Contents

Balance Sheet and Recent Trends 42

PART ONE	Other Fee-Generating Activities 49
	Regulation 49
INTRODUCTION 1	Industry Performance 55
Chapter One	Savings Institutions 59
•	Size, Structure, and Composition of the
Why Are Financial Institutions	Industry 59
Special? 2	Balance Sheet and Recent Trends 61
Introduction 2	Regulation 62
Financial Institutions' Specialness 4	Industry Performance 63
FIs Function as Brokers 5	Credit Unions 65
FIs Function as Asset Transformers 5	Size, Structure, and Composition of the
Information Costs 6	Industry 66
Liquidity and Price Risk 7	Balance Sheet and Recent Trends 68
Other Special Services 8	Regulation 69
Other Aspects of Specialness 8	Industry Performance 69
The Transmission of Monetary Policy 9	Global Issues: The Financial Crisis 71
Credit Allocation 9	Summary 72
Intergenerational Wealth Transfers or Time	Appendix 2A
Intermediation 9	Financial Statement Analysis Using a Return of
Payment Services 10	Equity (ROE) Framework 76
Denomination Intermediation 10	(www.mhhe.com/saunders7e)
Specialness and Regulation 10	Appendix 2B
Safety and Soundness Regulation 11	Commercial Banks' Financial Statements
Monetary Policy Regulation 13	and Analysis 76
Credit Allocation Regulation 13	(www.mhhe.com/saunders7e)
Consumer Protection Regulation 14	Appendix 2C
Investor Protection Regulation 14	Depository Institutions and Their
Entry Regulation 15	Regulators 77
The Changing Dynamics of Specialness 15	(www.mhhe.com/saunders7e)
Trends in the United States 16	Appendix 2D
Global Trends 19	Technology in Commercial Banking 77
Summary 20	(www.mhhe.com/saunders7e)
Appendix 1A	
The Financial Crisis: The Failure of Financial	Chapter Three
Services Institution Specialness 24	Financial Services: Insurance 78
Appendix 1B	
Monetary Policy Tools 34	Introduction 78
(www.mhhe.com/saunders7e)	Life Insurance 79
,	Size, Structure, and Composition of the Industry 79
Chapter Two	Balance Sheet and Recent Trends 83
Financial Services: Depository	Regulation 86
Institutions 35	Property–Casualty Insurance 87
	Size, Structure, and Composition of the Industry 87
Introduction 35	Balance Sheet and Recent Trends 89
Commercial Banks 38	Regulation 97
Size Structure and Composition of the Industry 39	Global Issues 98

Summary 100

Brokerage and Investment Banking 104	Industry Performance 174 Regulation 176 Global Issues 178
Introduction 104	Summary 178
Size, Structure, and Composition of the	
Industry 106	Chapter Seven
Balance Sheet and Recent Trends 114 Recent Trends 114	Risks of Financial Institutions 181
Balance Sheet 118	Introduction 181
Regulation 119	Interest Rate Risk 182
Global Issues 122	Market Risk 184
Summary 124	Credit Risk 186
_	Off-Balance-Sheet Risk 188
Chapter Five	Foreign Exchange Risk 189
Financial Services: Mutual Funds and	Country or Sovereign Risk 191
Hedge Funds 128	Technology and Operational Risks 192
Introduction 128	Liquidity Risk 194 Insolvency Risk 195
Size, Structure, and Composition of the Mutual	Other Risks and the Interaction of Risks 196
Fund Industry 129	Summary 197
Historical Trends 129	Samurary 137
Different Types of Mutual Funds 132	
Mutual Fund Objectives 137	PART TWO
Investor Returns from Mutual Fund Ownership 139	MEASURING RISK 203
Mutual Fund Costs 142	
Balance Sheet and Recent Trends for the Mutual	Chapter Eight
Fund Industry 145	Interest Rate Risk I 204
Money Market Funds 145	Justine desertions 204
Long-Term Funds 146	Introduction 204 The Level and Movement of Interest Rates 205
Regulation of Mutual Funds 147	
Global Issues in the Mutual Fund Industry 150 Hedge Funds 152	The Repricing Model 208 Rate-Sensitive Assets 210
Types of Hedge Funds 154	Rate-Sensitive Liabilities 210
Fees on Hedge Funds 158	Equal Changes in Rates on RSAs and RSLs 212
Offshore Hedge Funds 158	Unequal Changes in Rates on RSAs and RSLs 213
Regulation of Hedge Funds 159	Weaknesses of the Repricing Model 216
Summary 160	Market Value Effects 216
,	Overaggregation 216
Chapter Six	The Problem of Runoffs 217
Financial Services: Finance	Cash Flows from Off-Balance-Sheet Activities 217
Companies 164	Summary 218
•	Appendix 8A
Introduction 164	The Maturity Model 227
Size, Structure, and Composition of the Industry 165	(www.mhhe.com/saunders7e)
Balance Sheet and Recent Trends 169	Appendix 8B Term Structure of Interest Rates 227
	TECH STRUCTURE OF INTERACT ROTAL 777

Assets 169

Liabilities and Equity 173

Chapter Four Financial Services: Securities

Chapter Nine	Regulatory Models: The BIS Standardized
Interest Rate Risk II 234	Framework 302
	Fixed Income 303
Introduction 234	Foreign Exchange 306
Duration: A Simple Introduction 235	Equities 307
A General Formula for Duration 237	The BIS Regulations and Large-Bank Internal
The Duration of Interest-Bearing Bonds 239	Models 308
The Duration of a Zero-Coupon Bond 241	Summary 310
The Duration of a Consol Bond (Perpetuities) 241	•
Features of Duration 242	Chapter Eleven
Duration and Maturity 242	Credit Risk: Individual Loan Risk 317
Duration and Yield 243	
Duration and Coupon Interest 244	Introduction 317
The Economic Meaning of Duration 244	Credit Quality Problems 318
Semiannual Coupon Bonds 248	Types of Loans 321
Duration and Interest Rate Risk 249	Commercial and Industrial Loans 321
Duration and Interest Rate Risk Management on a	Real Estate Loans 324
Single Security 249	Individual (Consumer) Loans 325
Duration and Interest Rate Risk Management on the	Other Loans 327
Whole Balance Sheet of an FI 253	Calculating the Return on a Loan 327
Immunization and Regulatory	The Contractually Promised Return
Considerations 259	on a Loan 327
Difficulties in Applying the Duration Model 260	The Expected Return on a Loan 330
Duration Matching Can Be Costly 260	Retail versus Wholesale Credit Decisions 331
Immunization Is a Dynamic Problem 260	Retail 331
Large Interest Rate Changes and Convexity 261	Wholesale 332
Summary 263	Measurement of Credit Risk 333
Appendix 9A	Default Risk Models 334
The Basics of Bond Valuation 272	Qualitative Models 335
(www.mhhe.com/saunders7e)	Quantitative Models 337
Appendix 9B	Newer Models of Credit Risk Measurement
Incorporating Convexity into the Duration	and Pricing 341
Model 272	Summary 358
	Appendix 11A
Chapter Ten	Credit Analysis 368
Market Risk 283	(www.mhhe.com/saunders7e)
	Appendix 11B
Introduction 283	Black-Scholes Option Pricing Model 368
Calculating Market Risk Exposure 285	(www.mhhe.com/saunders7e)
The RiskMetrics Model 286	a
The Market Risk of Fixed-Income Securities 287	Chapter Twelve
Foreign Exchange 290	Credit Risk: Loan Portfolio and
Equities 291	Concentration Risk 369
Portfolio Aggregation 292	Introduction 200
Historic (Back Simulation) Approach 296	Introduction 369
The Historic (Back Simulation) Model versus	Simple Models of Loan Concentration Risk 369
RiskMetrics 299	Loan Portfolio Diversification and Modern

Portfolio Theory (MPT) 371

RiskMetrics 299

The Monte Carlo Simulation Approach 300

Moody's KMV Portfolio Manager Model 375 Partial Applications of Portfolio Theory 379 Regulatory Models 383 Summary 384 Appendix 12A CreditMetrics 389	Purchasing Power Parity 443 Interest Rate Parity Theorem 445 Summary 446 Chapter Fifteen Sovereign Risk 451
Appendix 12B CreditRisk+ 393	Introduction 451
Chapter Thirteen Off-Balance-Sheet Risk 396	Credit Risk versus Sovereign Risk 454 Debt Repudiation versus Debt Rescheduling 455 Country Risk Evaluation 457 Outside Evaluation Models 457
Introduction 396 Off-Balance-Sheet Activities and FI Solvency 397 Returns and Risks of Off-Balance-Sheet	Internal Evaluation Models 458 Using Market Data to Measure Risk: The Secondary Market for LDC Debt 468
Activities 402 Loan Commitments 404 Commercial Letters of Credit and Standby Letters of Credit 408	Summary 472 Appendix 15A Mechanisms for Dealing with Sovereign Risk Exposure 477
Derivative Contracts: Futures, Forwards, Swaps, and Options 411 Forward Purchases and Sales of When-Issued Securities 416	Chapter Sixteen Technology and Other Operational Risks 481
Loans Sold 416 Non-Schedule L Off-Balance-Sheet Risks 417 Settlement Risk 417 Affiliate Risk 418	Introduction 481 What Are the Sources of Operational Risk? 482 Technological Innovation and Profitability 483 The Impact of Technology on Wholesale and
The Role of OBS Activities in Reducing Risk 420 Summary 421 Appendix 13A	Retail Financial Service Production 485 Wholesale Financial Services 485
A Letter of Credit Transaction 425 (www.mhhe.com/saunders7e)	Retail Financial Services 487 The Effect of Technology on Revenues and Costs 488
Chapter Fourteen Foreign Exchange Risk 426	Technology and Revenues 489 Technology and Costs 490 Testing for Economies of Scale and Economies of
Introduction 426 Foreign Exchange Rates and Transactions 426 Foreign Exchange Rates 426 Foreign Exchange Transactions 427 Sources of Foreign Exchange Risk Exposure 429	Scope 494 The Production Approach 495 The Intermediation Approach 495 Empirical Findings on Cost Economies of Scale and Scope and Implications for Technology
Foreign Exchange Rate Volatility and FX Exposure 432 Foreign Currency Trading 433	Expenditures 495 Economies of Scale and Scope and X-Inefficiencies 496 Technology and the Evolution of the Payments
FX Trading Activities 433 Foreign Asset and Liability Positions 435 The Return and Risk of Foreign Investments 435 Risk and Hedging 437 Multicurrency Foreign Asset-Liability Positions 441 Interaction of Interest Rates, Inflation, and	System 497 Risks That Arise in an Electronic Transfer Payment System 499 Other Operational Risks 505 Regulatory Issues and Technology and Operational Risks 507
Exchange Rates 443	Summary 510

Chapter Seven	teen
Liquidity Risk	514

Introduction 514
Causes of Liquidity Risk 515
Liquidity Risk at Depository Institutions 516
Liability-Side Liquidity Risk 516
Asset-Side Liquidity Risk 520
Measuring a DI's Liquidity Exposure 522
Liquidity Risk, Unexpected Deposit Drains, and Bank Runs 529
Bank Runs, the Discount Window, and Deposit Insurance 530

Liquidity Risk and Life Insurance Companies 531 Liquidity Risk and Property–Casualty Insurers 532 Investment Funds 533 Summary 535

Sources and Uses of Funds Statement, Bank of America, June 2009 540 (www.mhhe.com/saunders7e)

PART THREE MANAGING RISK 541

Appendix 17A

Chapter Eighteen Liability and Liquidity Management 542

Introduction 542
Liquid Asset Management 542
Monetary Policy Implementation Reasons 543
Taxation Reasons 544
The Composition of the Liquid Asset
Portfolio 544
Return-Risk Trade-Off for Liquid Assets 545
The Liquid Asset Reserve Management Problem for U.S.
Depository Institutions 545
Undershooting/Overshooting of the Reserve Target 549
Managing Liquid Assets Other than Cash 553
Liability Management 554

Funding Risk and Cost 555

Choice of Liability Structure 556

Demand Deposits 556

Interest-Bearing Checking (NOW) Accounts 557

Passbook Savings 558

Money Market Deposit Accounts (MMDAs) 559

Retail Time Deposits and CDs 560

Wholesale CDs 561

Federal Funds 562
Repurchase Agreements (RPs) 563
Other Borrowings 563
Liquidity and Liability Structures for U.S.
Depository Institutions 565
Liability and Liquidity Risk Management in Insurance Companies 567
Liability and Liquidity Risk Management in Other FIs 567
Summary 568
Appendix 18A

Federal Reserve Requirement Accounting 573 (www.mhhe.com/saunders7e)

Appendix 18B

Bankers Acceptance and Commercial Paper as Sources of Financing 573 (www.mhhe.com/saunders7e)

Chapter Nineteen Deposit Insurance and Other Liability Guarantees 574

Introduction 574
Bank and Thrift Guaranty Funds 575
The Causes of the Depository Fund
Insolvencies 578

The Financial Environment 578 Moral Hazard 579

Panic Prevention versus Moral Hazard 580 Controlling Depository Institution Risk Taking 581

Stockholder Discipline 581 Depositor Discipline 586 Regulatory Discipline 592

Non-U.S. Deposit Insurance Systems 593

The Discount Window 594

Deposit Insurance versus the Discount Window 594

The Discount Window 594

Other Guaranty Programs 597

National Credit Union Administration 597

Property-Casualty and Life Insurance

Companies 597

The Securities Investor Protection Corporation 598 The Pension Benefit Guaranty Corporation 600

Summary 601 **Appendix 19A**

Calculation of Deposit Insurance

Premiums 607
Appendix 19B

FDIC Press Release of Bank Failures 611 (www.mhhe.com/saunders7e)

Appendix 19C Deposit Insurance Coverage for Commercial Banks in Various Countries 611 Www.mhhe.com/saunders7e)	Domestic Geographic Expansion 672 Regulatory Factors Impacting Geographic Expansion 673 Insurance Companies 673
Chapter Twenty	Thrifts 673 Commercial Banks 673
Capital Adequacy 612	Cost and Revenue Synergies Impacting
•	Domestic Geographic Expansion by Merger and
Introduction 612 Capital and Insolvency Risk 613	Acquisition 677
	Cost Synergies 677
Capital 613 The Market Value of Capital 614	Revenue Synergies 678
The Book Value of Capital 616	Merger Guidelines for Acceptability 679
The Discrepancy between the Market and Book Values of	Other Market- and Firm-Specific Factors
Equity 617	Impacting Domestic Geographic Expansion
Arguments against Market Value Accounting 618	Decisions 682
Capital Adequacy in the Commercial Banking	Global and International Expansions 683
and Thrift Industry 620	U.S. Banks Abroad 683
Actual Capital Rules 620	Foreign Banks in the United States 686
The Capital–Assets Ratio (or Leverage Ratio) 620	Advantages and Disadvantages of International
Risk-Based Capital Ratios 622	Expansion 688
Calculating Risk-Based Capital Ratios 627	Advantages 688
Capital Requirements for Other Fls 641	Disadvantages 689
Securities Firms 641	Summary 690
Life Insurance 642	Appendix 21A
Property–Casualty Insurance 643	EU and G-10 Countries: Regulatory
Summary 645	Treatment of the Mixing of Banking,
Appendix 20A	Securities, and Insurance
Internal Ratings–Based Approach to Measuring	Activities and the Mixing of Banking and
Credit Risk-Adjusted Assets 653	Commerce 695
Chapter Twenty-One	(www.mhhe.com/saunders7e)
Product and Geographic Expansion 656	-
	Chapter Twenty-Two
Introduction 656	Futures and Forwards 696
Product Diversification 657	Introduction (O)
Segmentation in the U.S. Financial Services Industry 658	Introduction 696 Forward and Futures Contracts 698
Commercial and Investment Banking Activities 658	Spot Contracts 698
Banking and Insurance 661	Forward Contracts 698
Commercial Banking and Commerce 663	Futures Contracts 699
Nonbank Financial Service Firms and Commerce 663	Forward Contracts and Hedging Interest Rate
Activity Restrictions in the United States versus	Risk 701
Other Countries 664	Hedging Interest Rate Risk with Futures
Issues Involved in the Diversification of Product	Contracts 702
Offerings 664	Microhedging 702
Safety and Soundness Concerns 665	Macrohedging 703
Economies of Scale and Scope 667	Routine Hedging versus Selective Hedging 703
Conflicts of Interest 668	Macrohedging with Futures 704
Deposit Insurance 670	The Problem of Basis Risk 711
Regulatory Oversight 670	Hedging Foreign Exchange Risk 713
Competition 670	Forwards 713

Futures /13	Chapter Twenty-Four
Estimating the Hedge Ratio 717	Swaps 774
Hedging Credit Risk with Futures and	onaps 772
Forwards 720	Introduction 774
Credit Forward Contracts and Credit Risk	Swap Markets 775
Hedging 721	Interest Rate Swaps 776
Futures Contracts and Catastrophe Risk 723	Realized Cash Flows on an Interest
Regulation of Derivative Securities 724	Rate Swap 780
	•
Summary 725	Macrohedging with Swaps 781
Appendix 22A	Currency Swaps 784
Microhedging with Futures 732	Fixed-Fixed Currency Swaps 784
(www.mhhe.com/saunders7e)	Fixed-Floating Currency Swaps 786
	Credit Swaps 787
Chapter Twenty-Three	Total Return Swaps 788
· ·	Pure Credit Swaps 790
Options, Caps, Floors, and Collars 733	Swaps and Credit Risk Concerns 791
Introduction 733	Netting and Swaps 792
Basic Features of Options 733	Payment Flows Are Interest and Not
Buying a Call Option on a Bond 734	Principal 793
	Standby Letters of Credit 793
Writing a Call Option on a Bond 735	Summary 793
Buying a Put Option on a Bond 736	Appendix 24A
Writing a Put Option on a Bond 737	Setting Rates on an Interest Rate Swap 799
Writing versus Buying Options 737	•
Economic Reasons for Not Writing Options 737	Chapter Twenty-Five
Regulatory Reasons 739	Loan Sales 802
Futures versus Options Hedging 739	
The Mechanics of Hedging a Bond or Bond	Introduction 802
Portfolio 740	The Bank Loan Sales Market 803
Hedging with Bond Options Using the Binomial	Definition of a Loan Sale 803
Model 741	Types of Loan Sales 804
Actual Bond Options 745	Types of Loan Sales Contracts 805
Using Options to Hedge Interest Rate Risk on the	Trends in Loan Sales 806
Balance Sheet 748	The Buyers and the Sellers 807
Using Options to Hedge Foreign Exchange	Why Banks and Other FIs Sell Loans 812
Risk 753	Reserve Requirements 812
Hedging Credit Risk with Options 754	Fee Income 812
Hedging Catastrophe Risk with Call Spread	Capital Costs 813
Options 756	Liquidity Risk 813
Caps, Floors, and Collars 756	Factors Affecting Loan Sales Growth 813
Caps 757	Access to the Commercial Paper Market 813
Floors 760	Customer Relationship Effects 813
Collars 761	Legal Concerns 814
	BIS Capital Requirements 814
Caps, Floors, Collars, and Credit Risk 764	Market Value Accounting 814
Summary 765	\$ *
Appendix 23A	Asset Brokerage and Loan Trading 814
Black-Scholes Option Pricing Model 773	Government Loan Sales 815
(www.mhhe.com/saunders7e)	Credit Ratings 815
Appendix 23B	Purchase and Sale of Foreign Bank
Microhedging with Options 773	Loans 815
(www.mhhe.com/saunders7e)	Summary 816

Chapter Twenty-Six Securitization 818

Introduction 818
Mechanisms Used to Convert On-Balance-Sheet
Assets to a Securitized Asset 819
The Pass-Through Security 823
GNMA 823
FNMA 823
FHLMC 824
The Incentives and Mechanics of Pass-Through Security
Creation 824
Prepayment Risk on Pass-Through Securities 830
Prepayment Models 835
Government Sponsorship and Oversight of FNMA and
Freddie Mac 842

The Collateralized Mortgage Obligation (CMO) 844

Creation of CMOs 845 Class A, B, and C Bond Buyers 847

Other CMO Classes 847

The Mortgage-Backed Bond (MBB) 848 Innovations in Securitization 850

Mortgage Pass-Through Strips 850 Securitization of Other Assets 853

Can All Assets Be Securitized? 854

Summary 856

Appendix 26A
Fannie Mae and Freddie Mac Balance Sheets 861

rannie Mae and Freddie Mac Balance Sheets 861 (www.mhhe.com/saunders7e)

INDEX 862