

The Wharton School
University of Pennsylvania
Fall Semester 2008

Richard J. Herring
2444 Steinberg Hall/Dietrich Hall
Office Hours: Tues. 4:30-5:30
Fri. 4:30-5:30 and by appointment

Teaching Assistant: To Be Announced

FNCE220: Issues in International Banking

This course focuses on international financial institutions. We will examine how historical and current events are reshaping the industry as well as the basic analytics of managing an institution's exposure to liquidity, credit, market and country risk. In addition, we will consider how to evaluate and compare the risk exposures and performance of individual banks. Throughout the semester we will discuss public policy issues such as financial crises, regulation, and bailouts.

The class format will include lectures and class discussions. Questions are encouraged. The reading list is integrated into the course calendar and is also available in the webCafé file marked "Syllabus". As a textbook, we will use *Financial Institutions Management, A Risk Management Approach*, Sixth Edition, by Anthony Saunders and Marcia Cornett (S&C). This textbook is a very current, and used widely throughout the industry. It will be particularly useful for those who have had no prior experience with banking. Copies are available at the University of Pennsylvania Bookstore and on reserve at the library.

Several cases and problems will be assigned to help you interact with the material and gauge your progress. The mid-term examination will be a common exam during the evening at a time and place to be announced early on in the semester. In compensation for your willingness to take the exam outside the regularly scheduled class time, we will not hold class on the day before Thanksgiving. The final examination will be a common exam on Tuesday, December 16 from 6:00 p.m. to 8:00 p.m. The mid-term examination will receive a 40% weight and the final examination a 45% weight in the computation of your final grade. In addition, two projects will be graded. Each will receive a weight of 7.5%. The first will involve analyzing an internationally active bank of your choice relative to an appropriate peer group using BankScope data. The second project will require you to compute value at risk (VaR) for a relatively simple bank under a number of different assumptions. I will adjust borderline scores upward to reward effective participation in class discussions.

International banking is an especially dynamic sector of the financial services industry, so you are urged to follow current developments in the *Financial Times*, *Wall Street Journal*, or *New York Times*. In addition, you may find it helpful to browse through some of the many periodicals which focus on banking and/or international finance. Among the most useful are:

The American Banker
The Economist
Euromoney
The Financial Regulator

Global Finance
The International Economy
The Institutional Investor (International Edition)
Risk

See the “Links” folder on webCafé for hot links to these publications as well as research institutes, public and private financial international financial institutions, and other sources of information relevant to international banking.

All course-related material will be available on webCafé except for the textbook assignments and a very small bulk pack containing a couple of Harvard cases. Don’t worry about purchasing the bulk pack until later in the semester.

Topical Outline of the Course

- I. Introduction and Overview
- II. Financial Crises
 - A. Real Estate Bubbles and Financial Crises
 - B. The Safety Net for Financial Institutions
 - 1. Banking Crises
 - a. Continental Illinois National Bank
 - b. Northern Rock
 - 2. Capital Market Crises
 - a. LTCM
 - b. Subprime Debt and Bear Stearns
 - C. Restructuring Financial Institutions
 - 1. Private sector initiatives
 - 2. Regulatory choices
 - D. Taxes and the Corporate Structure and Location of International Banking Activities
 - E. Corporate Complexity & the Challenge of Winding Down an International Financial Institution: Too Complex to Fail?
- III. The Securities Market Perspective
 - A. The Role of Capital in Financial Institutions
 - B. Standard metrics for comparing financial institutions: Bankscope Project
- IV. Risk Management and International Regulation and Supervision
 - A. Liquidity and Liquidity Risk Management
 - B. The Treasury Function
 - C. The Management of Credit Risk
 - D. The Original Basel Accord on Capital Adequacy
 - E. The New Standardized Approach
 - F. The Management of Market Risk: VaR Project
 - G. The Extension of the Basel Accord to Market Risk
 - H. The New Basel Accord: Basel II
 - H. Basel II: Operational Risk and Pillars 2 & 3
 - I. International Supervision: The Basel Concordat & the Organization of Financial Supervision
- V. Country risk analysis
 - A. Defining, measuring and monitoring country risk
 - B. Debt crises and their resolution
 - 1. From the oil crisis to Brady bonds
 - 2. From the Tequila Hangover to Bhatulism
 - 3. Proposals for a new international financial architecture

1. Introduction and Overview

Readings

International Banking Glossary

S&C, 3-22, 27-60, 167-184, & 465-474

Class notes: Convergence, Consolidation, Conglomeration and Capital Efficiency

2. Real Estate Bubbles and Financial Crises

Readings

Herring and Wachter, “Real Estate Booms and Banking Busts: An International Perspective”

Class notes: Real Estate Bubbles

3. The Safety Net in Principle: An International Comparative Perspective

Readings

G. Caprio and P. Honohan, “Preventing & Minimizing Crises,” Ch. 2 in *Finance for Growth: Policy Choices in a Volatile World*, World Bank, 2001, pp. 75-121

S&C, 551-557

Class notes: The Safety Net in Principle

Assignment

The Safety Net

4. The Safety Net in Practice, Part 1, Banking Crises: Continental Illinois

Readings

Continental Illinois and “Too Big to Fail,” Ch. 7 in *An Examination of the Banking Crises of the 1980s and Early 1990s*, FDIC

Class notes: The Safety Net in Practice: Continental Illinois

Assignment

The Safety Net in Operation: Continental Illinois National Bank & Trust

5. The Safety Net in Practice, Part 1, Banking Crises: Northern Rock

Readings

D. Llewellyn, “The Northern Rock Crisis: A Multi-Dimensional Problem Waiting to Happen”

6. The Safety Net in Practice, Part II, Capital Market Crises: LTCM

Readings

S&C, 143-150

J. Kambhu, T. Schuermann & K Stroh, “Hedge Funds, Financial Intermediation and Systemic Risk”

Class notes: Systemic Risk: Hedge Funds & Financial Stability

7. The Safety Net in Practice, Part II, Capital Market Crises: The Subprime Crisis and Bear Stearns

Readings

S&C, 814-821 & 833-847

A. Ashcraft & T. Schuermann, “Understanding the Securitization of Subprime Mortgage Credit”

Class notes: The Current Crisis: The Darker Side of Securitization

8. Restructuring Financial Institutions

Readings

D. Scott, “A Practical Guide to Managing Systemic Financial Crises: A Review of Approaches Taken in Indonesia, The Republic of Korea and Thailand”

Class Notes: Bank Restructuring: Opportunities and Pitfalls

Assignment

The Mellon Bank Case

9. Taxes and the Corporate Structure and Location of International Banking Activities

Readings

Y. K. Henderson, “The Taxation of Bank: Particular Privileges or Objectionable Burdens?” New England Economic Review, pp. 3-18
Excerpt from Bankers Trust presentation to security analysts on the use of foreign tax credits

Class notes: Taxation and the Structure of International Banking

Assignment

Taxes and the Geographic Distribution of Banking Activity

10. Corporate Complexity & the Challenge of Winding Down an International Financial Institution: Too Complex to Fail?

Readings

Herring & Carmassi, “The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety & Soundness”

Herring, “International Financial Conglomerates: Implications for Bank Insolvency Regimes”

11. The Birth of Modern Risk Management

Reading

G. Guill, Bankers Trust and the Birth of Modern Risk Management

Class notes: BT & the Birth of Modern Risk Management

12. The Role of Capital in Financial Institutions

Readings

S&C, Appendix 2A: Financial Statement Analysis Using a Return on Equity (ROE) Framework, p. 64, www.mhhe.com/saunders63

Koch, "The Effect of Capital Requirements on Bank Operating Policies," in *Bank Management*, 2nd Edition, 402-413

Class notes: The Capital Decision

Assignment

Financial Analysis of Banks, Part I

Group Project

Bankscope Exercise in comparing internationally active banks (due October 29th)

13. Liquidity and Liquidity Risk Management

Readings

S&C, 493-510

Class notes: Liquidity Risk and Liquidity Risk Management

Assignment

Financial Engineering to Enhance Liquidity

14. The Treasury Function

Readings

S&C, 190-248

Class notes: The Treasury Function: Funding the Bank Subject to Liquidity and Interest Rate Risk Constraints

Assignment

S&C, 248-251, problems 3, 4, 14 & 21

15. The Management of Credit Risk

Readings

S&C, 295- 338 & 348-361

Class notes: Credit Risk

Assignment

S&C, 339-340, problems 18, 22, 23, & 24

16. The Original Basel Accord & the New Standardized Approach

Readings

S&C, 594-609

Class notes: International Capital Regulation: The Original Basel Accord & the Standardized Approach

Assignment

Exercise on the Basel Accord

S&C, 621-622, problems 18 & 19

17. The Management of Market Risk

Readings

S&C, 266-282

Class notes: Managing Market Risk

Assignment

S&C, 291-293, problems 4, 5, 6, 14 & 16

18. Capital Regulation of Market Risk

Readings

S&C, 283-291

Class notes: Extension of the Basel Accord to Encompass Market Risk

Project Assignment

Value at Risk Analysis

19. The New Basel Accord: Basel II

Readings

Credit Suisse/First Boston, "Figuring out Basel II, The new standards, bank behavior and implications for investment" (For those with a passion for Basel II, the entire hundreds of pages of rules are available at:

<http://www.bis.org/publ/bcbs128.htm>)

Class notes: The New Basel Accord: Basel II

Assignment

B. Esty & A. Sesia, Jr., "Basel II: Assessing the Default and Loss Characteristics of Project Finance Loans," HBS0-203-035, January 2005

20. Basel II and Operational Risk

Readings

R. Herring, "Basel II: Is the Game worth the Candle"

Class notes: Operational Risk & Pillars 2 & 3

21. International Supervision: The Basel Concordat

Readings

R. Herring and R. Litan, Financial Regulation in the Global Economy, Chapters 4&5, pp. 86-152

R. Herring & J. Carmassi, “The Organizational Structure of Cross-Sector Financial Supervision”

Assignment

Trends in International Supervision

22. Country Risk and the Structure of International Loan Agreements

Readings

P.R. Stansbury, “Legal Aspects of Syndicated Euro lending”

Anonymous, “Eurodollar Loan Agreement Parody”

Class notes: The Structure of Syndicated Loan Agreements: Syndicated Loans

Case Assignment

G. Hoguet, *Republic of Zaire*

23. Country Risk Analysis

Readings

S&C, 425-453

Class notes: Country Risk Analysis

Assignment

Exercise on Country Risk Analysis

24. Debt Crises and Their Resolution: From the Oil Crisis to Brady Bonds

Readings

N. Ul Haque, D. Mathieson and N. Mark, “Rating the Raters of Country Creditworthiness” *Finance and Development*

“Mr. Laffer Meets Third-World Debt,” *Economist*

Class notes: Debt Crises and their Resolution

25. Debt Crises and Their Resolution: From the Tequila Hangover to Bhatulism & Calls for a New International Financial Architecture

Readings

The 1994-95 Mexican Peso Crisis, Harvard Business School, N9-296-056

Class notes: “Debt Crises and their Resolution: From the Tequila Hangover to Bhatulism & Calls for a New International Financial Architecture”