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International Banking in the New Era: Post-Crisis Challenges and Opportunities

Suk-Joong Kim
Michael D. McKenzie

Editors



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INTERNATIONAL BANKING IN THE NEW ERA: POST-CRISIS CHALLENGES AND OPPORTUNITIES

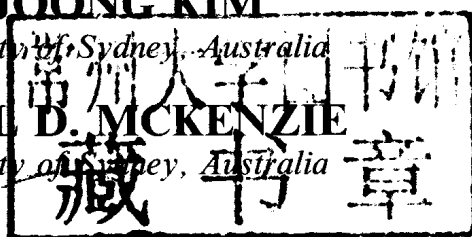
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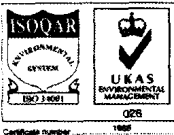
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PART I

AN OVERVIEW

INTRODUCTION TO INTERNATIONAL BANKING IN THE NEW ERA: POST-CRISIS CHALLENGES AND OPPORTUNITIES

Suk-Joong Kim and Michael D. McKenzie

1. OVERVIEW

International banking refers to the activities of providing financial services (banking) to clients (both institutional and individual) located in many different countries. This encompasses a wide range of activities, including transactions with foreigners and domestic residents relating to deposits and lending in domestic and foreign currencies, facilitating foreign currency transactions and foreign exchange risk hedging, participating in international loan syndications, and facilitating international trade finance for clients.

International banking activities were traditionally the domain of multinational banks, who enjoyed an overwhelming advantage in engaging in international banking activities as they operated across multiple banking jurisdictions. This meant that they were able to arbitrage bank regulations and systemic risks at the national level by internationalizing into offshore

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centers and those jurisdictions with lenient regulations of banking activities. For example, the Eurodollar market in London and the continental European countries with universal banking tendencies presented attractive opportunities for U.S. multinational banks in the 1960s.

In the early 1980s, many advanced economies began the process of deregulating their banking sectors, which reshaped the traditional boundaries of commercial and investment banking activities. This change has served to blur the distinction between domestic and international banking activities. Commercial banks diversified their asset and liability activities and actively participated in sophisticated financial engineering activities. This change meant that multinational as well as national banks were developing a capacity to service clients located in multiple jurisdictions and to engage in international banking activities.

By the early 1990s, the banking sectors of many emerging economies followed this trend and underwent their own wave of deregulation and liberalization. This change led to a significant penetration of foreign banks into these emerging market regions. For example, multinational banks from the United States and Western Europe are well represented in most emerging economies although each region has dominant players – European banks in emerging Europe, U.S. banks in East Asia, and Spanish and U.S. banks in Latin America (see Domanski, 2005). More recently, banks from the emerging economies themselves are venturing into international markets. The important difference here is that the emerging market bank internationalization is mostly limited to intraregion expansions. For example, 100% of foreign emerging market bank assets in East Asia and Latin America and 97% in Europe in 2004 were from other emerging economies in the same region (see Van Horen, 2007).

In the current environment of global deregulated banking systems, the role of banks is no longer limited to that of the traditional financial intermediation in national markets. Instead, banks in advanced economies are active in every aspect of the financial services industry. Furthermore, banks are not only active in their respective home markets, but globally, and both sides of their balance sheets will typically have international exposures. In addition, the banks from emerging markets also have both direct and indirect exposures to international banking markets.

Against this backdrop of a deregulated and truly integrated global banking system, we have watched a dramatic financial credit crisis unfold. The U.S. mortgage origination industry created a supply of assets for Wall Street investment banks, who in turn created and marketed asset-backed

Asset Backed Securities (ABS). It is these asset-backed securities that have been marketed globally have been identified as one of the most important causes of the current global financial crisis. Multinational banks have played a key role in creating linkages across the financial markets of both advanced and emerging economies, through which the adverse consequences of the U.S. subprime market collapse were able to spread to other financial systems. Western European banking systems were directly impacted, and banking systems around the world suffered both direct and indirect spillovers. The tightening in the international financial markets exposed the structural weakness of the economies of some the Euro zone countries, and this led to the current sovereign debt issues of Greece, Spain, Hungary, and potentially many others in Europe.

The scale of the financial crisis, in terms of its impact on the global economy and the size of the bailout/stimulus packages (e.g., US\$787tr in the United States and US\$586tr in China), has caused policy makers to question their past decisions to deregulate the banking sector. Ongoing discussions in numerous forums hark back to the era of regulation as a cure for the current problems and a means to prevent future crisis. For example, De Grauwe (2009) proposes a return to the “narrow banking” of the Glass–Steagall era as the Basle approach of regulation has not been effective. Thus, the roles of banks are once again being redefined with the possibility of a return to a more controlled environment.

This volume of the *International Finance Review* focuses on international banking in the postcrisis era. A total of 14 original chapters, not published elsewhere, have been selected from a competitive field. The chapters utilize various methods, including theoretical, empirical, and qualitative. Several papers offer combinations of these different categories, and among the empirical papers, there are a wide variety of datasets analyzed. These chapters serve to contribute to the knowledge on issues related to the field of international banking.

The chapters are divided into four parts. Part II formalizes much of what has been discussed in this introduction and discusses the role played by banks in the recent global financial crisis. The implications of the crisis on financial regulation are discussed in Part III. Part IV includes three chapters on operational aspects of banks during financial crises and one chapter on the relative performance of conventional versus Islamic banks in general and during financial crises. The last part of the book concentrates on the determinants of multinational banking presence in emerging markets.

2. THE ROLE OF BANKS AND LAWYERS IN THE GLOBAL FINANCIAL CRISIS

Part II considers the various roles played by banks and lawyers during the global financial crisis. The discussion begins with a chapter from Ola Sholarin entitled “The Subprime Mortgage Crises: How the Market Was Failed and Manipulated.” This chapter investigates the roles played by the Wall Street investment banks and commercial banks in triggering the worst financial crisis of the modern era. In addition, this chapter also discusses the shortcoming of the rating agencies, as well as failures of financial regulators during and after the crisis. The main proposition is that the financial derivatives and other exotic financial instruments – including Credit Default Swaps (CDS), ABS, and Collateralized Debt Obligations (CDO) – are not, in themselves, the financial “weapons of mass destruction.” Instead, the blame for the financial crises squarely and unreservedly rests with the unscrupulous and reckless institutional market practitioners, the unprofessional attitude and approach of the rating agencies as well as the regulatory failure on the part of the financial regulators and other gate keepers.

The second chapter in this section, “Bank Fragility and the Financial Crisis: Evidence from the U.S. Dual Banking System”, is by Christian Rauch, and it compares the stability of the U.S. dual banking system’s two bank groups, national and state banks, in light of the current financial crisis. The main finding of this chapter suggests that, *ceteris paribus*, national banks reduced their potential balance sheet fragility after the escalation of the crisis in August 2007 by reducing lending and liquidity creation stronger than state banks. Anecdotal evidence supports the empirical findings. Although both The Federal Deposit Insurance Corporation (FDIC) and The Office of the Comptroller of the Currency (OCC) did not anticipate the adverse effects of the crisis, the OCC publicly showed an earlier reaction to liquidity-related problems than the FDIC.

The third chapter is by Jonathan A. Batten, Warren P. Hogan and Peter G. Szilagyi and is entitled “Asia-Pacific Perspectives on the Global Financial Crisis 2007–2009.” They consider recent events in financial markets and the subsequent responses by monetary and fiscal authorities, which are impressive for their scale, innovation, and flexibility in the face of sharply deteriorating circumstances. Internationally, the economic malaise brought perverse responses not least being the apparent quest for higher capital adequacy requirements than was thought necessary before the downturn. Where possible, the uniqueness of the responses by authorities in the Asia-Pacific region is highlighted. Other features impeding recovery

cannot be dealt with immediately. Among these, the most important is the valuation procedures associated with accounting rules.

The fourth paper entitled “Bankers and Scapegoats” by Sinclair Davidson considers the issues surrounding the subprime crisis and explores arguments relating to regulation and the political economy of the recent crisis. He concludes that as long as the political cost-benefit of having inefficient banking regulation dominates an economic cost-benefit of having efficient regulation, we can expect that perverse incentives will remain, and financial crises will be a regular feature of the economic landscape.

The fifth and the last chapter in this section is by William V. Rapp and is entitled “The Lawyers and the Meltdown: The Role of Lawyers in the Current Financial Crisis.” He argues that lawyers, not just bankers, for good and bad have been involved in all aspects of the current financial crisis and that if lawyers had been less involved or had raised warnings about legal risks as well as economic ones, the financial impact may not have been so disastrous and widespread. This chapter then highlights a public policy need not only for financial regulatory reform but also for a tightening in the professional standards and regulatory penalties imposed on lawyers involved in such transactions.

3. POST-CRISIS FINANCIAL REGULATION

Following from the discussion on the global financial crisis and the role banks and lawyers played, the implication of these discussions on the financial market regulation are presented in Part III. The first chapter in this part is entitled “The Global Financial Crisis – Causes, Effects and Issues to Consider in the Reform of Financial Regulation” by Folarin Akinbami. Following the global financial crisis, the need for the reform of financial regulations in several jurisdictions across the globe, including the United Kingdom and the United States, has been highlighted. This chapter critically examines some of the areas where reforms are most needed and concludes that market fundamentalism and over-reliance on the alleged self-correcting powers of the market have led to excessive deregulation and liberalization in world financial markets. Financial regulatory reforms will therefore have to be substantial and comprehensive to properly address the problems caused by excessive financial liberalization.

The second chapter is by Pierre-Richard Agénor and Luiz A. Pereira da Silva and is entitled “Reforming International Standards for Bank Capital

Requirements: A Perspective from the Developing World.” In this chapter the authors discuss recent proposals for reforming international standards for bank capital requirements, from the perspective of developing countries. After evaluating the effectiveness of capital requirements reforms and progress in implementing existing regulatory accords, they discuss the pro-cyclical effects of Basle regimes and suggest a reform proposal. Their main finding is that the minimum bank capital requirements proposals in developing countries should be complemented by the adoption of an incremental, size-based leverage ratio.

The third chapter is entitled “Financial Fragility and Securitisation: The Discussions with Australian Regulators and Bank Risk Managers” by Siquwen Li. Among divergent approaches to understanding the global financial crisis, Minsky’s Financial Instability Hypothesis has gained increased attention. In part, the chapter draws upon Minsky’s notion that the seeds of instability are sown when banks, households, and firms move from hedge, to speculative, and then into Ponzi financial positions. Financial innovations such as securitization contribute to this transformation. Furthermore, this chapter includes the findings arising from an analysis of interviews that focus on securitization-related issues after the subprime crisis with practitioners who were closely involved in regulation and risk management. The need for fundamental reform in the financial sector with a more consistent regulatory platform and enhanced supervision is highlighted, to facilitate rapid healing from the damage arising from the financial crisis in Australia.

4. FINANCIAL MARKETS AND BANKING

Part IV of this volume contains four chapters on operational aspects of banks. The first chapter in this group is “The Effects of Underwriting Practices on Loan Losses: Evidence from the FDIC Survey of Bank Lending Practices” by John P. O’Keefe. This chapter investigates the influence of U.S. bank loan underwriting practices on loan losses and identifies potential determinants of lending practices for five categories of loans: business, consumer, commercial real estate, home equity, and construction and land development loans. For business loans, the likelihood that bank management will adopt low-risk lending practices increases with bank financial performance, management quality hierarchical complexity and decreases with market competition. Results for the selection of lending practices for consumer loans and three categories