

Provisional Reading List & Course Outline
The Wharton School
University of Pennsylvania
Fall Semester 2009

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: David Muir
1350 Steinberg Hall/Dietrich Hall
Office Hours: Thurs. 4:30-5:30
Project Advisor: Michael Michaux

FNCE 732: 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, operational 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, proposed regulatory changes, and bailouts.

The class format will include lectures and class discussions. Questions are encouraged. The reading list and other class material are integrated into the course calendar on web Café. It may change over the semester as events warrant. This provisional syllabus is also available in the web Café file marked "Syllabus," but please note that it will not be updated—i.e., the syllabus embedded in the calendar is definitive. We will use *Financial Institutions Management, A Risk Management Approach*, Sixth Edition, by Anthony Saunders and Marcia Cornett (S&C) as a textbook for part of the course. This textbook is very current, and is 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. Please try to do them before the relevant class. Answers will be posted on the calendar for the following class. Since many of the questions are former exam questions, it is in your interest to work through them carefully. The mid-term examination will be a common exam from 6:00 pm to 8:00 pm on Tuesday, October 27th. 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 exam will be held at the time specified by the registrar on Friday, December 18th, from 3:00 pm to 5:00 pm. Web café contains mid-term and final exams (along with answers) for the past two times the course has been offered. These exams are a good way for you to judge quickly whether this course is a good fit for you. They are also a good indication of the kind of questions that I am likely to pose, but please be aware that the course does change from year to year both with regard to concepts covered and the emphasis placed on particular topics.

You will also be required to complete three projects, which will be graded. (You may form teams as large as five to complete these projects.) The first will involve using BankScope data to analyze a bank of your choice and to select an appropriate peer group. The second will involve analyzing a Collateralized Debt Obligation (CDO), one of the instruments associated with the

outbreak of the current crisis. The third project will require you to compute value at risk (VaR) for a relatively simple bank under a number of different assumptions.

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 that focus on banking or international finance such as *The American Banker*, *The Economist*, *Euromoney*, *The Financial Regulator*, *Global Finance*, *The International Economy*, *The Institutional Investor* (International Edition), and *Risk*. In addition, you may want to read the ever-growing number of blogs, some of which are linked on web Café. I regard this list as a collaborative project, so if you have found something useful that is not on the list, please let me know and I will add it.

To provide you with an incentive to keep up with current events, every two weeks you will be asked to submit an article that you have read that is relevant to issues we have been discussing in class. A copy of the article should be accompanied by your brief explanation of how it relates to the course. Of course, your choice may illustrate a concept we have discussed in class or it may raise questions about conclusions reached in class. In either case, you should type two concise paragraphs explaining the relationship between the article and the course material. This exercise must be undertaken individually (not in teams) and must be turned in on the date specified for credit. Some of the most interesting articles will be posted on the Current Events section of the website.

Your grade will depend on your final score weighted as follows:

- 15% for the combined three projects
- 10% for your analyses of current articles
- 35% for your grade on the mid-term exam
- 40% for you grade on the final exam, which will not be cumulative.

If your weighted final score falls on a borderline, it will be adjusted upward if you have participated actively and effectively in class discussions.

Topical Outline of the Course

- I. Introduction and Overview
 - A. Consolidation
 - B. Conglomeration

- 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. The role of bank capital: BankScope Project
 - b. Northern Rock
 - 2. Capital Market Crises
 - a. LTCM
 - b. The Demise of Bulge Bracket Investment Banks: CDO Project
 - 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?

- IV. Risk Management and International Regulation and Supervision
 - A. Liquidity and Liquidity Risk Management
 - B. The Treasury Function
 - C. Country Risk Analysis
 - D. The Management of Credit Risk
 - E. The Original Basel Accord on Capital Adequacy
 - F. Basel II: The Standardized Approach
 - G. The Management of Market Risk: VaR Project
 - H. The Extension of the Basel Accord to Market Risk
 - I. Basel II: Pillar 1
 - J. Basel II: Pillars 2 & 3
 - K. International Supervision: The Basel Concordat & the Organization of Financial Supervision

- V. Prospects for Regulatory Reform

1. Introduction and Overview: Consolidation and Conglomeration

Readings

International Banking Glossary

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

Class notes: Consolidation and Conglomeration

Assignment

Financial Conglomerates Problem Set

2. Real Estate Bubbles and Financial Crises

Readings

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

C. Reinhart and K. Rogoff, “Is the 2007 Sub-Prime Crisis So Different? An International Historical Comparison,” *American Economic Review* 98(2), 2008, pp. 339-344

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 I, 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, 1997, pp. 235-257

Class notes: The Safety Net in Practice: Continental Illinois

Assignment

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

5. The Role of Capital in Financial Institutions

Readings

S&C, “Appendix 2A: Financial Statement Analysis Using a Return on

Equity (ROE) Framework,” p. 64, <http://www.mhhe.com/saunders6e>

T. Koch, "The Effect of Capital Requirements on Bank Operating Policies," in *Bank Management*, 2nd Edition, 1992, pp. 402-413

Class notes: The Capital Decision

Assignment

Financial Analysis of Banks, Part I

Group Project Assignment

Bankscope Exercise comparing internationally active banks

6. The Safety Net in Practice, Part I, Banking Crises: Northern Rock

Readings

D. Llewellyn, "The Northern Rock Crisis: A Multi-Dimensional Problem Waiting to Happen," *Journal of Financial Regulation and Compliance* 16(1), 2008, pp. 35-58

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

Readings

S&C, 143-150

J. Kambhu, T. Schuermann & K. Stiroh, "Hedge Funds, Financial Intermediation and Systemic Risk," *Economic Policy Review* 13(3), 2007, pp. 1-18

Class notes: Systemic Risk: Hedge Funds & Financial Stability

8. The Safety Net in Practice, Part II, Capital Market Crises: The Current Crisis and The Demise of the Bulge Bracket Investment Banks

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

Group Project Assignment: Analyzing a CDO

9. 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"

W. Buiter, "Don't touch the unsecured creditors! Clobber the tax payer instead: Good Bank vs. Bad Bank" *ft.com/maverecon*, 13 March 2009

Class notes: Bank Restructuring: Opportunities and Pitfalls

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

Readings

Wikipedia (9.4.09), “International Taxation”

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

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

Readings

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

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

12. The Birth of Modern Risk Management

Readings

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

Class notes: BT & the Birth of Modern Risk Management

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, #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, #18, 22, 23, & 24

16. Country Risk Analysis and the Structure of International Loan Agreements

Readings

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

Anonymous, “Eurodollar Loan Agreement Parody”

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

S&C, 425-453

Case Assignment

G. Hoguet, *Republic of Zaire*

In-Class Analysis

Exercise on Country Risk Analysis

Class notes: Country Risk Analysis

17. 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, #18 & 19

18. The Management of Market Risk

Readings

S&C, 266-282

Class notes: Managing Market Risk

Assignment

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

19. Capital Regulation of Market Risk

Readings

S&C, 283-291

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

Group Project Assignment

Value at Risk (VaR) Analysis

20. The New Basel Accord: Basel II

Readings

Credit Suisse Equity Research, “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, “Basel II: Assessing the Default and Loss Characteristics of Project Finance Loans (A),” HBS 0-203-035, 2005

21. Basel II and Operational Risk

Readings

R. Herring, “Basel II: Is the Game worth the Candle,” *Financial Markets, Institutions & Instruments* 14(5), 2005, pp. 267-287

Class notes: Operational Risk & Pillars 2 & 3

22. 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

23. Prospects for Regulatory Reform

Readings

G. Caprio, A. Demirgüç-Kunt & E.J. Kane, “The 2007 Meltdown in Structured Securitization: Searching for Lessons not Scapegoats”

K. Ayotte & D.A. Skeel, “Bankruptcy or Bailouts?”

R. Herring, “Why and How Resolution Policy Must Be Improved”