Bank Financial Management

Module Introduction and Overview

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1 Introduction to the Module

Welcome to this module on *Bank Financial Management.* At the outset, it is worth noting that this module has a somewhat more *applied* feel to it than many other modules in the Master's and Postgraduate Diploma programme, focusing as it does on the microeconomic problems of financial management of banking firms. This does not mean, however, that the module is devoid of theoretical interest.

The module begins by examining, in Unit 1, some of the major changes that have occurred in banking since the late twentieth century. With the benefit of hindsight they can be seen as precursors of the banking crisis of 2007–09, which had its origins and focus in the large banks of the United States and United Kingdom. The unit discusses the changes from that perspective. Our main purpose in the unit is to show how bank financial management is a dynamic and changing practice.

Unit 2 focuses on the importance that measurement has for bank financial management and introduces banks' financial accounts as a prime measurement tool. The unit teaches that the accounting rules underlying banks' accounts are not immutable or universal and focuses on types of rules – the rules governing fair value accounting – that became especially controversial after the sharp worsening of the US financial system's crisis in 2008.

Unit 3 then narrows its focus even more, to look at the role of the financial manager within the banking firm. Examining this role involves us in looking also at the question of how we can put a value on a banking firm, and assess bank performance. Improving performance and maximising value are chief aspects of the role of the bank financial manager but, again, we can ask how special this role is, or how similar it is to the role of a financial manager in any firm.

One way in which the role of the bank financial manager is distinct is that the role involves the management of various kinds of financial *risks* to a particularly marked extent. Three units of the module are therefore taken up with examining particular kinds of risk management in considerable detail. Unit 4 looks at overall risk management questions and then specifically at managing liquidity risk. Unit 5 focuses on interest rate risk and on techniques for analysing and for managing that. Unit 7 looks at credit risk, chiefly the risk of default on loans, and at the associated problem of how loans should be priced to reflect different degrees of risk. Meanwhile, Unit 6 prepares you for the subject of credit risk, by examining *funding* sources and costs, and risks associated with funding sources.

Last but not least, the module concludes in Unit 8 with an examination of bank capital and capital structure. This takes us back to the question of the adequate regulation of the banking sector to ensure its safety. Preserving bank liquidity and preventing bank failures are issues running right through the module, given their fundamental importance, but Unit 8 looks directly at modern international standards designed to deliver them.

2 Study Resources

The materials for this module comprise the study guide, presented in eight units covering different aspects of the study of the financial management of the banking sector, a key text and supplementary module readings.

The study guide illustrates the main ideas arising from a consideration of the management of banks and suggest how to proceed in the study of each issue. The units are designed in the expectation that you will devote about 15–20 hours to studying each topic, including all the associated readings and the set questions.

Key text

The key text for the module is:

Timothy W Koch and S Scott MacDonald (2015) *Bank Management.* 8th Edition, Boston, MA USA: Cengage Learning.

Koch and MacDonald's book not only provides an excellent analysis of key issues, but also contains a series of case studies that demonstrate how the more theoretical and academic concepts can be placed into a real-world context. You will be asked to examine these cases in specific units. In addition, each chapter provides you with a summary of issues discussed and a set of questions that you may find useful to try as part of your revision of the topic. While specific answers are not provided, the solutions can be found in reading the chapter.

This is an American book and the terminology used may be slightly different from that with which you are familiar from your own country's banking system. The book does contain a glossary and this should help you to clarify any definitional problems. Since banking terminology does differ around the world, this problem would arise for some students whatever the nationality of the title, and you should not worry about it unduly, since major differences of terminology will be pointed out in the module texts.

Because the text is organised around discussion of the banking sector in the USA, it is also worth noting at the outset that banking in the United States has some specific characteristics which may mean that some details of its operation differ from those of the banking system you know best.

Module readingsr

Besides the key text, there are also multiple supplementary readings for the module; including a range of important articles, academic papers and reports considering issues relating to bank financial management, and the study guide will direct you to read them as appropriate.

You are expected to read them as an essential part of the module, although you will find that some academic articles range more widely than the study guide or use more advanced techniques and have a greater level of conceptual difficulty than the key text. That is the nature of academic articles, but we have selected articles and reports whose main arguments can be understood and appreciated at the level appropriate to this module.

3 Module Overview

Unit 1 Banking Innovations and Risk

1.1 Introduction
1.2 Bank Management and Bank Financial Management
1.3 'The good old days': A Simple Balance Sheet View of Banking
1.4 The Transformation of Banking – 1970 to 2007
1.5 Financial Innovation
1.6 Implications of Banking Innovations for Bank Financial Management
1.7 An Assessment of Credit Risk Transfer
1.8 Conclusion

Unit 2 Bank Accounts – A Useful Tool if Handled with Care

2.1 Introduction
2.2 The Bank's Balance Sheet: An Introduction
2.3 The Bank's Income Statement
2.4 Fair Value and Mark-to-Market Accounting – A Hot Topic with Real Potential Effects
2.5 Conclusion

Unit 3 Bank Valuation

3.1 Introduction
3.2 The Functions of Bank Financial Managers
3.3 The Risks Facing Bank Financial Managers
3.4 The Value of the Banking Firm
3.5 The Difference Between Market and Book Value
3.6 Performance Analysis Using Financial Ratios
3.7 Conclusion

Unit 4 Bank Risk Management – Liquidity Management

4.1 Introduction
4.2 Bank Risk Management
4.3 Concepts of Liquidity and Solvency
4.4 Sources of Liquidity
4.5 Measuring Banks' Liquidity
4.6 Practical Liquidity Management
4.7 Payments System Risk and its Potential Impact on Bank Liquidity
4.8 Conclusion

Unit 5 Bank Risk Management – Interest Rate Risk Management

5.1 Introduction
5.2 Interest-Rate Risk Management
5.3 GAP Analysis
5.4 Duration Analysis

5.5 Hedging Interest Rate Risk With Derivatives
5.6 Conclusion

Unit 6 Cost of Funds and the Funding of Operations

6.1 Introduction
6.2 Measuring the Cost of Funds
6.3 A Note on the Cost of Capital
6.4 Using Cost of Funds Measures
6.5 Risks Associated with Raising Funds
6.6 Conclusion

Unit 7 Bank Risk Management – Credit Risk

7.1 Introduction
7.2 Credit Risk
7.3 Credit Risk and Default Premiums
7.4 Loan Administration – General Procedure
7.5 Credit Assessment
7.6 Loan Pricing
7.7 Problem Loans
7.8 Conclusion

Unit 8 Capital Management

8.1 Introduction
8.2 Basel Accords' Rules and Categories of Bank Capital
8.3 Conclusion
Appendix 8.1 'Report for G7 Summit'

4 Learning Outcomes

When you have completed this module, you will be able to:

- discuss trends affecting the whole financial services industry and assess the implications of change for bank risk management
- outline how the behaviour of banks has been modelled
- identify the risks facing bank financial managers
- explain the need to adapt risk management procedures to an increasingly international financial system.
- discuss how interest-rate risk can be managed using hedging activities through the use of financial derivatives and securitisation
- explain why funding mix and costs are important to bank management when making loan and investment decisions
- discuss how credit risk and default premiums are assessed and monitored
- analyse the relationship between bank performance and capital adequacy.