

# Modern Banking

**Shelagh Heffernan**

*Professor of Banking and Finance,  
Cass Business School, City University, London*



John Wiley & Sons, Ltd

# CONTENTS

---

|  |     |
|--|-----|
| <b>ACKNOWLEDGEMENTS</b> .....  | ix  |
| <b>PREFACE</b> .....   | xi  |
| <b>CHAPTER 1</b>   |     |
| <b>What are Banks and What Do They Do?</b>                           | 1   |
| 1.1 Introduction .....   | 1   |
| 1.2 The Meaning of Banking .....                                     | 1   |
| 1.3 Organisational Structures .....                                  | 5   |
| 1.4 Banking Structures .....   | 15  |
| 1.5 Financial Conglomerates .....                                    | 26  |
| 1.6 Central Banking .....  | 29  |
| 1.7 Summary: Why are Banks Special? .....                            | 36  |
| 1.8 Conclusion .....   | 38  |
| <b>CHAPTER 2</b>   |     |
| <b>Diversification of Banking Activities</b>                         | 41  |
| 2.1 Introduction .....   | 41  |
| 2.2 The Expansion of Banks into Non-banking Financial Services ..... | 41  |
| 2.3 The Effect of Non-interest Income on Banks' Total Income .....   | 51  |
| 2.4 Global Markets and Centres .....                                 | 55  |
| 2.5 International Banking .....                                      | 64  |
| 2.6 Banking Issues in the 21st Century .....                         | 72  |
| 2.7 Conclusion .....   | 98  |
| <b>CHAPTER 3</b>   |     |
| <b>Management of Risks in Banking</b>                                | 101 |
| 3.1 Introduction .....   | 101 |
| 3.2 Key Financial Risks in the 21st Century .....                    | 103 |
| 3.3 Approaches to the Management of Financial Risks .....            | 113 |
| 3.4 Financial Derivatives and Risk Management .....                  | 125 |
| 3.5 Management of Market Risk .....                                  | 142 |

|  |  |     |
|--|--|-----|
| 3.6  | Management of Credit Risk . . . . .                              | 155 |
| 3.7  | Risk Management by Major Global Bank . . . . .                   | 169 |
| 3.8  | Conclusion . . . . .   | 171 |
| <b>CHAPTER 4</b>   |  |     |
| <b>Global Regulation of Banks</b>                        |  | 173 |
| 4.1  | Introduction . . . . .   | 173 |
| 4.2  | Why Regulate? . . . . .  | 173 |
| 4.3  | International Regulation . . . . .                               | 179 |
| 4.4  | Basel 2 – The Three Pillar Approach . . . . .                    | 192 |
| 4.5  | Alternative or Complementary Approaches to Basel . . . . .       | 210 |
| 4.6  | International Financial Architecture . . . . .                   | 213 |
| 4.7  | Conclusion . . . . .   | 219 |
| <b>CHAPTER 5</b>   |  |     |
| <b>Bank Structure and Regulation: UK, USA, Japan, EU</b> |  | 221 |
| 5.1  | Introduction . . . . .   | 221 |
| 5.2  | Bank Structure and Regulation in the UK . . . . .                | 222 |
| 5.3  | Bank Structure and Regulation in the USA . . . . .               | 242 |
| 5.4  | Bank Structure and Regulation in Japan . . . . .                 | 258 |
| 5.5  | Bank Structure and Regulation in the EU . . . . .                | 262 |
| 5.6  | Conclusions: Structure and Regulation of Banks . . . . .         | 285 |
| <b>CHAPTER 6</b>   |  |     |
| <b>Banking in Emerging Economies</b>                     |  | 287 |
| 6.1  | Introduction . . . . .   | 287 |
| 6.2  | Financial Repression and Evolving Financial Systems . . . . .    | 288 |
| 6.3  | Banking Reforms in Russia, China and India . . . . .             | 293 |
| 6.4  | Islamic Banking . . . . .  | 322 |
| 6.5  | Sovereign and Political Risk Analysis . . . . .                  | 332 |
| 6.6  | Conclusion . . . . .   | 347 |
| <b>CHAPTER 7</b>   |  |     |
| <b>Bank Failures</b>                                     |  | 351 |
| 7.1  | Introduction . . . . .   | 351 |
| 7.2  | Bank Failure – Definitions . . . . .                             | 351 |
| 7.3  | Case Studies on Bank Failure . . . . .                           | 358 |
| 7.4  | The Determinants of Bank Failure: A Qualitative Review . . . . . | 390 |
| 7.5  | Bank Failure: Quantitative Models . . . . .                      | 399 |
| 7.6  | Conclusion . . . . .   | 405 |

|   |         |
|---|---------|
| <b>CHAPTER 8</b>  |         |
| <b>Financial Crises</b>   | 407     |
| 8.1 Introduction . . . . .  | 407     |
| 8.2 Definitions and Controversies . . . . .   | 407     |
| 8.3 The South East Asian Financial Crisis, 1997–99 . . . . .                                    | 415     |
| 8.4 The Japanese Banking Crisis . . . . .   | 434     |
| 8.5 Scandinavian Banking Crises . . . . .   | 449     |
| 8.6 Long Term Capital Management (LTCM) . . . . .   | 454     |
| 8.7 Lender of Last Resort . . . . .   | 459     |
| 8.8 Conclusions . . . . .   | 466     |
| Appendix 8.1 Japanese Financial Reforms (Big Bang, 1996) . . . . .                              | 467     |
| Appendix 8.2 Reform of the Regulators . . . . .   | 470     |
| <br><b>CHAPTER 9</b>  |         |
| <b>Competitive Issues in Banking</b>  | 473     |
| 9.1 Introduction . . . . .  | 473     |
| 9.2 Measuring Bank Output . . . . .   | 473     |
| 9.3 X-efficiency, Scale Economies and Scope Economies . . . . .                                 | 477     |
| 9.4 Empirical Models of Competition in Banking . . . . .  | 494     |
| 9.5 Consolidation in the Banking Sector . . . . .   | 517     |
| 9.6 Conclusion . . . . .  | 538     |
| <br><b>CHAPTER 10</b>   |         |
| <b>Case Studies</b>   | 541     |
| 10.1 Introduction . . . . .   | 541     |
| 10.2 Goldman Sachs . . . . .  | 542     |
| Appendix . . . . .  | 560     |
| 10.3 Kidder Peabody Group . . . . .   | 564     |
| 10.4 From Sakura to Sumitomo Mitsui Financial Group . . . . .                                   | 570     |
| 10.5 Bancamer: A Study of an Emerging Market Bank . . . . .                                     | 582     |
| 10.6 Crédit Lyonnais . . . . .  | 595     |
| 10.7 Continental Illinois Bank and Trust Company . . . . .                                      | 617     |
| 10.8 Bankers Trust: From a Commercial/Investment Bank to Takeover by<br>Deutsche Bank . . . . . | 631     |
| <br><b>REFERENCES/BIBLIOGRAPHY</b>  | <br>653 |
| <br><b>INDEX</b>  | <br>682 |