

Draft Reading List & Course Outline

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

The Wharton School

**University of Pennsylvania**

Spring Semester 2016

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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 comments. 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 assignments page embedded in Canvas integrates the reading list, lecture notes and other class materials with direct links to the underlying files or material on the web. 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 page as definitive with regard to assignments, readings, and deadlines.

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 to provide you with a cheaper alternative to 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 S&C. 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 the week following relevant class (beside the problem set itself). Since some 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. Please use Canvas to form teams **no larger than five** to work on these projects as well as to submit projects and other assignments. All three sections of this course will be assigned the same projects and so please feel free to form teams than may include students enrolled in other sections.

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 collected and linked on Canvas in a resources folder that also contains a glossary of technical terms. I regard these resources 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 and we will update the list.

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 on Canvas and discussed in class. Please note I have designed this exercise to sharpen your writing skills. The folder “Writing Assignment” in Files 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. (This information is also conveniently provided for you at the top of the Syllabus page as well.)

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 will take place on **Monday evening, February 29<sup>th</sup>, 6:00-8:00 pm**. The second mid-term will take place on **Thursday evening, April 21<sup>st</sup>, 6:00-8:00 pm**. Please consult these dates on the course calendar to see the room to which you are assigned. We will not have a final exam. In compensation for your willingness to take these mid-term exams outside the regularly scheduled class time, we will **not** hold class on both Wednesday, March 2<sup>nd</sup> and Wednesday, April 27<sup>th</sup>.

A folder on 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. (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 the exams by focusing mainly on the sample exams rather than reviewing what we do in class. Please note these exams emphasize critical thinking, not memorization or computation.

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. Each year several students benefit from these adjustments.

### **Topical Outline of the Course**

- I. Introduction and Overview of the Course**
  - A. The Evolution of Banks and Financial Intermediation
  - B. The Shadow Banking System
    - 1. Securitization
    - 2. Hedge Funds
  
- II. An Overview of the Business of Banking**
  - A. How Banks Generate Profits (usually)
  - B. The Role of Capital in Banks
    - 1. Conceptual Issues
    - 2. Accounting and Regulatory Issues

C. Taxes

### **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. The Demise of the Big Five Investment Banks

b. The Vulnerability of Central Clearing Parties and Exchanges

D. Private Sector Restructurings: The Good Bank/Bad Bank Model

E. Resolution Policy and the Single Point of Entry Paradigm

### **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

## 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)

“Financial Stability Board reports to G20 Leaders on financial regulatory reform progress,” Financial Stability Board, 14 November 2014

#### Class note

The Evolution of International Financial Institutions

#### Assignment

Complete and Submit Student Questionnaire

## II. Overview of the Business of Banking

### A. How Banks Make Money (...usually)

#### Readings

M. O’Connor, A. Chaim, R. Placet, and D. Ho, “How Banks Make Money,” *Banking 101: US Large Cap Banks*, Deutsche Bank Global Markets Research, 11 May 2011 (***Hereafter, excerpts from this publication are designated DB.***)

DB, “Credit”

DB, “Liquidity”

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

R.J. 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:

<http://www.youtube.com/watch?v=h3IMANILkw0>

You may also enjoy a video analysis about how banks have made money from the policy of Quantitative Easing:

<http://www.youtube.com/watch?v=cxfMxpB9-Ds>

Class note

How Banks Make Money (usually...)

## **B. Financial Statement Analysis**

Readings

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

You may sample these according to your interest

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 U.S. banks that are required to file the Uniform Bank Performance Report.)*

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

R.J. 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:*

<http://www.youtube.com/watch?v=1-neFtPSMLU>

*(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 note

Continuation of "How Banks Make Money..." from the previous lecture

Assignment

Financial Analysis of Banks

**Distribution of Group Project #1:** *Comparing and Contrasting the Performance of Two Global, Systemically Important Financial Institutions*

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

Readings

A. Berger, R. Herring and G. Szegő, 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"

"Bank Capital and Liquidity," M. Farag, D. Harland, and D. Nixon

Class note

The Role of Capital in Financial Institutions

## **D. The Controversy over the Cost of Equity Capital**

### Readings

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

“The Parade of the Bankers’ New Clothes Continues: 23 Flawed Claims Debunked,” A. Admati and M. Helwig, June 23, 2013

### Class Note

Continuation of “The Role of Capital...” from the previous lecture and Martin Wolf on ROE Targets and the Cost of Capital

## **E. The Evolving Definition of Regulatory Capital**

### Readings

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

### Sample according to your interest

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

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

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

<http://www.youtube.com/watch?v=o2kGYUP7Vro>

<http://www.youtube.com/watch?v=oWGY-NYzz0g>

<http://www.youtube.com/watch?v=oWGY-NYzz0g>



BNPParibas/Fortis has produced a very simple video overview of Basel III at:

<http://www.youtube.com/watch?v=CVsjFVEZnCE>

Class Note

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

## **F. 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

Class Note

Taxation and the Corporate Structure and Geographic Location of International Banking

Assignment

Taxes and the Geographic Distribution of Banking Activity

## **G. Disintermediation, and the Growth of the Shadow Banking System**

### **1. Shadow Banking in General**

Readings

S. Claessens, Z. Pozsar, L. Ratnovski, and M. Singh, “Shadow Banking: Economic and Policy,” pp. 1-36

N. Cetorelli, B. Mandel, and L. Mollineaux, “The Evolution of Banks & Financial Intermediation: Framing the Analysis,” pp. 1-12

P. Olson, "Regulation's Role in Bank Changes," pp. 13-20

"Global Shadow Banking Monitoring Report 2014," 30 October 2014, pp. 1-27

"Shadow banking and systemic risk regulation," Dan Tarullo, speech 22 November 2013

*Sample according to your interest*

V. Bod and J. Santos, "The Rise of the Originate-To-Distribute Model and the Role of Banks in Financial Intermediation," pp. 21-34

N. Cetorelli and S. Peristiani, "The Role of Banks in Asset Securitization," pp. 47-63

"Strengthening Oversight and Regulation of Shadow Banking," Financial Stability Board, 18 November 2012

"Shadow Banking in China," Andrew Sheng, 5 November 2014

"Lending Club," *The Economist*, 13 December 2014

"Virtual Currencies: Emerging Regulatory, Law Enforcement, and Consumer Protection Challenges," GAO Report, May 2014

*For those who enjoy learning by watching videos, two useful videos on Shadow Banking appear on YouTube:*

[http://www.youtube.com/watch?v=\\_mq1Nh1hIXk](http://www.youtube.com/watch?v=_mq1Nh1hIXk)

<http://www.youtube.com/watch?v=v3rfgkTAlho>

In addition, you may enjoy these videos on securitization by bionicturtledotcom:

<http://www.youtube.com/watch?v=iTehlK4nF6w>

<http://www.youtube.com/watch?v=cuG4kcGu6tA>

[http://www.youtube.com/watch?v=Sac-qiZoU\\_0](http://www.youtube.com/watch?v=Sac-qiZoU_0)

<http://www.youtube.com/watch?v=KvG3X7KPb3M>

<http://www.youtube.com/watch?v=oWGY-NYzz0g>

And just for fun (and for the amazing foresight of two comedians in the fall of 2007) watch:

<http://www.youtube.com/watch?v=z-oIMJMGd1Q>

Class Note

Shadow Banking

**2. Hedge Funds, An example of institutions operating in the shadows**

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

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

“Fees for hedge funds and private equity,” *The Economist*, February 8, 2014

“Can’t Pay, Won’t Pay,” *The Economist*, 20 September 2014

Class Note

Hedge Funds & Financial Stability

Assignment

How Do Hedge Funds Differ from Other Financial Institutions?

**III. Financial Crises**

**A. Real Estate Booms & Banking Busts**

Readings

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

“Housing, Why Grumble,” *The Economist*, 20 December 2014

Class note

Real Estate Booms and Banking Busts

**B. How Real Estate Bubbles Often 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 Are Real Estate Prices Especially Prone to Bubbles?

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

### Readings

P. Tucker, "The lender of last resort and modern central banking: principles and reconstruction," in BIS Papers, No. 79, *Rethinking the lender of last resort*, pp. 1-42B. Keoun and P. Kuntz, "Wall Street Aristocracy Got \$1.2 Trillion from Fed," *Bloomberg.com*, 22 August 2011

### Read according to your interest

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

T. Humphrey, "Lender of Last Resort: What it is, whence it came and why the Fed isn't it," *Cato Journal*, Spring 2010, pp. 333-364.

Class note: 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-

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, 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.J. 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: Capital Markets

Readings

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

*For more on the intricacies of secured funding you may find the following videos to be of interest:*

[http://www.youtube.com/watch?v=qF11rk1M\\_Rw](http://www.youtube.com/watch?v=qF11rk1M_Rw)

<http://www.youtube.com/watch?v=GTTePQucg68>

DBE, “Investment Banks”

S. Claessens, R.J. 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

Sample according to your interests

House Banking Committee Release of Confidential Bear Stearns Memo

H. Miller, “Lehman – An Unnecessary Tragedy – Lessons that Should Have Been Learned,” 25 July 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 note: The Demise of the Big Five Investment Banks

Assignment

The Demise of the Big Five Investment Banks

## **G. After the Crisis had Occurred: 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

R. Hall and S. 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*, 23 February 2009.

W. Buiters, “Good Bank vs. Bad Bank: Don’t touch the unsecured creditors! Clobber the tax payer instead. Not.” *FT.com*, 13 March 2009

“The Single Point of Entry Strategy,” Federal Deposit Insurance Corporation, December 2013

Class notes: Bank Restructuring: Opportunities and Pitfalls

## **IV. Risk Measurement and Management**

### **A. VaR and the Revolution in Risk Management**

#### Readings

Text, pp. 88-110

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

R.J. Herring and T. Schuermann, “Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies,” pp. 84-100

Class Note: Managing Market Risk

#### Assignment

Text, pp. 118-122, #4, 5, 6, 18, & 21

**Distribution of Group Project #2:** *Value-at-Risk & Stress Testing*

### **B. The Management of Credit Risk**

#### Readings

Text, pp. 126-168, 180-193

Class notes: Credit Risk

#### Assignment

Text, pp. 168-176, #11, 20, 25, 26, 27 & 38

### **C. The Treasury Function: Managing Interest Rate Risk**

### Readings

Text, pp. 2-85

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

### Assignment

Text pp. 66-68, #3, 4, 16, & 17

## **D. The Treasury Function: Managing Liquidity Risk**

### Readings

Text, pp. 243-266

*For those with advanced training in economics or a special interest in liquidity, a survey by the most recent winner of the Nobel Prize in Economics*

J. Tirole, 2011, "Illiquidity and All Its Friends," *Journal of Economic Literature* 49(2): pp.287-325

Class Note: Liquidity & Liquidity Risk Management

## **V. Sovereign Debt Crises**

### **A. The Dynamics of Sovereign Debt Crises**

#### Readings

Text pp. 208-229

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

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

### **B. Sovereign Debt Crises & How they are Resolved**



Readings

Text pp. 235- 239

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

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

Class notes: Country Risk Analysis

Assignment

Text pp. 230-231, # 6, 9, 11, 17 & 20