

International Banking and Money Market

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Chapter Objective:

This chapter serves to begin our discussion of world financial markets and institutions.

Chapter Six Outline

- International Banking Services
 - The World's Largest Banks

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- International Banking Services
- Reasons for International Banking

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- International Banking Services
- Reasons for International Banking
- Types of International Banking Offices
 - Correspondent Bank
 - Representative Offices
 - Foreign Branches
 - Subsidiary and Affiliate Banks
 - Edge Act Banks
 - Offshore Banking centers
 - International Banking Facilities

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- International Money Market
 - Eurocurrency Markets
 - Eurocredits
 - Forward Rate Agreements
 - Euronotes
 - Euro-Medium-Term Notes
 - Eurocommercial Paper

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- International Banking Services
- Reasons for International Banking
- Types of International Banking Offices
- Capital Adequacy Standards
- International Money Market
- International Debt Crisis
 - History
 - Debt-for-Equity Swaps
 - The Solution: Brady Bonds
 - The Asian Crisis

International Banking Services

- International Banks do everything domestic banks do and:
 - Arrange trade financing.
 - Arrange foreign exchange.
 - Offer hedging services for foreign currency receivables and payables through forward and option contracts.
 - Offer investment banking services (where allowed).

The World's 10 Largest Banks

Bank of America	U.S.
Citigroup	U.S.
HSBC Holdings	U.K.
Crédit Agricole Group	France
Chase Manhattan	U.S.
Industrial & Commercial Bank of China	China
UBS	Switzerland
Deutsche Bank	Germany
Wells Fargo	U.S.
Bank One	U.S.

Reasons for International Banking

- Low Marginal Costs
 - Managerial and marketing knowledge developed at home can be used abroad with low marginal costs.

Reasons for International Banking

- Low Marginal Costs
- Knowledge Advantage
 - The foreign bank subsidiary can draw on the parent bank's knowledge of personal contacts and credit investigations for use in that foreign market.

Reasons for International Banking

- Low Marginal Costs
- Knowledge Advantage
- Home Nation Information Services
 - Local firms in a foreign market may be able to obtain more complete information on trade and financial markets in the multinational bank's home nation than is obtainable from foreign domestic banks.

Reasons for International Banking

- Low Marginal Costs
- Knowledge Advantage
- Home Nation Information Services
- Prestige
 - Very large multinational banks have high perceived prestige, which can be attractive to new clients.

Reasons for International Banking

- Low Marginal Costs
- Knowledge Advantage
- Home Nation Information Services
- Prestige
- Regulatory Advantage
 - Multinational banks are often not subject to the same regulations as domestic banks.

Reasons for International Banking

- Low Marginal Costs
- Knowledge Advantage
- Home Nation Information Services
- Prestige
- Regulatory Advantage
- Wholesale Defensive Strategy
 - Banks follow their multinational customers abroad to avoid losing their business at home and abroad.

Reasons for International Banking

- Low Marginal Costs
- Knowledge Advantage
- Home Nation Information Services
- Prestige
- Regulatory Advantage
- Wholesale Defensive Strategy
- Retail Defensive Strategy
 - Multinational banks also compete for retail services such as travelers checks, tourist and foreign business market.

Reasons for International Banking

- Knowledge Advantage
- Home Nation Information Services
- Prestige
- Regulatory Advantage
- Wholesale Defensive Strategy
- Retail Defensive Strategy
- Transactions Costs
 - Multinational banks may be able to circumvent government currency controls.

Reasons for International Banking

- Home Nation Information Services
- Prestige
- Regulatory Advantage
- Wholesale Defensive Strategy
- Retail Defensive Strategy
- Transactions Costs
- Growth
 - Foreign markets may offer opportunities to growth not found domestically

Reasons for International Banking

- Prestige
- Regulatory Advantage
- Wholesale Defensive Strategy
- Retail Defensive Strategy
- Transactions Costs
- Growth
- Risk Reduction
 - Greater stability of earnings due to diversification.

Types of International Banking Offices

- Correspondent Bank
- Representative Offices
- Foreign Branches
- Subsidiary and Affiliate Banks
- Edge Act Banks
- Offshore Banking Centers
- International Banking Facilities

Correspondent Bank

- A *correspondent banking relationship* exists when two banks maintain deposits with each other.
- Correspondent banking allows a bank's MNC client to conduct business worldwide through his local bank or its correspondents.

Representative Offices

- A *representative office* is a small service facility staffed by parent bank personnel that is designed to assist MNC clients of the parent bank in dealings with the bank's correspondents.
- Representative offices also assist with information about local business customs, and credit evaluation of the MNC's local customers.

Foreign Branches

- A *foreign branch bank* operates like a local bank, but is legally part of the the parent.
 - Subject to both the banking regulations of home country and foreign country.
 - Can provide a much fuller range of services than a representative office.
- Branch Banks are the most popular way for U.S. banks to expand overseas.

Subsidiary and Affiliate Banks

- A *subsidiary bank* is a locally incorporated bank wholly or partly owned by a foreign parent.
- An *affiliate bank* is one that is partly owned but not controlled by the parent.
- U.S. parent banks like foreign subsidiaries because they allow U.S. banks to underwrite securities.

Edge Act Banks

- *Edge Act banks* are federally chartered subsidiaries of U.S. banks that are physically located in the U.S. that are allowed to engage in a full range of international banking activities.
- The Edge Act was a 1919 amendment to Section 25 of the 1914 Federal Reserve Act.

Offshore Banking Centers

- An *offshore banking center* is a country whose banking system is organized to permit external accounts beyond the normal scope of local economic activity.
- The host country usually grants complete freedom from host-country governmental banking regulations.

Offshore Banking Centers

- The IMF recognizes
 - the Bahamas
 - Bahrain
 - the Cayman Islands
 - Hong Kong
 - the Netherlands Antilles
 - Panama
 - Singapore
- as major offshore banking centers

“Shell” Branches

- *Shell branches* need to be nothing more than a post office box.
- The actual business is done by the parent bank at the parent bank.
- The purpose was to allow U.S. banks to compete internationally without the expense of setting up operations “for real”.

International Banking Facilities

- An *international banking facility* is a separate set of accounts that are segregated on the parents books.
- An international banking facility is not a unique physical or legal identity.
- Any U.S. bank can have one.
- International banking facilities have captured a lot of the Eurodollar business that was previously handled offshore.

Capital Adequacy Standards

- *Bank capital adequacy* refers to the amount of equity capital and other securities a bank holds as reserves.
- There are various standards and international agreements regarding how much bank capital is “enough” to ensure the safety and soundness of the banking system.

Capital Adequacy Standards

- While traditional bank capital standards may be enough to protect depositors from traditional credit risk, they may not be sufficient protection from derivative risk.
- For example, Barings Bank, which collapsed in 1995 from derivative losses, looked good on paper relative to capital adequacy standards.

International Money Market

- Eurocurrency is a time deposit in an international bank located in a country different than the country that issued the currency.
 - For example, Eurodollars are U.S. dollar-denominated time deposits in banks located abroad.
 - Euroyen are yen-denominated time deposits in banks located outside of Japan.
 - The foreign bank doesn't have to be located in Europe.

Eurocurrency Market

- Most Eurocurrency transactions are interbank transactions in the amount of \$1,000,000 and up.
- Common reference rates include
 - LIBOR the London Interbank Offered Rate
 - PIBOR the Paris Interbank Offered Rate
 - SIBOR the Singapore Interbank Offered Rate
- A new reference rate for the new euro currency
 - EURIBOR the rate at which interbank time deposits of € are offered by one prime bank to another.

Eurocredits

- Eurocredits are short- to medium-term loans of Eurocurrency.
- The loans are denominated in currencies other than the home currency of the Eurobank.
- Often the loans are too large for one bank to underwrite; a number of banks form a syndicate to share the risk of the loan.
- Eurocredits feature an adjustable rate. On Eurocredits originating in London the base rate is LIBOR.

Forward Rate Agreements

- An interbank contract that involves two parties, a buyer and a seller.
- The buyer agrees to pay the seller the increased interest cost on a notational amount if interest rates fall below an agreed rate.
- The seller agrees to pay the buyer the increased interest cost if interest rates increase above the agreed rate.

Forward Rate Agreements: Uses

- Forward Rate Agreements can be used to:
 - Hedge assets that a bank currently owns against interest rate risk.
 - Speculate on the future course of interest rates.

Euronotes

- Euronotes are short-term notes underwritten by a group of international investment banks or international commercial banks.
- They are sold at a discount from face value and pay back the full face value at maturity.
- Maturity is typically three to six months.

Euro-Medium-Term Notes

- Typically fixed rate notes issued by a corporation.
- Maturities range from less than a year to about ten years.
- Euro-MTNs is partially sold on a continuous basis –this allows the borrower to raise funds as they are needed.

Eurocommercial Paper

- Unsecured short-term promissory notes issued by corporations and banks.
- Placed directly with the public through a dealer.
- Maturities typically range from one month to six months.
- Eurocommercial paper, while typically U.S. dollar denominated, is often of lower quality than U.S. commercial paper—as a result yields are higher.

International Debt Crisis

- Some of the largest banks in the world were endangered when loans to sovereign governments of some less-developed countries.
- At the height of the crisis, third world countries owed \$1.2 *trillion*.

International Debt Crisis

- Like a great many calamities, it is easy to see in retrospect that:
- It's a bad idea to put too many eggs in one basket, especially if:
- You don't know much about that basket.

End Chapter Six