

*Provisional Reading List & Course Outline*  
The Wharton School  
University of Pennsylvania  
Fall Semester 2010

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

Teaching Assistants, Office Hours:  
David Muir, Thurs. 12-1:30, SH/DH 1350  
William Fradin, Wed. 9-10:30, Desk A, 2305 SH/DH  
Charles Hendren, Fri. 11-12:30, Desk A, 2305 SH/DH  
Adam Piekarski, Mon. 12-1:30, Desk A, 2305, SH/DH

**FNCE 220/732: Issues in International Banking**

---

This course focuses on international financial institutions. We will examine how historical and current events reshape 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, bailouts and proposed regulatory changes.

The class format will include lectures and class discussions. I welcome your questions and, indeed, the extent of your appropriate classroom participation will help you if you end up at the breakpoint between two different grades. The reading list and other class material are integrated into the course calendar on web Café. This will undoubtedly change over the semester as events warrant. This *provisional reading list* is also available in the web Café file marked "Provisional Syllabus," but please note that it will **not** be updated over the course of the semester —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, largely for the last part of the course. It will be particularly useful for those who have had no prior experience with banking. The University of Pennsylvania Bookstore has copies available as does the reserve desk at Lippincott library.

I have assigned several problem sets to help you think more deeply about the course material and gauge your progress. Please try to do them before the relevant class. They will not be graded, but 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.

You will also be required to complete three projects that will be graded. (You may use web café to form teams as large as five to work on 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 project will require you to compute value at risk (VaR) for a relatively simple bank under a number of different assumptions. The third and final project, an integrative case, will be distributed

(electronically) just after the second mid-term and due (electronically) on the last day of classes, December 10.

International banking is an especially dynamic sector of the financial services industry, so I urge you 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*. And you will undoubtedly want to sample some of 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 (or a web link that is broken), please let me know.

To provide you with an incentive to keep up with current events, every two weeks you will be asked to submit an article (or blog) you have read that relates to concepts we have discussed in class. You should attach a copy of the article to 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 electronically on the date specified for credit. Some of the most interesting articles will be posted in the Current Events folder of webcafe. I have designed this exercise to sharpen your writing skills as well. The folder Current Events assignment explains rules I want you to follow to improve the clarity of your writing as well as a sample submission.

Because this course has an unusually large number of students who were born outside the United States, I prefer to give mid-term examinations outside of regularly scheduled class periods so that time constraints can be as flexible as possible. It also permits me to get a much larger statistical sample to assign grades consistently across the three sections of the class (although by Graduate Division rules, MBAs must be graded on a different scale than undergraduates). The first mid-term examination takes place from **6:00-8:00 on Tuesday evening, October 26<sup>th</sup> in JMHH G-06 and SH/DH 351**. The second mid-term takes place **on Wednesday evening, December 1, from 6:00-8:00 in SH/DH 350-351 and JMHH G-60**. There will be no final exam. In compensation for your willingness to take these exams outside the regularly scheduled class time, we will **not** hold class on November 17<sup>th</sup> or the day before Thanksgiving.

Web café contains mid-term exams (along with answers) for the past two times the course has been offered. These exams can help you judge quickly whether this course fits your needs and interests. They also indicate the *kind* of questions that I am likely to pose. Please be aware, however, that the course does change from year to year both with regard to concepts covered and the emphasis placed on particular topics so the content of the exam you take is likely to be different.

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

- 20% for the combined three projects – 5% for the first two and 10% for the last
- 10% for your analyses of current articles
- 35% for your grade on the first mid-term exam

35% for your grade on the second mid-term exam

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 of the Course
  - A. The evolving institutional infrastructure of the international banking system
  - B. Taxes and the corporate structure and geographical location of international banking activity
  - C. The role of capital in banks
    - 1. Viewing banks from the perspective of a security analyst
  
- II. Financial Crises
  - A. Real Estate Bubbles and Financial Crises
  - B. The Safety Net for Financial Institutions
    - 1. The safety net in principle
    - 2. The safety net for banks in practice
      - a. Continental Illinois National Bank
      - b. Northern Rock
      - c. Fortis
      - d. Dexia
      - e. The Icelandic Banking Crisis
    - 3. Capital Market Crises
      - a. LTCM
      - b. Bear Stearns
      - c. Lehman Brothers
      - d. AIG
  - C. Private Sector Initiatives
    - 1. Restructuring Banks
      - a. Mellon Bank
      - b. Barclays Bank
  - E. Regulatory reforms in response to the crisis
    - 1. The Dodd-Frank Bill
      - a. What has been done
      - b. What remains to be done
        - (1) Consolidation of regulatory institutions
        - (2) Addressing the too-big, too-interconnected or too-complex to fail
    - 2. Basel III
      - a. Basel I and its perceived defects
      - b. Basel II and its revealed defects
      - c. The evolving scope of Basel III
      - d. The likely impacts on the banking system
        - (1) Impacts on profitability
        - (2) Consolidation and conglomeration

- e. The unfinished agenda
  - (1) How to deal with cross-border failures
  - (2) How to deal with internationally active banks that are too-big, too-interconnected or too complex to fail

### III. Risk Management and the International Supervision of Risk

- A. Liquidity and Liquidity Risk Management
  - 1. Proposals to regulate liquidity
- B. The Treasury Function
- C. Country Risk Analysis
  - 1. The traditional LDC crises of the 1980s
  - 2. The Asian Crisis of 1997-1998
  - 3. The Current PIGS crisis
  - 4. Is the US headed for a country risk crisis
- D. The Management of Credit Risk
- G. The Management of Market Risk
  - 1. The VaR Project
- H. The Governance of Risk Management
- K. International Supervision of Risk
  - 1. The Basel Concordat
  - 2. Proposed Revisions to the Concordat

## **1. Introduction and Overview of the Course & the Evolving Structure of Official International Institutions and Development of Modern Risk Management**

### Readings

International Banking Glossary

S&C, 3-22, 27-60

“About the Group of 20,” “What is the Group of 20,” “Pittsburgh Communiqué of the Group of 20”

ICFR, *While You Were Away: An Update on Financial Regulation Developments, September 1, 2010*

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

Class notes: The Evolving Structure of Official International Financial Institutions & the Birth of Modern Risk Management

## **2. Taxes and the Corporate Structure and Location of International Banking Activities**

### Readings

Wikipedia (9.4.09), “International Taxation”

L. Vaughan, “Tax Shadow of €90 bn hangs over Europe’s Banks,” *Financial News*, July 13, 2010

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

## **3. 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>

Class notes: The Capital Decision

Assignment

Financial Analysis of Banks

**4. How Security Analysts Evaluate International Banks**

Readings

Fitch Ratings New York, *Demystifying Recent Accounting Pronouncements: An Analytical Guide for Reviewing 10-Ks and 10-Qs*

Fitch Ratings, *Criteria Report: Bank Rating Methodology*

Class notes: A Quick Review of Bank Accounting Issues

Group Project Assignment Distributed

BankScope Exercise comparing internationally active banks

**5. Real Estate Bubbles and Financial Crises**

Readings

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

Class notes: Real Estate Bubbles

**6. Real Estate Bubbles and Financial Crises (cont'd)**

Readings

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

Assignment:

Why Real Estate Markets are Particularly Prone to Form Bubbles?

## **7. 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. Buitier, “Don’t touch the unsecured creditors! Clobber the tax payer instead: Good Bank vs. Bad Bank” *ft.com/maverecon*, 13 March 2009

W. Buitier, “Fixing the banking system: How to set up a new ‘good bank’,” VOX, February 2009

J. Bulow & P. Klemperer, “Reorganising the banks: Focus on the liabilities, not the assets,” VOX, March 2009

W. Buitier, “Slaughtering sacred cows: it’s the turn of the unsecured creditors now,” VOX, March 2009

Class notes: Bank Restructuring: Opportunities and Pitfalls

### Assignment:

How did Barclays Escape the Clutches of the British Government?

## **8. 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

## **9. The Safety Net in Practice, Part I, Banking Crises: The First Modern Bank Run, Continental Illinois National Bank**

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: The First International Bank Run, Continental Illinois

Assignment

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

**10. The Safety Net in Practice, Part I, More Recent Banking Crises: Northern Rock, Fortis, Dexia, and the Icelandic Banks**

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

S. Claessens, R. Herring, and D. Schoenmaker, *A Safer World Financial System: Improving the Resolution of Systemic Institutions*, Geneva Studies on the World Economy, 12, pp. 49-55

**11. The Safety Net in Practice, Part II, Capital Market Crises: Hedge Funds**

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

The Economist, “Hedge Funds: Bigger, Safer, but Duller,” August 16, 2010  
Sidley Austin LLP, “Title IV –Regulation of Advisers to Hedge Funds and Others,” June 30, 2010

Class notes: Systemic Risk: Hedge Funds & Financial Stability

Assignment:

How do Hedge Funds Differ from Other Financial Institutions?

**12. The Safety Net in Practice, Part II, Capital Market Crises: 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”

S. Claessens, R. Herring, and D. Schoenmaker, *A Safer World Financial System: Improving the Resolution of Systemic Institutions*, Geneva Studies on the World Economy, 12, pp. 42-49

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

Assignment:

How Securitization Became Too Clever by Half: Analyzing a CDO

**13. The Problem of Too-Complex-To-Fail**

Readings

R. Herring & J. Carmassi, “The Corporate Structure of International Financial Conglomerates: Complexity and Its Implications for Safety & Soundness,” *The Oxford Handbook of Banking*, edited by A. Berger, P. Molyneux, and J. Wilson, Oxford University Press, 2010

S. Claessens, R. Herring, and D. Schoenmaker, *A Safer World Financial System: Improving the Resolution of Systemic Institutions*, Geneva Studies on the World Economy, 12, pp. 57-82

**14. US Regulatory Reform in Response to the Crises: The Dodd-Frank Bill**

Readings

Davis Polk, *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010* or if you prefer the full 900 pages of full text: [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111\\_cong\\_bills&docid=f:h4173enr.txt.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf)  
Davis Polk, *Regulatory Implementation Slides*

E. Kane, “Missing Elements in US Financial Reform: A Kübler-Ross

Interpretation of the Inadequacy of the Dodd-Frank Act,” August 5, 2010

K. Scott, “Dodd-Frank: Resolution or Expropriation?” August 25, 2010

Wall St. Cheat Sheet, *Financial Reform Cheat Sheet*, July 22, 2010 (for fun)

## **15. International Regulatory Reform in Response to the Crises: The Precursors to Basel III**

### Readings

S&C, 594-609

Credit Suisse Equity Research, “Figuring out Basel II, The new standards, bank behavior and implications for investment”

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

Class notes: Basel I & II and their Perceived Defects

### Assignment

Exercise on Basel Accords I & II

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

## **16. The Emerging Outline of Basel III**

### Readings

Basel Committee on Banking Supervision, “Consultative Document, Strengthening the resilience of the banking sector, for Comment by April 16” December 2009

Institute of International Finance, “Comment on Strengthening the Resilience of the Financial Sector,” April 16, 2010

Basel Committee on Banking Supervision, “Annex on Main Design Elements (in response to comments on strengthening the resilience of the financial sector), August, 2010

Morgan Stanley, “Banks: Basel III confirming 2018 eases organic build for UK/European Banks,” July 27, 2010

### Assignment

Is Basel III likely to End Too-Big-to-Fail?

**17. 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

VAR group project distributed

**18. 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

**19. Country Risk Analysis and the Structure of International Loan Agreements**

Readings

S&C, 425-453

Anonymous, "Eurodollar Loan Agreement Parody"

Morgan Stanley, "Sovereign Subjects: Ask Not Whether Governments Will Default, but How," August 25, 2010

B. Davis, "IMF Warns Countries of Debt Risks, Dismisses Idea of Greek Default," *Wall Street Journal*, September 2, 2010

Economist, "Soft Centre: Can a Currency Survive Without a State?" *The Economist*, June 11, 2009

H. Schneider, "Political Economy: Will the US Ever Default?" *The Washington Post*, September 2, 2010

Class notes: Country Risk Analysis

In-Class Exercise

Exercise on Country Risk Analysis

Exercise on Country Risk Analysis

Neither Japan nor the US Ranks Among the Safest 10 Countries: Which is More Likely to Default?

**20. Liquidity and Liquidity Risk Management**

Readings

S&C, 493-510

Class notes: Liquidity Risk and Liquidity Risk Management

Assignment

Market Liquidity: Compare the Market for Perpetual Floating Rate Notes to the Market for Auction Rate Preferreds

**21. 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

**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"

Basel Committee on Banking Supervision, "Good Practice Principles on Supervisory Colleges, Consultative Document," March 2010

Assignment

Trends in International Supervision

