

Provisional Reading List & Course Outline

FNCE 220/732: Issues in International Banking

The Wharton School

University of Pennsylvania

Spring Semester 2014

Richard J. Herring
herring@wharton.upenn.edu
2444 Steinberg Hall/Dietrich Hall
Office Hours: Tues. 4:30-6:00 &
by appointment

Teaching Assistants, Office Hours:
Anna Cororaton (annadc@wharton.upenn.edu)
Jessica Jeffers (jeffersj@wharton.upenn.edu)
David Muir (muir@wharton.upenn.edu)
Tanvi Rai (tanvirai@wharton.upenn.edu)
Andrew Wynne (awynne@sas.upenn.edu)

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, market, operational, credit, country and reputational risk. In addition, we will consider how to evaluate and compare risk exposures and performance across individual banks. Throughout the semester we will discuss industry challenges and public policy issues such as financial crises, bailouts, proposed regulatory changes and sovereign debt crises.

The class format includes lectures and class discussions. I welcome your questions and, indeed, your constructive classroom participation **will help boost your grade** if your final score is at the breakpoint between two different grades. More importantly, the more actively you participate in class, the more easily you will master the material.

The course calendar embedded in Canvas integrates the reading list and other class materials. Some readings and assignments will undoubtedly change over the semester as events warrant. You can find the *provisional reading list* on the web should you wish to refer back to it for logistical details, but please note that it will **not** be updated during the semester. You should regard the syllabus embedded in the assignment list and the calendar as definitive with regard to assignments, readings and deadlines. It will contain links to all readings and assignments as well as due dates for cases and information about review sessions and examinations.

We will use excerpts from *Financial Institutions Management, A Risk Management Approach*, by Anthony Saunders and Marcia Cornett (S&C) as a basic reference, largely for the last part of the course. The relevant excerpts will be available at the bookstore in a book especially prepared for this course, *International Banking, FNCE-220/732* (Text). This book has been assembled specifically for our class so that your cost will be much less than buying the full textbook. If you have had no prior experience with the financial services industry or if you plan to build your career in the sector, however, you may want acquire the complete eighth edition of the full textbook. It has become the industry standard.

I have assigned several problem sets to help you think more deeply about the course material and to help you gauge your progress. Please attempt them before the relevant class. They will not be graded, but answers will be posted on the calendar beside the questions on the week following relevant class. Since many of the questions derive from former exams, you will find it rewarding to work through them carefully.

You will also be required to complete three projects that will be graded. (You may use Canvas to form teams **as large as five** to work on these projects as well as to submit projects and other assignments.) The first project will involve using accounting and market data to compare and contrast the performance of two internationally active banks. This project will also take you into some of the more subtle details of reading annual reports. The second project will require you to compute value at risk (VaR) and perform a stress test for a relatively simple bank. 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 the reading period.

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 *The 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 Canvas. 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. 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 and why you think it is important. This exercise must be undertaken individually (not in teams) and must be turned in electronically on (or before) the date specified in order for you to receive credit. Some of the most interesting articles will be posted in the Current Events folder of Canvas and discussed in class. Please note that I have designed this exercise to sharpen your writing skills. The folder “Current Events Assignment” explains the rules I want you to follow to improve the clarity of your writing as well as a sample submission. It may seem an annoying constraint at first, but by the end of the course, students generally feel that they have improved their ability to write concise, effective memos.

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 relaxed. (This does not mean I intend to give you longer exams, only that I want you to have enough time to do your best.) It also permits me to obtain a much larger statistical sample to assign grades consistently across the three sections of the class (although following Graduate Division rules, MBAs must be graded on a different scale than undergraduates).

The first mid-term examination takes place on **Tuesday evening, February 25th, 6:00-8:00**. The second mid-term takes place on **Thursday evening, April 24th, 6:00-8:00**. Please consult these dates on the course calendar to see the room to which you are assigned. 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 2nd and the day before Thanksgiving, November 22nd.

Canvas contains mid-term exams (along with answers) for the past two years. I have posted them for two purposes: (1) These exams can help you judge quickly whether this course fits your needs and interests. If they emphasize ideas that do not interest you, this course is definitely not a good fit for you. (2) These exams also indicate the *kind* of questions 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. Resist the temptation to study for our exams by focusing mainly on the sample exams rather than reviewing what we do in class.

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

- 24% for the combined three projects
- 10% for your analyses of current events
- 33% for your grade on the first mid-term exam
- 33% 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
- II. An Overview of the Business of Banking
 - A. How Banks Generate Profits (usually)
 - B. Taxes
 - C. The Role of Capital in Banks
 - 1. Conceptual Issues
 - 2. Accounting and Regulatory Issues
- IV. Risk Management
 - A. Reputational Risk
 - B. VaR and the Revolution in Financial Risk Management
 - C. The Management of Credit Risk
 - D. The Treasury Function: Managing Interest Rate Risk
 - E. The Treasury Function: Managing Liquidity Risk
 - F. Country Risk
 - 1. The Dynamics of Sovereign Debt Crises
 - 2. Sovereign Debt Crises and How They Are Resolved
- III. Financial Crises
 - A. Real Estate Booms and Banking Busts
 - B. How Real Estate Booms and Banking Busts Can Lead to Sovereign Deb Crises

- C. The Safety Net for Financial Institutions
 - 1. The Safety Net in Principle: An International Comparative Example
 - 2. The Safety Net in Practice: Banks
 - a. The First Modern Bank Run: Continental Illinois National Bank
 - b. Recent Banking Crises: Northern Rock, Fortis, Dexia, WaMu, et al.
 - 3. Capital Market Crises
 - a. Hedge Funds
 - b. The Darker Side of Securitization
 - c. The Role of Ratings Agencies
 - d. The Vulnerability of Central Clearing Parties & Exchanges
 - d. The Demise of the Big Five Investment Banks
- D. Private Sector Restructurings: The Good Bank/Bad Bank Paradigm
- E. Resolution Policy and the emerging Single Point of Entry Paradigm

V. Regulatory Reform

- A. What the Crisis Taught Us about the Inadequacy of Regulation and Supervision
- B. International Regulatory Reform: Introduction to Basel I & II
- C. Basel III
 - a. Redefinition of regulatory capital
 - b. Introduction of regulatory capital add-ons
 - c. Introduction of a leverage ratio constraint
 - d. Attempts to regulate liquidity
- D. Dodd-Frank and the US implementation of Basel III
- E. The EU challenge in forming a Single Banking Market

VI. The Shadow Banking System

- A. What is it?
- B. Why did it grow?
- C. Does it represent a source of vulnerability or resilience for the financial system?
- D. Should it (could it) be regulated?

I. Overview of the Course

A. The Evolving Structure of Official International Institutions

Readings

International Banking Glossary (a resource that you can use throughout the semester)

“What is the Group of 20?” <http://www.g20.org>

“Leader’s Statement: The Pittsburgh Summit” 24-25 September 2009

A. Walter, 2011, “Global Governance after the Crisis: The G2, the G20, and global imbalances,” pp.1-24 only

Class notes: The Evolution of International Financial Institutions

Assignment

Fill-out Student Questionnaire and Return to Questionnaire Folder in Canvas

II. Overview of the Business of Banking

A. How Banks Make Money (Usually)

Readings

Matt O’Connor, Adam Chaim, Robert Placet & David Ho, “How Banks Make Money,” **Banking 101: US Large Cap Banks**, Deutsche Bank Global Markets Research, May 11, 2011 (Hereafter, excerpts from this publication are designated DB.)

DB, “Credit”

DB, “Liquidity”

Matt Spick, “Banks and Funding,” **Banking 101: European Banks for Beginners**, Deutsche Bank Markets Research, April 16, 2012 (Hereafter, excerpts from this publication are designated DBE.)

Herring, “Notes on Bank Accounting & Ratio Analysis”

If your recollection of accounting fundamentals is hazy, you may find it useful to watch a very basic review of income statement and balance sheet relationships on YouTube *A Bank’s Income Statement*
<http://www.youtube.com/watch?v=h3IMANILkw0>

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

Readings

“International Taxation,” Wikipedia.org

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

R. Reid, “A Taxing Time for Financial Transactions,” *ICFR*, 17 August 2011

C. Comstock, “Here’s What Mike Mayo Thinks Citi Is Doing to Cook Its Books,” *Business Insider*, 27 August 2010

Class notes: Taxation and the Corporate Structure and Geographic Location of International Banking

Assignment

Taxes and the Geographic Distribution of Banking Activity

C. The Role of Capital in Financial Institutions: Conceptual Issues

Readings

A. Berger, R. Herring and G. Szegö, 1995, “The Role of Capital in Financial Institutions,” Reprinted in *The Regulation and Supervision of Banks*, edited by Maximilian J.B. Hall, The International Library of Critical Writings in Economics, Edward Elgar Publishing Limited

DB, “Capital”

P. Pflleiderer, 2011, “On the Relevancy of Modigliani and Miller to Banking: A Parable and Some Observations”

C. Calomiris and Richard J. Herring, 2012, “Why and How to Design a Contingent Convertible Debt Requirement”

Class notes: The Role of Capital in Financial Institutions

D. The Role of Capital in Financial Institutions: Valuation, Accounting & Regulatory Issues

Readings

Saunders and Cornett, “Financial Statement Analysis Using a Return on Equity (ROE) Framework”

DBE, “The Valuation of Bank Stocks”

DB, “Banks Stocks: How they are Value” (This reading is somewhat redundant with the prior reading, but it is interesting to see the different issues highlighted in valuing European stocks.)

Federal Financial Institutions Examination Council, “A User’s Guide for the Uniform Bank Performance Report,” December 2008 & “Definitions of UBPR Items,” *UBPR’s User Guide*, December 2008. Together these give you access to the largest, most-detailed data for banks available publicly anywhere. Unfortunately, it only includes US banks that are required to file the Uniform Bank Performance Report.

FitchRatings, “Bank Rating Process,” excerpt from **Criteria Report: Bank Rating Methodology**

R. Herring, 2011, “Fair Value Accounting and Financial Instability,” Reprinted from *Encyclopedia of Financial Globalization*

A. Jones and J. Thompson, “IASB criticizes Greek debt write-downs,” *Financial Times*, 30 August 2011

For those who like learning by video, a very simplistic explanation of capital and leverage ratios can be found on YouTube, “Bank Balance Sheet & Leverage Ratio,” <http://www.youtube.com/watch?v=1-neFtPSMLU&feature=related>. But beware. The author uses too broad a definition of core capital for the leverage ratio and makes a qualitatively wrong inference about risk-weighting assets. Risk-weighted assets are almost always significantly lower than total assets.

Class notes: Continuation of “The Role of Capital...” from the previous lecture

Assignment

Financial Analysis of Banks

Distribution of First Team Project: *Comparing and Contrasting the Performance of Two Global, Systemically Important Financial Institutions*

II. Financial Crises

A. Real Estate Booms & Banking Busts

Readings

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

Class notes: Real Estate Booms and Banking Busts

B. How Real Estate Bubbles Can Turn Into Sovereign Debt Crises

Readings

C. Reinhart and K. Rogoff, 2008, “Is the 2007 Sub-Prime Crisis So Different? An International Historical Comparison,” *American Economic Review* 98(2), pp.339-34

DBE, “Case study: the Celtic Tiger”

Assignment

Why Real Estate Prices Especially Prone to Form Bubbles?

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

Readings

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

G. Morgenson, "The Rescue That Missed Main Street," *New York Times*, 27 August 2011

B. Keoun and P. Kuntz, "Wall Street Aristocracy Got \$1.2 Trillion from Fed," Bloomberg.com, 22 August 2011

DBE, "The Lender of Last Resort: the ECB"

Class notes: The Safety Net in Principle: An International Comparative Perspective

Assignment

The Safety Net

D. The Safety Net in Practice, Part I: 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: Continental Illinois National Bank

Assignment

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

E. The Safety Net in Practice, Part II: More Recent Banking Crises: Northern Rock, Fortis, Dexia, WaMu, etc.

Readings

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

“Rock carving: Splitting Northern Rock is just the beginning,” *The Economist*, 29 October 2009

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

Class notes: Systemic Risk: The Safety Net in Practice: Northern Rock et al

F. The Safety Net in Practice, Part III: Hedge Funds & the Crucial Role of Clearing Banks & Prime Brokers

Readings

Text, pp.143-150

C. Geczy, 2010, “Thoughts on the Future of the Hedge Fund Industry”

Sidley Austin LLP, “Title IV – Regulation of Advisers to Hedge Funds and Others,” 30 June 2010

“Hedge funds: Bigger, safer but duller,” *The Economist*, 26 August 2010

“Focus: Hedge Funds,” *The Economist*, 31 January 2012

Darrell Duffie, “Replumbing our Financial System: Uneven Progress,” April 23, 2012

Class notes: Systemic Risk: Hedge Funds & Financial Stability

Assignment

How Do Hedge Funds Differ from Other Financial Institutions?

G. The Darker Side of Securitization

Readings

Text, pp.814-821, 833-847

A. Ashcraft and T. Schuermann, 2007, “Understanding the Securitization of Subprime Mortgage Credit”

For those who enjoy learning by video, several videos by bionicturtledotcom are useful:

["Subordination in structured finance"](#)

["Overcollateralization in structured finance"](#)

["The ABCs of CDO \(CLO, CBO, CDO², of ABS\)"](#)

["Asset-backed commercial paper \(ABCP\) conduit to securitize receivables"](#)

["On the Abacus transaction, example of a partially funded CDO"](#)

And just for fun (and for the amazing foresight of two comedians in the fall of 2007: “The Long Johns”

Class notes: The Darker Side of Securitization

Assignment

Securitization

H. The Role of the Ratings Agencies

Readings

R. Herring and E. Kane, “How to Reform the Credit-Rating Process to Support a Revival of Private-Label Securitization”

Class notes: The Role of Ratings Agencies

Assignment

Ratings Agencies

I. The Demise of the Big Five Investment Banks

Readings

DBE, “Investment Banks”

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. 41-50

House Banking Committee Release of Confidential Bear Stearns Memo

Harvey Miller, “Lehman – An Unnecessary Tragedy – Lessons that Should Have Been Learned,” July 25, 2012

“Lehman, two years on: Mission unaccomplished,” *The Economist*, 9 September 2010

R. Drew, “Goldman Sachs Group Inc.,” *New York Times*, 19 October 2010

Class notes: The Demise of the Big Five Investment Banks

Assignment

The Demise of the Big Five Investment Banks

J. Restructuring Financial Institutions

Readings

McKinsey, “Managing Successful Bank Restructuring: The Mellon Bank Story,” November 2003

J. Bulow and P. Klemperer, “Reorganizing the banks: Focus on the liabilities, not the assets,” VOX, 21 March 2009

Robert Hall and Susan Woodward, “The good bank/bad bank debate: A new proposal: The right way to create a good bank and a bad bank,” from Hall-Woodward blog, *Financial Crisis and Recession*, February 23, 2009.

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

Morrison/Foerster, “Good Bank – Band Bank: A Clean Break and a Fresh Start,” February 18, 2009

Class notes: Bank Restructuring: Opportunities and Pitfalls

Assignment

Restructuring Financial Institutions

III. Risk Measurement and Management

A. Reputational Risk

Readings:

Ingo Walter, “Reputational Risk”

Class notes: To be supplied

Assignment

To be supplied

B. VaR and the Revolution in Risk Management

Readings

Text, pp.81-110

G. Guill, 2007, “Bankers Trust and the Birth of Modern Risk Management”

Class notes: Managing Market Risk

Assignment

Text, pp.107-110, #4, 5, 6, 14, & 16

Group Project to be Distributed

Value-at-risk & Stress Testing (Questions and case material to be distributed)

C. The Management of Credit Risk

Readings

Text, pp.112-154, 167-181

R. Herring and T. Schuermann, “Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies”

Class notes: Credit Risk

Assignment

Text, pp.155-159, #18, 22, 23, 24, & 32

D. The Treasury Function: Managing Interest Rate Risk

Readings

Text, pp.1-80

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

Assignment

Text, pp.63-68, #3, 4, 14, & 21

E. The Treasury Function: Managing Liquidity Risk

Readings

Text, pp. 230-252

J. Tirole, 2011, “Illiquidity and All Its Friends,” *Journal of Economic Literature* 49(2): pp.287-325 (for those with advanced training in economics or a special interest in liquidity)

Class notes: Liquidity & Liquidity Risk Management

IV. Sovereign Debt Crises

A. The Dynamics of Sovereign Debt Crises

Readings

...to be supplied reflecting current developments

“Sovereign-debt theories: Domino theory,” *The Economist*, 18 February 2010

M. Wolf, “Is there the will to save the eurozone?” *Financial Times*, 7 December 2010

Class notes: The Dynamics of Debt Crises and How They Are Resolved

B. Sovereign Debt Crises & How they are Resolved

Readings

Text, pp. 228

A. Mares, “Ask Not Whether Governments Will Default, but How,” Morgan Stanley, 26 August 2010

Economist, “The Merkel memorandum,” August 11, 2012

Class notes: Country Risk Analysis

V. Evolving Financial Regulatory and Supervisory Policies

A. What the Crisis Taught Us about the Inadequacy of Regulatory & Supervisory Policies

Readings

R. Herring, “How Financial Oversight Failed and What it May Portend About the Future of Regulation”

Class notes: The Inadequacy of the Initial Policy Response

B. International Regulatory Reform: Introduction to Basel I, II, & III

Readings

R. Herring, “Implementing Basel II: Is the Game Worth the Candle?”

R. Herring, “The Rocky Road to Implementation of Basel II in the United States”

R. Herring, “Basel III: A Non-Official American View”

Basel Committee on Banking Supervision, 2011, “Basel III Framework for Liquidity – Frequently Asked Questions”

Basel Committee on Banking Regulation, 2011, “Basel III Definition of Capital – Frequently Asked Questions”

Y. Onaran, 2011, “Global Bank Capital Regime at Risk as Regulators Spar over Rules,” Bloomberg.com, 20 August 2011

For those who enjoy learning by video, the bionicturtledotcom has a series of useful YouTube posts:

"Basel II overview"

"On the Standardized Approach"

"On the Internal Ratings Approach"

BNPParibas/Fortis has produced a very simple video overview of Basel III
at: <http://www.youtube.com/watch?v=CVsjFVEZnCE>

Class notes: Basel I, II & III (A Reader's Digest)

C. National Regulatory Reform: Dodd-Frank, British & EU Reform Efforts

Readings

Davis Polk, 2010, “Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010”

Morrison/Foerster, “Dodd-Frank at 2”

Cleary Gottlieb, “Alert Memo: Financial Regulatory Reform in the European Union: State of Play and Prospects,” 28 July 2011

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

Class notes: Dodd-Frank, Basel III & 2 Key Remedies: CoCos & Rapid Resolution