

# Abbreviated Contents

Preface	xv
Acknowledgments	xix
About the Authors	xxi
<b>PART I THE BACKGROUND</b>	<b>1</b>
A Friendly Conversation	3
Chapter 1 Basic Concepts	13
<b>PART II WHAT IS FINANCIAL INTERMEDIATION?</b>	<b>39</b>
Chapter 2 The Nature and Variety of Financial Intermediation	41
Chapter 3 The What, How, and Why of Financial Intermediaries	91
<b>PART III MAJOR “ON-BALANCE-SHEET” RISKS IN BANKING</b>	<b>125</b>
Chapter 4 Major Risks Faced by Banks	127
Chapter 5 Spot Lending	169

Chapter 6	Further Issues in Bank Lending	227
Chapter 7	Special Topics in Credit: Syndicated Loans, Loan Sales, and Project Finance	279
<b>PART IV</b>	<b>OFF THE BANK'S BALANCE SHEET</b>	<b>293</b>
Chapter 8	Off-Balance Sheet Banking and Contingent Claims Products	295
Chapter 9	Securitization	345
<b>PART V</b>	<b>THE DEPOSIT CONTRACT</b>	<b>395</b>
Chapter 10	The Deposit Contract and Insurance	397
<b>PART VI</b>	<b>BANK REGULATION</b>	<b>439</b>
Chapter 11	Objectives of Bank Regulation	441
Chapter 12	Milestones in Banking Legislation and Regulatory Reform	479
<b>PART VII</b>	<b>OVERALL MANAGEMENT OF THE BANK</b>	<b>519</b>
Chapter 13	Management of Risks and Opportunities in Banking	521
<b>PART VIII</b>	<b>CORPORATE CONTROL AND GOVERNANCE</b>	<b>559</b>
Chapter 14	Mergers and Acquisitions	561
Chapter 15	Investment Banking	587
<b>PART IX</b>	<b>THE FUTURE</b>	<b>609</b>
Chapter 16	The Future	611
<b>INDEX</b>		<b>619</b>

# Extended Contents

Preface	xv
Acknowledgments	xix
About the Authors	xxi
<b>PART I THE BACKGROUND</b>	<b>1</b>
<b>A Friendly Conversation</b>	<b>3</b>
Introduction	3
The Conversation: 1991	3
Follow-Up to the Conversation: 2007	11
<b>Chapter 1 Basic Concepts</b>	<b>13</b>
Introduction	13
Risk Preferences	13
Diversification	16
Riskless Arbitrage	19
Options	20
Market Efficiency	21
Market Completeness	22
Asymmetric Information and Signaling	24
Agency and Moral Hazard	29
Time Consistency	32
	ix

Nash Equilibrium	34
Revision of Beliefs and Bayes Rule	35
<b>PART II WHAT IS FINANCIAL INTERMEDIATION?</b>	<b>39</b>
<b>Chapter 2 The Nature and Variety of Financial Intermediation</b>	<b>41</b>
Introduction	42
What Are Financial Intermediaries?	43
The Variety of Financial Intermediaries	50
Depository Financial Intermediaries	53
Nondepository Intermediaries	61
The Role of the Government	72
Financial Intermediaries on the Periphery	72
Conclusion	75
<i>Appendix 2.1: Measurement Distortions and the Balance Sheet</i>	76
<i>Appendix 2.2: Guide to Federal Reserve Regulations</i>	78
<b>Chapter 3 The What, How, and Why of Financial Intermediaries</b>	<b>91</b>
Introduction	92
Fractional Reserve Banking and the Goldsmith Anecdote	93
A Model of Banks and Regulation	97
The Macroeconomic Implications of Fractional Reserve Banking: The Fixed Coefficient Model	103
Large Financial Intermediaries	107
How Banks Can Help to Make Nonbank Financial Contracting More Efficient	109
The Empirical Evidence: Banks Are Special	110
Ownership Structure of Depository Financial Institutions	112
The Borrower's Choice of Finance Source	115
Conclusion	117
<i>Appendix 3.1: The Formal Analysis of Large Intermediaries</i>	119
<b>PART III MAJOR "ON-BALANCE-SHEET" RISKS IN BANKING</b>	<b>125</b>
<b>Chapter 4 Major Risks Faced by Banks</b>	<b>127</b>
Introduction	127
The Source of Business Risk	128

Credit, Interest Rate, and Liquidity Risks	129
The Term Structure of Interest Rates	132
Duration	141
Convexity	146
Interest Rate Risk	148
Liquidity Risk	151
Conclusion	157
<i>Case Study: Eggleston State Bank</i>	158
<i>Appendix 4.1: Dissipation of Withdrawal Risk Through Diversification</i>	164
<i>Appendix 4.2: Lender-of-Last-Resort Moral Hazard</i>	164
<b>Chapter 5 Spot Lending</b>	<b>169</b>
Introduction	171
Description of Bank Assets	171
What Is Lending?	177
Loans Versus Securities	179
Structure of Loan Agreements	180
Informational Problems in Loan Contracts and the Importance of Loan Performance	182
Credit Analysis: The Factors	185
Sources of Credit Information	206
Analysis of Financial Statements	208
Loan Covenants	212
Conclusion	215
<i>Case Study: Indiana Building Supplies, Inc.</i>	216
<i>Appendix 5.1: Trends in Credit Analysis</i>	222
<b>Chapter 6 Further Issues in Bank Lending</b>	<b>227</b>
Introduction	228
Loan Pricing and Profit Margins: General Remarks	228
Credit Rationing	238
The Spot Lending Decision	246
Long-Term Bank-Borrower Relationships	248
Loan Restructuring and Default	255
Conclusion	265
<i>Case Study: Zeus Steel, Inc.</i>	266

<b>Chapter 7 Special Topics in Credit: Syndicated Loans, Loan Sales, and Project Finance</b>	<b>279</b>
Introduction	279
Syndicated Lending	280
Project Finance	287
Conclusion	290
<b>PART IV OFF THE BANK'S BALANCE SHEET</b>	<b>293</b>
<b>Chapter 8 Off-Balance Sheet Banking and Contingent Claims Products</b>	<b>295</b>
Introduction	296
Loan Commitments: A Description	299
Rationale for Loan Commitments	304
Pricing of Loan Commitments	315
The Differences Between Loan Commitments and Put Options	317
Loan Commitments and Monetary Policy	320
Other Contingent Claims: Letters of Credit	321
Other Contingent Claims: Swaps	323
Other Contingent Claims: Credit Derivatives	329
Risks for Banks in Contingent Claims	330
Regulatory Issues	334
Conclusion	335
<i>Case Study: Youngstown Bank</i>	336
<b>Chapter 9 Securitization</b>	<b>345</b>
Introduction	346
Preliminary Remarks on the Economic Motivation for Securitization and Loan Sales	348
Different Types of Securitization Contracts	351
Going Beyond Preliminary Remarks on Economic Motivation: The "Why," "What," and "How Much Is Enough" of Securitization	363
Strategic Issues for a Financial Institution Involved in Securitization	383
Comparison of Loan Sales and Loan Securitization	386
Conclusion	386
<i>Case Study: Lone Star Bank</i>	387

<b>PART V THE DEPOSIT CONTRACT</b>	<b>395</b>
<b>Chapter 10 The Deposit Contract and Insurance</b>	<b>397</b>
Introduction	398
The Deposit Contract	399
Liability Management	407
Deposit Insurance	409
The Great Deposit Insurance Debacle	431
Conclusion	435
<b>PART VI BANK REGULATION</b>	<b>439</b>
<b>Chapter 11 Objectives of Bank Regulation</b>	<b>441</b>
Introduction	442
The Essence of Bank Regulation	443
The Agencies of Bank Regulation	446
Market Structure and Competition	451
The Basel I Capital Accord	459
Safety and Soundness Regulation: Bank Portfolio Restrictions	466
Consumer Protection, Credit Allocation, and Monetary Control Regulation	467
Conclusion	475
<b>Chapter 12 Milestones in Banking Legislation and Regulatory Reform</b>	<b>479</b>
Introduction	480
Milestones of Banking Legislation	480
Problems of Bank Regulation	489
The 1991 FDICIA and Beyond	497
Liquidity Constraints, Capital Requirements, and Monetary Policy	504
The Basel II Capital Accord	506
The Debate Over Capital Requirements	512
Conclusion	515
<b>PART VII OVERALL MANAGEMENT OF THE BANK</b>	<b>519</b>
<b>Chapter 13 Management of Risks and Opportunities in Banking</b>	<b>521</b>
Introduction	522
Opportunities and Risks in Banking	524

Day-to-Day Management	528
Crisis Management and Enterprise Risk Management	545
Strategic Planning	546
<i>Case Study</i>	554
Conclusion	556
<b>PART VIII CORPORATE CONTROL AND GOVERNANCE</b>	<b>559</b>
<b>Chapter 14 Mergers and Acquisitions</b>	<b>561</b>
Introduction	562
Recent Trends in Mergers and Acquisitions in Banking	562
Corporate Control Issues	563
Mergers in Banking	572
Hostile Takeovers in Banking	577
Conclusion	582
<b>Chapter 15 Investment Banking</b>	<b>587</b>
Introduction	587
What Investment Banks Do	588
Risk Management, Structured Finance, and Investment Banks	598
Conclusion	602
<i>Appendix 15.1</i>	602
<b>PART IX THE FUTURE</b>	<b>609</b>
<b>Chapter 16 The Future</b>	<b>611</b>
Introduction	611
Future Opportunities for Banks: Expanded Role for Relationship Banking and the Implications for Universal Banking, Financial Innovation, and Globalization	612
Risk Management by Banks	614
The Basel Initiative and Future Capital Accords	614
Conclusion	618
<b>INDEX</b>	<b>619</b>