UNIT 1 INTERNATIONAL BANKING : AN INTRODUCTION

Objectives

After studying this unit, you should be able to :

- understand the meaning and concept of International Banking
- describe the brief history of International Banking
- distinguish various forms of International Banking

Structure

1.1 Introduction
1.2 Definitions
1.3 Brief History of International Banking
1.4 New Characteristics and Dimensions
1.5 Reasons for Growth of International Banking
1.6 Size of the International Banking Market
1.7 Organisational forms of International Banking
1.8 profitability and Prospects of International Banking
1.9 Prospects
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1.1 INTRODUCTION

International banking has been one of the major growth industries of the 1970s, 1980s and 1990s. It seems at times as if the entire industry is rushing on fast-forward into the future. The changes in the world of international banking over the lasl few years have been nothing if not swift and sweeping. New financial centres have sprung up during the period and any bank which has any pretensions or ambitions for growth can no longer afford to operate just within its home country.

1.2 DEFINITIONS

Aliber defines "international banking" as a sub-set of commercial banking transactions and activity having a cross-border and/or cross currency element, Ill other words,' international banking comprises a range of transactions that can be distinguished from purely domestic operations by (a) the currency of denomination of the transaction, (b) the residence of the bank customer and (c) the location of the booking office. A deposit or loan transacted in local currency between a bank in its home country and a resident of that same country may be termed pure domestic banking. Anything else, in one form or another, is international banking. The range of possible variations of international (or cross-border) banking is obviously considerable.

Cohen illustrates one approach to finding suitable labels for all these possible variations in table 1.1 While transactions in subset "A" represent pure domestic banking, those in subset "B" broadly correspond to what traditionally have been described as foreign banking operations — deposits from abroad or loans to customers abroad booked in local currency by a bank in ils home country. Historically until the development of what is

today commonly called the Euro- currency market that was the predominant from of international banking.

The Euro-currency market is conventionally defined to encompass all deposit and loan operations of a banking office transacted in a currency olher than that of a nation in which the office is located. In table-1.1 Euro-currency transactions include subset 'C' as well as much of those comprising subsets 'D1', 'D2' and 'D3'. Subset D4 comprising transactions in local currency with local residents, differ from subset 'A' only in the fact that the booking office is not locally owned.

Table- 1.1: Scheme of Banking Transactions

Transactions with a		Resident	Non- Resident
Denominated in the domestic currency	Booked in home country	A	B
	Booked outside home country	D1	D2
Denominated in the foreign currency	Booked 'in home country	C	
	Booked outside home country	D3	D4

We use the term international banking to refer to the cross-currency facets of banking business. For examples, cross-border lending can occur in the traditional manner of taking deposits from foreigners and making loans to foreigners in the currency of the country where the bank is located. Lending by banks in New York to foreigners in US Dollars is an example of this traditional activity. Until the 1960s, banks conducted lhe great bulk of their international banking transactions from offices in the home country. But now loans in US Dollars may be made by banks located in London (Some of which are branches of US banks). If the foreign currency loans by UK-based banks are to foreigners (i.e. non- residents of the UK) they are cross-border (i.e. external) claims and come under the definition of international banking. When such loans are made in US Dollars to UK residents they are cross-currency claims and are also included in the definition of international banking.

By the term "multinational banking" we refer to the location and ownership of banking facilities in a large number of countries and geographic regions , that is, focus is laid upon the global nature, and ownerships characteristics of banking operations, Frequently the term "foreign banking is used to refer to the ownership of banking facilities located in one country by citizens of another. We prefer the term "multinational banking" to signify the more global character of banking ownership and financial activities today. Multinational banking involves the ownership of banking facilities in one country by the citizens of another.

Euro-currency banking involves intermediation in foreign currencies and the relative freedom from local reserve requirements and monetary regulation.

Offshore banking can be defined in two different ways. The first concentrates on the distinction between location and currency denomination of business, Defined as 'banking carried out in one country but denominated in foreign currencies', offshore banking is the same as Eurocurrency business, Alternatively residence may be emphasised, so that 'offshore business banking in a country is business carried out there denominated in currencies other than the currency of the country with non-residents'. Defined this way the business has normally been free of reserve requirements and monetary controls by the domestic authorities. This category is sometimes called "entrepot" or "turntable" business.,

Freedom from domestic monetary regulation is the basis of onshore offshore banking, This is business conducted by essentially onshore "duty-free" Zones like International Banking Facilities (IBFs) in USA and Tokyo Offshore Banking Centre. Although called a facility there is no office or physical identity in the US other than a separate set of books within existing banking institutions. IBFs are directly equivalent to the operations of US banks with "Booking", "shell" or "brassplate" offshore centres located in the Bahamas and Cayman Islands.

1.3 BRIEF HISTORY OF INTERNATIONAL BANKING

The old Testament book Ecclesiastes says "There is nothing new under the sun." The last four decades of international expansion by banks controlled from head offices in the economically most powerful countries is merely another chapter in a centuries old story. International banking hearkens back at least to the second millenium before the common era, when Babylonian temples under the code of Hammurabi safeguarded the idle funds of the opulent and extended loans to merchants to finance the movement of goods. Likewise during the period of Greek ascendency in the ancient world (roughly 500 to 300 BC) "banks" regularly advertised interest for deposits and loans, and routinely handled foreign money payments. Under the Roman Empire a variety of financial instruments were legalised, such as bills of exchange, to promote regional (international) trade, During the Dark Ages, most of such activity disappeared. But with the coming of the Renaissance international banking again emerged as a powerful force on the landscape.

In more recent history the Florentine banking houses of the fourteenth and fifteenth centuries - the Bardi Peruzzi and the Medicislipstreamed in the wake of the growth of international wade in wool cloth and silks and at their perihelion, had branches, subsidiaries and offices throughout Europe. The Bardi and the Peruzzi collapsed as a result of defaults on extensive loans to monarchs such as Edward I and Edward II of England and Robert of Aujon, king of Naples. Makin describes these loans as the first instance of international lending by the forerunners of modern banks to the forerunners of modern governments. Similar fate befell the Medici Bank which had lent four times its capital resources to Edward IV.

During the nineteenth century, British and European bankers lent to the "new world". The economic development of the United States, from the colonial periods throughout the nineteenth century was financed in large part by capital from London and European centres. British merchant banking houses—notably Barings, Hamros, Rothschild - sponsored, underwrote and held issues of foreign bonds. Many of the foreign bonds issued were acquired in the traditional way by private investors through the London Stock Exchange. Others were issued "internationally" much like the Eurobonds are placed now a days.

Led by British institutions banks in the 19th century promoted two distinctly different types of international lending-trade financing and investment banking. The former, short term commercial lending on the traditional basis of bills of exchange was typically used to finance commodity exports and imports or to deal in foreign exchange. The latter, a pioneering development of the era consisting of the placement of long-term funds of fixed interest securities on an agency or undertaking basis was used more for Infrastructural and industrial investment. Trade financing was only a relatively small part of the story in the nineteenth century. Far more important was the development of investment banking which accounted for the great bulk of the international lending, where, financial houses acted primarily as agents or underwriters for the placement of long-term debt or equity issues with the broader investing public rather than as lenders on their own account. Risk was borne by the tens of thousands of individual savers who invested in the capital market, rather than directly by the shareholders or partners of bank themselves.

In the 1920s, New York, rapidly supplanted London as the centre of global finance, and American banking institutions came to dominate the market for international lending. England and France declined notably as sources of new funds and Germany hamstrung by its mammoth reparations burden was transformed into one of the biggest borrowers.. The United States found itself in, undated with requests for funds from Europe and elsewhere. In absolute magnitude the sale of foreign investment by Americans during the euphoric Roaring Twenties transcended even the records set by Europeans in the previous century.

World War I changed little in international finance, The elements of continuity were strong. For once, investment banking continued to account for the bulk of overseas lending, Likewise, sovereign loans continued to dominate overall lending tallies.

The international banking system became one of the main victims of the Great Depression and the Second World War. A rash of bank failures, default and violent contractions in international wade and investment shattered confidence in international lending. Banking

across national borders ground to a halt in the early 1930s and really did not resume until after the second World War. The machinery of private international finance spent twenty years in cold storage.

The establishment of the Bretton Woods monetary system restored confidence in international trade and investment, establishing a new set of rules governing trade, finance and exchange rates that formed the basis of the postwar world economy. With a secure financial framework in place multinational business blossomed and revolutionalized economic life by creating a global shopping center. The practical business requirements of running a global shopping center eventually led US banks to create history is first global money market. Ultramodern communications and information technology soon bound banks together in a single global financial market.

Perhaps the most remarkable development that the financial industry has experienced since the end of the world War II has been the iiternationalisation of banking. This development was commenced by the major commercial banking institutions located principally in Western Europe and the Western hemisphere. The banks that took the lead and embarked on multinational banking were individual institutions from such foreign banking oriented countries as Canada, France, Germany, Switzerland, UK & USA and Japan. Undeterred by geographical barriers, these banks embarked upon the creation of worldwide networks of outlets and became actively engaged in international operations. The international expansion of these banks has brought about the effective linkage of national financial markets and the increasing integration of worldwide banking systems. Despite apparent differences in the patterns of their international expansion these banks have become a truly multinational set of competing financial institutions.

International banking has become one of the dominant features of the international monetary and financial system since the first oil crisis in 1973. The main factors in this development have been (a) the unspent oil receipts of the low absorber oil - exporting countries, which were mainly deposited with US and European banks, and (b) the increasing financial needs of non-oil Less Developed Countries, which were mainly covered by loans from those banks. On the purely technical side, the development of the market has been greatly facilitated by technological progress in the telecommunications sector.

1.4 NEW CHARACTERISTICS AND DIMENSIONS

As stated above international banking is certainly a very old business, but since 1973 it has acquired new characteristics and dimensions. First, the number of participants, which at the beginning of the period were mainly American banks, has considerably widened to include German, UK, Japanese, French and Italian banks operating directly or through foreign branches and subsidiaries. Second, the foreign component of total assets of the big international banks has grown at a rate considerably above the average so that many major banks have now more international loans outstanding than domestic ones. Third, nearly three quarters of the deficit of LDCs have probably been financed by commercial banks. Fourth, the amount of individual loans has risen considerably thus increasing the risk from individual borrowers. Fifth, there has been a lengthening of maturities. Average maturities are now about 10 years. Finally, along with the assets international banks have diversified their sources of funds.

Two novel kinds of overseas bank operations characterized international bank expansion in the late 1960s and 1970s. The first was the multinational consortium bank, a new bank 'created by several established parent banks. The second was the shell branch·which is not really a bank at all but a device to get around domestic government regulation.

The global network in place the volume of international banking business exploded loans and other international business began to grow much more rapidly than domestic business. The rate of increase of international business was so explosive that it soon became the growth industry of the financial world, For the big American banks the boom in international business came along just in time, like a deus ex machina to rescue them from facing oceans of red ink and possible failure, liquidation or forced mergers resulting from the lugubrious performance of the domestic banking.

What are the distinctive features of the growth of international banking in postwar years that set it apart from the earlier phases? One feature is simply that of scale. Another is the extent of business carried out in so-called offshore centres - the locales where the conduct of banking is facilitated by favourable and/or flexibly administered banking laws, exchange control and tax structures and in which the volume of business is unrelated to the size and needs of the domestic market. The third one came when banks operating in London and elsewhere began making loans in US Dollars and in a wide variety of currencies. Previously the location of a bank's operations determined the currency in which it would make loans. This nexus between the location of financial centres and currency of lending has been snipped.

1.5 REASONS FOR GROWTH OF INTERNATIONAL BANKING

Numerous explanations have been offered to account for the growth of international banking. Aliber surveys these explanations. The "follow-the-leader" explanation suggests that banks expand across national borders to continue to service customers who themselves establish branches or subsidiaries abroad because it is profitable to do so in the context of monopolistic competition due to differentiation of the package of banking services provided by different banks. Another explanation sees expansion abroad as the pervasive effect of competition, banks operating under intense competition in some home markets are forced to develop low cost technologies for financial intermediation and have then an incentive to exploit their competitive advantage in other markets. A third explanation drawn from the analysis of foreign direct investment, argues that banks use management technology and marketing knowhow developed for domestic uses at very low marginal cost abroad. A fourth explanation, which is an application of the "electric theory of production" developed in the context of the analysis of multinational enterprises combines the existence of ownership-specific and location- specific advantages to account for the phenomenon of multinational banking. Fifth, market imperfections due to domestic rules, regulation and taxation combined with the drastic reduction in the cost of communications, have been seen as a major cause being the growth of euro-currency banking. Finally, inter-country differences in the cost of capital have also been used as an explanation, firms in general are able to expand their market share when their cost of capital (or any other input) is lower than their competitors; because of the high leverage of equity in banking, this general principle is seen as particularly relevant to explain the pattern of growth of banks on the world market.

Phillip Callier has advanced another reason for the growth of international banking. The argument elaborated by him in his paper "Professional Trading, Exchange Rate Risk and the growth of International Ranking" is that, thanks to the establishment of money market and foreign exchange operations in major trading centres throughout the world, large banks can significantly reduce the risk of those operations or increase theirreturn without increasing their risk by increasing their ontreats. The argument resis fundamentally on the well-known fact that the Earth executes a complete rotation around its axis once in every 24 hours, generating in the process a sequence of days and nights (as least in areas of the planet with large concentration of population).

Explanations can be classified under three headings:

1. **Financial activity following real-sector transactions:**

   - Cross-border financial transactions, many of them conducted from home-country offices of financial institutions, that were closely associated with and driven by cross- border trade in goods and services.
   - Establishment by financial institutions of affiliated offices abroad to improve services for existing non-financial customers who themselves had established operations abroad.

2. **Financial activity leading real-sector transactions:**

   - Cross-border financial transactions, conducted from home offices of financial institutions that proceeded in advance and independently of cross-border trade in goods and services.
   - Establishment by financial institutions of affiliated offices abroad in advance and

independent of the current requirements of existing non-financial customers in the home country.

3. **Regulatory, tax and supervisory explanations:**

- Lowering of national separation fences.
- Establishment by financial institutions of affiliated offices abroad to escape from more stringent regulation, taxation and supervision in the home environment.

It is convenient to refer to categorise 1 & 2 as the basic non-policy hypotheses about international financial intermediation and to category 3 as the government policy hypotheses.

The first variant of each explanation can partially account for the more extensive movement of funds from one national reservoir to another. But the second variants were probably at least as important; they pre-suppose a still deeper involvement in foreign activities through the establishment of actual bricks-and-mortar presences outside the home-nation reservoir, such ownership and locational penetration of foreign economies represented more than a mere ladling out of funds among the reservoirs. In effect financial institutions installed pipes, siphons and pumping stations to ,facilitate their inter-reservoir transfer of funds.

Financial Activity Following Real-Sector Transactions:

The generally faster post-war expansion of cross-border trade than of incomes and outputs occurred because governments reduced barriers to trade. Even more importantly, it occurred because of the effective economic distances between nations were shrinking for non-policy reasons such as a sharp fall in the relative price of transportation.

By itself, the faster growth of trade than of output would have given rise to a faster growth of cross-border financial activity than of domestic financial activity. When cross-border financial activity is merely the financing counterpart of trade transactions. The goods trade may be said to drive the financial activity that is supporting it. Because some of their most important non-financial customers were establishing offices abroad, banks and other financial institutions themselves had incentives to set up physical facilities abroad-branches or separately incorporated subsidiaries supplement the support they could give to customers from the home economy. Some of the lending and borrowing transactions with their customers were then booked on the balance-sheets of the foreign offices. The financial institutions setting up foreign offices followed their existing customers to retain or to participate in the growth of the customers' financial business. When a financial institution established offices within foreign economies, the real-scctor activity being financial need not have been wholly or in part, domestic within the host-country economy.

Financial Activity Heading Real-Sector Transaction:

Although the non-policy factors shrinking the effective economic distances between nationslstates encouraged international trade in the post-war period those forces had arguably an even more dramatic impact on international financial transactions.

New developmeiits in communications technology were especially important. Innovations in electronic equipment permitted, the processing and transmission of information, the confirmation of transactions, and the making of payments for transactions in a progressively less costly manner. Sophisticated methods of using the new equipment revolutionized the delivery of financial services. Entirely new vistas of possibilities for financial transaction were unfolded. Early in the post-war period for example, a large sale or purchase of foreign exchange could be executed only during the conventional business hours in the initiating party's time zone, By the mid- 1980s large foreign exchange transactions in the major currencies could be readily consummated twenty four hours a day. Large banks passed the detailed management of their worldwide foreign exchange positions from one branch to another around the globe staying continuously ahead of the setting sun.

Partly in response to such technological innovations, information and education about financial opportunities in foreign countries became much more readily and cheaply

available. Those changes in turn helped to alter consumers' and producers' tastes. Foreign goods, foreign financial investments-virtually anything foreign-hecame much less a rarity than had been true early in the postwar years.

The implications for financial activity were far- reaching. Economic agents became more sensitive to and had improved capacities to take advantage of incentives for arbitrage among the national financial reservoirs. Financial instruments denominated in different currencies and issued by borrowers in different nations became less imperfect substitutes in the portfolio of increasingly sophisticated investors. Accordingly large amounts of cross-border ladling of funds began to occur.

The economic distances between reservoirs were effectively shrinking for all types of economic agents. But financial institutions, and most of all large commercial banks, were best equipped to exploit. the enhanced arbitrage opportunities. They had more and higher-quality information about foreign financial systems. They were hetter placed to introduce new communications technology. The relative costs of cross-border financial transactions thus fell most rapidly for banks and other financial institutions.

Lading of funds between reservoirs that were directly induced by newly profitable or newly perceived arbitrage opportunities may be described as leading rather than following real-sector transactions. The gross flows and the resulting net transfers of savings were independentiy initiated.

In addition to arbitraging among national reservoirs by initiating financial transactions from their home bases, some financial institutions-again on their own initiative - moved abroad to establish actual physical offices within foreign reservoirs. Such offices enabled them to conduct arbitraging and inter-mediation activities directly from foreign locations. For example, by the establishment of foreign branches banks with head offices in a home ("parent") country were able to facilitate their collection of funds from and their lending of funds to the residents of foreign ("host") countries. Many of those foreign residents may not have had any real sector transactions with economic agents resident in the parent country. Such internationally oriented banks wanted not merely to service home customers, with international transactions or foreign facilities, they also wanted new foreign customers and wanted to become active borrowers and lenders in host country financial market.

Regulatory, Tax And Supervisory Explanations:

From the perspective of private sector agents the existence of a government-erected separation fence around their home reservoir imposed extra costs on cross-border financial transactions. For reservoirs around which the fence was very high and effectively maintained, the cost of transferring funds, in or out was prohibitive. For given economic distances between reservoirs attributable to nun-policy factors government actions to lower separation fences caused a decline in the differential cnsts required to get across the fence, thereby enhancing incentives for the ladling of funds between reservoirs. The partial dismantling of policy-crected barriers to international capital flows is thus another conceptually distinct category of explanation for the rapid growth of international financial intermediation in the last four decades.

Still other incentives caused by government policies resulted from the interaction of non-policy technological innovations with regulatory tax and supervisory restraints on the financial systems within some of the economies. Such incentives would have been operative even if separation fences themselves had not been altered.

These latter stimuli were important in nations having a domestic regulatory tax and supervisory environment that was more constraining than the environments in some foreign countries. High reserve requirements against deposit liabilities, binding interest rate, ceilings on deposits, high ratios of required capital to assets, high effective tax rates on domestic profits and unusually strict examination procedures are examples of such constraints. Financial institutions in nations with these constraints have incentives to locate affiliated offices outside their home country and to book transactions through those offices to take advantage of the less constrained operating environments abroad.

By locating offices abroad a financial institution gained access to possibilities for financial intermediation in the wider world economy without the encumbrances of the home

environment. To be sure financial institutions with offices in foreign host locations still had to cope with the domestic operating environment in the host nations. This environment has often hampered their business with host country customers. And the institutions still had to cope with getting across the separation fences of third nations to conduct business with residents of those nations.

The incentives for getting outside the home regulatory environment were related to but not the same as the incentives for getting over the home nations separation fence. The distinction is between continuously Shutting over the home separation fence versus jumping over the separation fence once and then staying outside it.

Important variants of behaviour for getting outside the fence occurred as national regulatory authorities permitted banks to establish offshore facilities—typically segregated accounting units—for conducting transactions with foreign customers or transactions in foreign currencies. In effect banks were permitted to carry out "offshore" transactions as though the facility were just outside the home separation fence-even though the facility was physically located in the home nation. Regulation, supervision and taxation were altered to discriminate in favour of the offshore transactions. Prominent examples of this phenomenon have included the creation of 'Asian Currency Units' in Singapore 'offshore Banking Units' in Bahrain and 'international Banking Facilities' in the United States.

Bankers talking about the location decisions for foreign branches and subsidiaries often portray their organisations behaving in an anticipatory way, seeking new customers and profit opportunities in advance of the current service requirements of existing customers. It appears that financial institutions themselves have often been the cutting edge of internationalisation'and finance has been much more than a passive veil draped over or shrouded by real-sector activity.

1.6 SIZE OF THE INTERNATIONAL BANKING MARKET

According to Bank for international Settlements, the total assets and liabilities of the international banking market were US$ 10491.5 billion and US$ 10306.5 billion respectively at the end June 1998 up from 843.36 billion and 734.9 billion respectively at the end of December 1977, The net international banking credit increased from $ 415 Billion to $ 5390 billion during this period, The market has been charting an upward trajectory on the back of the forces of deregulation, liberalization, institutionalization, globalisation and securitisation.

Offices of foreign-owned banks are becoming common-place in financial districts of large cities and towns. Banks are competing in each others' markets for deposits and loans, taking bigger and bigger shares of activity according to just every measure.

1.7 ORGANISATIONAL FORMS OF INT'ERNATIOAL BANKING

International banks are linked together in various formal and informal ways from simple holding account with each other-correspondent accounts-to common ownership. These and other forms of banking organisation are described below.

1. Correspondent Banking:

An informal linkage between banks in different countries is set up when banks maintain correspondent accounts with each other. Large banks have correspondent relationships with banks in almost every country in which they do not have an office of their own. The purpose of maintaining foreign correspondent. is to facilitate international payments and collections for customers. The term "correspondent" comes from the main or cable communications that the banks used for settling customer accounts. Today, these communications have largely been replaced by SWIFT messages, and the settling between banks occurs via CHIPS. For example, if Aviva wants to pay a Canadian supplier, it will ask its U.S. Bank which will communicate with its Canadian correspondent bank via

SWIFT. The Canadian bank credits the account of the Canadian firm, while Aviva's bank debits Aviva's account. The U.S. and Canadian banks then settle through Chips.

Correspondent banking allows banks to help their custolners who are doing business abroad, without having to maintain any personnel or offices overseas. This relationship is primarily for settling customer payments, but it can extend to providing limited credit for each other's customers and to setting up contacts local business people and the clients of the correspondent banks,

2. Resident Representatives:

In order to provide their customers with help from their own personnel on the spot in foreign countries, banks open overseas business Offices. These are not banking offices in the sense of accepting local deposits or providing loans. The primary purpose of these offices is to provide information about local business practices and conditions, including the creditworthiness of potential customers and the bank's clients. The resident representatives will keep in contact with local correspondent banks and provide help when needed. Representative offices are generally small, and they have the appearance of an ordinary commercial office rather than a bank.

3. Bank Agencies:

An agency is like a full-fledged bank in every respect except that it does not handle ordinary retail deposits. The agencies deal in the local money markets and in the foreign exchange markets, arrange loans, clear bank drafts and checks, and channel foreign funds into financial markets. Agencies are common in New York, for example, Canadian and European banks keep busy offices there, with perhaps dozens of personnel dealing in the short-tern1 credit markets and in foreign exchange. Agencies also often arrange long-term loans for customers and act on behalf of the home office to keep it directly involved in the important foreign financial markets.

4. Foreign Branches:

Foreign branches are operating banks like local banks, except that the directors and owners tend to reside elsewhere. Generally, foreign branches are subject to both local banking rules and the rules at home, but because they can benefit from loopholes, the extra tier of regulations is not necessarily onerous. The books of a foreign branch are incorporated with those of the parent bank, although the foreign branch will also maintain separate books for revealing separate performance, for tax purposes, and so on, The existence of foreign' branches can mean very rapid check clearing for customers in different countries, because the dehit and credit operations are internal and can be initiated by fax or electronic mail. This can offer a great advantage over the lengthy clearing that can occur via correspondents. The foreign branch also offers bank customers in small countries all the service and safety advantages of a large bank, which the local market might not be able to support.

There would probably be far more extensive foreign branch networks of the large international banks if not for legal limitations imposed by local governments to protect local banks from aggressive foreign competition. Britain has traditionally been liberal in allowing foreign banks to operate and has gained in return from the reciprocal rules that are frequently offered. On the other hand, until the 1980 Bank Act was passed, the opening of foreign bank subsidiaries within Canada was prohibited, and branches of foreign banks are still not allowed. The United States selectively allows foreign banks to operate. The regulation and supervision of foreign banks within the United States is provided for in the International Banking Act of 1978. This act allows the U.S. Comptroller of the Currency to grant foreign banks a licence to open branches (or agencies). The foreign banks can open wherever state banking laws allow them to. The banks are restricted to their declared "home state" and are subject to federally imposed reserve requirements when they ate federally chartered. They have access to services of the Federal Reserve and can borrow form its discount window, Since 1980, the foreign banks that accept retail deposits have been required to provide deposit insurance for customers. The foreign banks are relatively more important in providing commercial and industrial loans than in other investment activities.

5. Foreign Subsidiaries and Affiliates:

A foreign branch is part of a parent organisation that is incorporated elsewhere. A foreign subsidiary is a locally incorporated bank that happens to be owned either completely or partially by a foreign parent. Foreign subsidiaries do all types of banking, and it may be very difficult to distinguish them from an ordinary locally owned bank.

Foreign subsidiaries are controlled by foreign owners, even if the foreign ownership is partial. Foreign affiliates are similar to subsidiaries In being locally incorporated and so on, but they are joint ventures, and no individual foreign owner has control (even though a group of foreign owners might have control).

6. Consortium Banks:

Consortium banks are joint ventures of the larger commercial banks. They can involve half a dozen or more partners from numerous countries. They are primarily concerned with investment, and they arrange large loans and underwrite stocks and bonds, Consortium banks are not concerned with taking deposits, and they deal only with large corporations or perhaps governments. They will take equity positions—part ownership of an investment—as well as make loans, and they are frequently busy arranging takeovers and mergers.

1.8 PROFITABILITY AND PROSPECTS OF INTERNATIONAL BANKING

During the past 40 years, important changes have taken place in the arena of international banking. International divisions became very powerful within the large banks throughout the 1950s and 1960. The typical experiences was for growth in international earnings and for the mix of total earnings to shift progressively in favour of overseas profits.

a. A period of stability - the 1950s and 1960s:

The 1450 -73 period was relatively free of adversity for firms doing business abroad. Banks owned:

- Cheap sources of funding and the sizeable float
- Privileged access to liquidity (discount windows, payment services, inter-bank market)
- Regulatory franchise
- Informational franchise
- Relatively limited competition.

Aided by low-cost funds and limited competition the banks' profitable growth also reflected the increasing demand for banking services that was fuelled by growth in world commerce, affluence among businesses and households' savings available for deposit and demand for credit and payment system to support consumption and investment by government, households and businesses.

Because of limited and "polite" competition as well as the growing demand for their services and credit facilities banks evolved without being particularly market sensitive. To a significant extent they were acceptors of deposits and rationer of credit. With such asset and liability opportunities a principal element in securing attractive profitability was the avoidance of large credit losses. Absent these, banks had generally excellent return on equity potential. This gave rise to a general philosophy of conservatism among bankers in extending credit developing new products, entering new markets delivering new services and/or funding themselves.

b. A decade of high risk the 1970s:

This sense of sanguinity was disrupted by the first oil shock, war in the Middle East and the failure of the Herstaff Bank in West Germany. The ensuing global recession of

1974-76 caused severe problems in overseas markets for the first time in the post-war period.

The mistakes made by bankers in country lending - essentially extending credit overseas on the presumed creditworthiness of sovereign entities are well known. Lending to both private and public entities abroad was heavily influenced by the widely held view that "countries do not go bust"

The major US commercial banks led by Citibank/Citicorp, had developed significant business links and loan experience in LDCs, especially in Latin nations, through the 1950s and 1960s. Their profit experiences there and the Latin American growth rates had been impressive. Extrapolation, often the enemy of wise prediction, suggested until the late 1970s that the good times could roll on in Latin lending. Bankers ignored the red flags-the warning signals - of 1979 which brought the second (Iran-provoked) oil shock and the draconian anti-inflation interest rate actions by Paul Volcker and the Fed. Worldwide recession, capital flight from LDCs, massive Latin deficits—all were rapidly triggered. The game was over, but the bankers just could not stop playing.

The banks kept on lending, hostage to their own lack of adequate capital and reserves to cover the deteriorating. LDC loans. Since they could not take the "hit" then without going under they made matters worse certainly for the debtors and arguably for themselves. They lent massively more. Their exposure in 1982 was nearly 80% higher than it had been in 1978.

c. Bankers Blues — 1980s:

Mexico's August 1982 announcement that it was broke stet shocked the public into awareness of the LDC debt problems and it changed the thinking behind the banks' lending. But in a very real sense it did not change their direction. The restructuring agreements meant still more lending. Only now the banks disparately sought to make more money up-front on loans they knew to he questionable. They got stiff rescheduling fees and unusually high spreads above their own cost of funds.

With every restructuring deal, the banks made more short-term money yet increased odds, they ultimately would loose money.

The major money centre banks profited handsomely from LDC lending from 1976-1986 and especially from 1983-1986 after the debt crisis had erupted. The sky fell in on those profits in 1987. Citicorp still in the load here took massive reserves. The others followed. The 1987 reserving led to losses that in effect swallowed an entire decade of profits from LDC lending (1976-1986). The 18 biggest US banks lost $ 17.3 billion pre-tax in 1987 on their LDC lending.

On top of the fall-out from LDC lending came the bursting of the real estate bubble of the late 1980s, souring of the loans to the oil patch and the stock market crash of 1987. Merger mania, a major source of earning burned itself out, leaving junk bonds living up to their names. The hanks that were hardest hit were those that expanded their global presence and their lending most aggressively assuming that profits would take care of themselves. Several top US banks, it was said, were technically insolvent. Citibank's share price fell to below $5. Few banks were very profitable. 15% was considered an exceptional return on equity. Many after write-offs-were dangerously unprofitable.

1980s also saw the displacements of banks as the main conduit for depositing and borrowing money (the process of "disintermediation"), a process made all the more agonising for commercial banks by the growing tendency of companies not only to arrange their borrowings through other financial intermediaries but also to place their deposits directly in the market and to use finance as a profit centre in its own right. Commercial banks' share of total assets in financial institutions in the US has fallen dramatically from over 70 per cent around the turn of the century to just around 30 p a cent today. Bank share of corporate debt in the US had declined from 19.6 per cent in 1979 to 14.5 per cent in 1994. Competition on both sides of bank balance sheet increased, leading to squeezing of profit margins.

The world's bankers were glad to have seen the back of the 1980s. Many banks vowed never again to "trust their forlunes abroad or respond to the requests of recreant foreign governments". Management aspirations in many of the capital market countries turned

inward, to focus more on home markets. This however, did not add up to an end of internationalisation. The pull of international market remained fundamentally strong. There are still all those multinational corporate clients oul there to be serviced, plenty of opportunities for asset diversification through trade and project financing, the attractions of a broader and potentially less expansive funding basc, and the allure of expanding foreign-based banking operations of many countries. In fact the retreat that began in 1982 was probably more tactical than strstegic - a shaking out of the market rather than a fading away. After the excesses of the 1970s a period of consolidation was inevitable as banks reconsidered their options and some of the more peripheral players were bound to get out of the game.

d. 1990s era of consolidation, capitalisation and return of profitability:

There can be few industries that have changed as much this decade as banking. The 1990s have been a period of astonishing (and almost unpredicted) success for banks. The world's best banks now make a return on equity of 25% or even more in case of Lloyds', TSB almost 40%. With only a few exceptions (notably in Japan) most are considerably better managed with clear strategies, good control of costs and an almost fanatical focus on improving the return to shareholders.

The world's top banks now have open to them a range of options much large than they have enjoyed before. In 1990 a big U.S. bank for instance had little room for maneuver. It was basically barred for securities business. The struggle to write off the mistakes of the past (and rebuild capital) made mergers difficult. The actions of European banks were even more circumscribed. In most countries even reducing costs was almost impossible because of the social taboo on firing staff.

Today about the only choice a bank cannot make is to continue as it is. In most jurisdictions, commercial banks can choose to get together with (or buy) an insurance business, an asset management firm or securities operation. Conversely, they can just as easily sell any of these operations if they decide they don't like a business they are already in.

Not that it is roses, roses all the way. There have been three fears. The first is the banks exposure to emerging markets. Russia has, in effect, defaulted. Asia is deep in recession. Brazil has teetered on the brink. Of late, China too has become a worry. These crises have demonstrated clearly not only the importance of banks but also their vulnerability. American and Spanish banks lend heavily to Latin America. French and German banks lend lots in Asia Shareholders of these banks have been worrying how many of these loans to troubled markets will be repaid.

e. Performance in 1997:

In performance terms 1997 was a mixed bag. According to Banker (July 1998) total pre-tax profits for Top 1000 banks amounted to $ 205 bn. slightly down on the $ 216.2 bn. 1996 but strong profit in the US and Europe shielded losses elsewhere, the combined $ 23 bn. losses of the Japanese banks which find the bad debts incurred from the days of the bubble economy becoming worse by the day. The biggest Japanese bank, Bank of Tokyo - Mitsubishi had the distinction of reporting a $ 6.2 bn. pre-tax loss.

Deutsche Bank set aside DM 3.9 bn. ($2.2bn.) to cover losses in Asia. J.P. Morgan was also hit by Asian crises. Credit Suisse First Boston had its nct exposure on Russia over $ 2bn. and lost $ 250mn. Barclays took a $ 250 mn. ($ 420 mn.) charge speciiically against its Russian exposure, Bankers Trust lost $ 488 mn. in the third quarter of 1998 on its emerging market operations. Dresdner Bank made provision of DM 2 bn. ($ 1.12 bn.)in 1998, reflecting the bank's extensive exposure to Russia where the government effectively defaulted in August 1998 on its foreign debt. Bayrisube Hypovereins put aside DM 3.5 bn. in October 1998. Standard Chartered suffered a 19% fall in pre-tax profits to Pound 703 mn. as bad debts charges shot up to pound 436 mn, in 1998.

Most of the lending to emerging markets is by big banks with deep pockets. In America, for example, three-quarters of lending to emerging markets come from the six biggest banks. Even if all the sickly borrowers defaulted, most these banks would lose to the extent of some $ 40 bn., nasty but not life-threatening. And with some signs of progress

in fixing Japan's progress and IMF rescues of countries in crisis, the world looks less bleak.

HSBC Holding, although crimped by Asian bad-debt provisions of Pound 617 mn. relating mainly to Asian exposure has spread its interest wide enough to buck the Asian effect—its Midland Bank unit in Britain increased profits by 28%.

The second fear is that recession in emerging countries would spread to America and Europe. For hanks, that would mean a fall in lending and an increase in problem loans. However even in a recession banks might not do too badly since their lending has generally not been marked by the same excesses - such as over- lending to property companies as in the giddy days of the late 1980s.

The third fear is commercial banks' rush into investment banking and risk-taking. Investment banking is less profitable than it was. New deals and trading in share and bond markets have shriveled. But that again means merely smaller profits for the banks that have gone into investment banking. More worrying, is the amount that bank? have lost in risk taking. Trading in derivative is one such area. Look at the following Figures:

Bank's trading Losses	less	Loss $ bn	Reason
Barings	Feb. 1995	1.40	Derivatives
Daiwa Bank	Oct. 1995	.1.10	Bond trading
Kidder Peabody	Apr. 1994	0.35	Bond trading
Salomon	1995	0.28	Account errors
Chase	Oct. 1997	0.16	Bond trading
Natwest	Mar. 1997	0.12	Mispricing
Salomon	Aug. 1997	0.10	Share Trading
UBS	1997	1.2	Derivatives trading And hedge fund
Bank America	1997	0.53	Trading loss

Set against all these worries is the fact that banks are far-better capiialised than they were at the beginning of the 1990s, due to the Basle Capital Accord of 1988 (an accord among the. Group of Ten industrial counuies and Luxembourg which established a framework for the measurement of bank capital internationally and set a standard for minimum capital adequancy requiring banks to hold minimum capital cushion equivalent to 8 percent of their balance sheet with half of that capital held in the form of shareholders' equity and with a limited amount of adjustment to take amount of the varying riskiness of different assets on the balance sheet). It has had the salutary effect of increasing the overall amount of capital in the international banking system. The overall amount of capital held in the banking system is $ 830.5 bn. for the world's 100 largest bank according to Fitch IBCA, the credit rating agency. The average American bank has 30-40% more capital than it did at the start of the decade. And this is echoed with some exceptions (French banks for example) in Europe.

For commercial banks there are opportunities in the recent turmoil. Banks hold large quantities of government bonds and the flight to quality has increased the worth of these. The flight to cash has meant that investors have put money into big banks, giving them cheap financing. Brisk demand has meant that for the first time in years, banks are charging more for their loans. It may not be such a bad time for banks,

1.9 PROSPECTS

Financial institutions are under increasing and accelerated pressure to strategically reposition themselves in a marketplace where the competitive landscape.is being redefined almost overnight. Banks will be forced to identify new ways to increase efficiency, enter into developing markets, provide new products, shed unprofitable operations and capitalise on new opportunities presented especially by the euro. Promoting innovation by peering

into the gloom ahead rather than behind through the rear-view mirror has become a top priority for the smartest banks. It is a continuous track race, which contestants join, win a few laps/fall behind, recover or quit success will belong to those that produce a "trajectory" of improvements and predicting a "corridor" or characteristics that users would demand. "The market is an experimental discovery process".

1.10. SUMMARY

International Banking is a very old business but since 1973 it has acquired new characteristics and dimensions. The number of participants, which at the beginning of the period were mainly American banks, has considerably widened to include German, UK, Japanese, French and Italian Banks operating directly or lhrough foreign branches and subsidiaries. The foreign component of total assets of the big international banks has grown at a rate considerably above the average so that many major banks have now more international loans outstanding than domestic ones. Nearly three quarters of the deficit of LDCs have probably been financed by commercial banks. The amount of individual loans has risen considerably thus increasing the risk. There has also been a lengthening of maturities.

Aliber defines "International banking" as a subset. of commercial banking transactions and activity having a cross-border and/or cross currency element Multinational banking refers to the location and ownership of banking facilities in a large number of countries and geographic regions.

Reasons for growth of international banking can be summarised as: i) Financial activity following real-sector transactions, ii) Financial activity leading real-sector transactions, and iii) Regulatory, tax and supervisory explanation.

International banks are linked together in various formal and informal ways from simply holding account with each other correspondent accounts — to common ownership. Profitability of International Banking has gone through four distinct phases.

Activity 1

1. List out the important characteristics of International banking.

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2. Identify the reasons for the growth of International banking.

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1 KEY WORDS

International Banking: International Banking refers to the cross-currency facets of banking business.

Multinational Banking: The term "multinational banking" refers to the location and ownership of banking facilities in a large number of countries and geographic regions.

Correspondent Banking: An informal linkage between banks in different countries set up when banks maintain correspondent accounts with each other.

Agency: Is like a full **fledged,** bank in every respect except that it does not handle ordinary retail deposits.

Consortium banks: Joint ventures of the large commercial banks.

Global Custodians: They take possessions of foreign securities for safekeeping, collect dividends, or offer up coupons and handle stock, right issues, tax reclamation and so on.

1.12 SELF ASSESSMENT QUESTIONS

1. What is international and multinational banking? Define its conceptual framework?
2. What are the different forms of international banking?
3. What are the features relating to organisational structure of multinational banking?
4. What are the factors leading to the growth of international banking?