over 20 years is the Stanford Bank Game (Version 11).

Acknowledgments

Since I started teaching banking at The University of Georgia in 1976, I recognized and thought about the need for a banking textbook based on the concept of financial and risk management. This vision was realized with the first edition of *Commercial Bank Financial Management* (1983). Through the second, third, fourth, and now the fifth edition of the book, the vision has continued.

Writing a book and revising it four times means fewer hours to devote to loved ones. I thank Joanne, my wife, and Alison and Jessica, my daughters, for their love, patience, encouragement, and understanding. When Jessica was very young, she thought that I lived upstairs in my home office. As an honor student at Georgia Southern University, Jessica understands effective time management. Alison, a 1996 graduate of the Terry College of Business of The University of Georgia, has embarked on a career in banking with the Factoring Division of SunTrust Banks in

Atlanta. Joanne, a devoted wife and mother, continues her work as a community and church volunteer. Lately, she has come to learn and appreciate why her husband, a native of Latrobe, Pennsylvania, the home of Arnold Palmer, loves golf so much. More than that, she has taken up the game and appreciates the challenge of the skill level, focus, and mental toughness it takes to play golf. Finally, Joanne's chocolate-chip cookies have become famous among my students. Last spring when she was writing a check at a local grocery store, she asked the clerk if he wanted to verify her identification. Looking at the check, he said, "Are you Dr. Sinkey's wife?" Joanne affirmed that she was, and he said, "That won't be necessary and, by the way, your chocolate-chip cookies are great." Manolis Kipreos, a native of Greece and a good student during my spring quarter 1997 banking class, was the clerk.

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Six reviewers contracted by the publisher provided valuable comments and suggestions on the manuscript for the fifth edition. In alphabetical order, they are:

- Scott W. Barnhart, Clemson University
- David R. Durst, University of Akron
- Jocelyn D. Evans, Georgia State University
- Brian Gibson, Iowa State University
- James E. McNulty, Florida Atlantic University
- Robert C. Winder, Christopher Newport University

I thank each of you for taking the time to read and comment on the portions of the manuscript you reviewed.

Finally, pay special attention to the list of people on page ii. They are the Prentice Hall people who worked on this project. A special thanks to Paul Donnelly, Anne Graydon, Gladys Soto, and Jodi Hirsh; they tried their best to keep me on schedule.

If I have inadvertently omitted anyone from the acknowledgments for this edition, I apologize in advance. *Mea culpa, mea culpa, mea maxima culpa*. Individuals who provided valuable assistance on the previous four editions of the book are too numerous to mention. They are acknowledged in the prefaces of the earlier editions.

—Joseph F. Sinkey, Jr.
Athens, Georgia
October 1997

About the Author

JOSEPH F. SINKEY, JR., is Professor of Banking and Finance and holds the Edward W. Hiles Chair of Financial Institutions, Department of Banking and Finance, Terry College of Business, The University of Georgia, Athens, Georgia. He received his Ph.D. in economics from Boston College in 1971 and his B. A. in economics from St. Vincent College, Latrobe, Pennsylvania, in 1966. From 1971 to 1976, he was a financial economist with the Division of Research of the Federal Deposit Insurance Corporation, Washington, D.C. He joined the faculty of The University of Georgia in 1976 as an associate professor and was promoted to full professor in 1983. From 1985 to 1992, he held the Georgia Bankers Association Chair of Banking.

Professor Sinkey has distinguished himself as a teacher, author, and researcher. He was recognized for superior teaching at The University of Georgia Honors Day in 1984 and 1985 and by the Georgia Finance Club in 1984. He is the author of six previous books: *Commercial Bank Financial Management*, published in 1983, 1986, 1989, and 1992; *Application of Classification Techniques in Business, Banking, and Finance*, a coauthored research book published by JAI Press, Inc., in 1981; and *Problems and Failed Institutions in the Commercial Banking Industry*, a research book published by JAI Press, Inc., in 1979. Professor Sinkey has written numerous articles, chapters, and book reviews for various banking and finance publications. He is an associate editor and the book review editor for the *Journal of Banking and Finance*, a former associate editor for the *Journal of Financial Research*, and an ad hoc reviewer for major banking and finance journals.

In addition to his teaching and research duties, Professor Sinkey has served as a consultant to industry and government, testified before the United States Senate, and been an expert witness in cases involving banking and financial matters. Professor Sinkey has taught at various banking schools across the country including the School for Bank Administration, The Michigan Graduate School of Bank Management, The Management School of Bank Marketing, The School for Executive Development, and the Georgia Banking School. His international experience includes teaching, seminars, paper presentations, and speeches in Bratislava (Slovakia), Byblos (Lebanon), Istanbul, Jerusalem, London, Lyon, Montevideo, Oslo, Phnom Penh, Rome, Seoul, Taipei, Tours, and Vilnius (Lithuania).

Professor Sinkey has been married to Joanne Marie Forsyth since 1970, and they have two daughters—Alison, 23, and Jessica, 20. His nonacademic interests include golf, tennis, duplicate bridge, long-distance running, theater/cinema, travel, and freelance writing. A hole-in-one in 1986 and a completed marathon (26 miles 385 yards in 3:34:51) in 1978 mark his accomplishments in these areas. Becoming a life master in duplicate bridge, lowering his golf handicap, and writing a book about life in and beyond the Latrobe Restaurant are his post-retirement goals.

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