

Rose, Peter S. & Hudgins, Sylvia C. – Bank Management & Financial Services*McGraw-Hill, 2010, [Business] Grade* ★★ ★

It is an ungrateful task to try to give a fair overview of banks when the entire industry is in flux. Finance Professors Peter Rose and Sylvia Hudgins should however be more qualified than most as this is their 8th edition textbook on bank management. They don't fully succeed. The text gives a broad overview of banks. Industry structures, financial statements, products and financing are covered. The most important part is the chapters on how banks handle operational risks.

The operation of a modern bank is hugely complex and it's full of opposing forces, for example the trade-off between liquidity and profitability in the banks securities investments. The bank has to handle credit risk, liquidity risk, market risk - which mainly consists of interest rate risk, off-balance sheet risk, various operational risks etc. The key is to manage the interest sensitive gap (matching of interest sensitive assets and interest sensitive liabilities) and the duration gap (matching the duration of asset and liability portfolios). It's in many ways an odd business that the authors describe. It must be very easy for bank managers to become overly focused on financial engineering instead of the customer offering.

Banks have rather low operational gearing as the fixed costs are small and this means they are not that sensitive to variations in sales volumes. As in all businesses the driving force is to create profits and the low operational gearing gives opportunity to compensate with a high financial gearing. ROE can be broken up into ROA and the so called equity multiplier (Total Assets/Equity Capital, i.e. financial leverage). There are plenty of things you can do to increase ROA such as sell more services to earn more fees, optimize the interest margin earned, control costs, manage the mix of the loan and investment portfolios and so on. The point is that this is hard work and as all the other competitors seem to take the easy road and leverage up, the appeal to do the same will often be overpowering.

Mats Larsson, October 1, 2012

Despite that this 8th edition is published in 2010 there are plenty of pages that "feel so 2005". Given today's trend of increased regulation it is interesting to note how insistent the authors of a student text book are in their arguing for looser bank regulations as the stock market is the prime supervisor of risk and any classification of loans into risk classes will only trigger a maximizing of risk taking within the risk classes. It is evident how a book like this is revised gradually and how some parts of the book have taken the financial crisis into account and others have not. Statements such as the one that banks seldom run out of liquidity as they can always borrow from each other, a focus on risk monitoring through the volatility of stock prices and the discussion of the positive effects of securitization as this removes the loans from the balance sheet and also removes the credit risk, are examples that give this 2005-ish feeling.

Banks have a high interdependence as they rely on funding from each other and I'm amazed that the concept of systemic risks isn't discussed at all (almost) in the book. If the students don't realize the risk of being one domino in a long line, they cannot gain the full understanding of the counterparty risk in, for example, derivatives such as interest rate swaps that's used to hedge interest rate and duration gaps. Normally I very much object to government ownership of enterprises. But I also want things to be fair. If it is the case that the banking sector every 10th or 15th year will have a Minsky-crisis that requires taxpayer aid, the party funding the business is actually the taxpayer and it is then only just that he should also be allowed to be an integral part of the governance of the sector.

As an outsider you'll have a very hard time judging the quality of a bank's assets and liabilities. This makes it even more important than usual to judge the culture and management character of the company before investing. This book will give you an understanding of the mechanics of a bank but it will not make you understand the gist of banking.