THE INTERNATIONAL BANKING SYSTEM

Capital Adequacy, Core Businesses & Risk Management

FELIX LESSAMBO

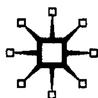
The International Banking System

The International Banking System

Capital Adequacy, Core Businesses and Risk Management

Felix Lessambo
St John's University USA

palgrave
macmillan



© Felix Lessambo 2013

All rights reserved. No reproduction, copy or transmission of this publication may be made without written permission.

No portion of this publication may be reproduced, copied or transmitted save with written permission or in accordance with the provisions of the Copyright, Designs and Patents Act 1988, or under the terms of any licence permitting limited copying issued by the Copyright Licensing Agency, Saffron House, 6–10 Kirby Street, London EC1N 8TS.

Any person who does any unauthorized act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

The author has asserted his right to be identified as the author of this work in accordance with the Copyright, Designs and Patents Act 1988.

First published 2013 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN 978–1–137–27512–7

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

10 9 8 7 6 5 4 3 2 1
22 21 20 19 18 17 16 15 14 13

Contents

List of Tables xv

List of Figures xvii

Acknowledgements xix

Disclaimer xx

Abbreviations xxi

Cited Cases xxiv

Preface xxv

Part I Regulators

1 The US Federal Reserve Bank 3
1.1 Introduction 3
1.2 The Organizational Structure of the Federal Reserve 5
1.2.1 The Board of Governors 5
1.2.2 The Federal Open Market Committee 6
1.2.3 The Federal Reserve Banks 7
1.3 Role and Functions of the Federal Reserve 8
1.4 The Federal Reserve's Policies and Processes 9
1.5 Activities and Responsibilities of the Federal Reserve 11
1.5.1 Monetary Commission 14
1.5.2 Policy Operations 14
1.5.3 Congressional Oversight of Monetary Policy 15
1.5.4 Open Market Operations 15
1.6 Independence of the Federal Reserve 16
1.7 Reforming the Federal Reserve 17
1.8 Conclusion 18

2 The European Central Bank System 19
2.1 Introduction 19
2.2 Organization of the European Central Bank 21
2.2.1 The Executive Board 21
2.2.2 The Governing Council 22
2.2.3 The General Council 22
2.3 Objectives of the European Central Bank 23
2.3.1 The European Central Bank and Price Stability 23

2.3.2 The European Central Bank and Financial Stability 24
2.4 Implementation of Monetary Policy 24
2.4.1 Open Market Operations 24
2.4.2 The Inadequate Implementation of Policy 26
2.5 Monetary Growth and Inflation 28
2.6 Independence of the European Central Bank 29
2.7 Comparing the Fed and the European Central Bank 29

3 The Central Bank of Japan 31
3.1 Introduction 31
3.2 The Organizational Structure of the Bank of Japan 32
3.2.1 The Bank of Japan Policy Board 32
3.2.2 The Officers of the Bank of Japan 33
3.3 Core Functions of the Bank of Japan 33
3.4 The Monetary Policy of the Bank of Japan 33
3.5 Implementation of the Monetary Policy 34
3.5.1 Money Market Operations 34
3.5.2 Foreign Exchange Interventions 35
3.6 The Independence of the Bank of Japan 36
3.7 Reforming the Bank of Japan 36

4 The Bank of England 37
4.1 Introduction 37
4.2 The Organizational Structure of the Bank of England 37
4.3 The Monetary Policy Committee 37
4.4 The Core Functions of the Bank of England 39
4.5 The Bank of England Monetary Policy Framework 39
4.6 Implementation of the Monetary Policy 40
4.6.1 Reserve Averaging 40
4.6.2 Operational Standing Facilities 40
4.6.3 Quantitative Easing 41
4.6.4 Discount Window Facilities 41
4.6.5 The Extended Collateral Term Repo Facility 42
4.6.6 Operational Contingencies 42
4.7 The Independence of the Bank of England 42
4.8 Reforming the Bank of England 43

5 The People's Bank of China 44
5.1 Introduction 44
5.2 The Status of the People's Bank of China 45
5.3 The Organizational Structure of the People's Bank of China 46
5.4 The Monetary Policy of the People's Bank of China 46
5.4.1 Interest Rates 47

5.4.2 The Reserve Requirement 47
5.4.3 Open-market Operations 47
5.4.4 Foreign Exchange Rates 48
5.4.5 The Administrative Monetary Policy 49
5.5 The Independence of the People's Bank of China 49

6 The Reserve Bank of India 51
6.1 Introduction 51
6.2 The Organizational Structure of the Reserve Bank of India 51
6.2.1 Management 51
6.2.2 Structure 53
6.3 Core Functions of the Reserve Bank of India 53
6.3.1 The RBI as Monetary Authority 53
6.3.2 The RBI as Issuer of Currency 54
6.3.3 The RBI as Banker and Debt Manager of the Government 54
6.3.4 The RBI as Banker to Banks 54
6.3.5 The RBI as Regulator of the Banking System 55
6.3.6 The RBI as Foreign Exchange Manager 55
6.3.7 The RBI as Regulator and Supervisor of Payment and Settlement Systems 55
6.3.8 The RBI's Developmental Role 55
6.4 The Reserve Bank of India's Monetary Policy Framework 55
6.4.1 Monetary Policy Instruments 56
6.4.2 Foreign Exchange Intervention 56

7 The Central Bank of Russia 57
7.1 Introduction 57
7.2 The Organizational Structure of the Central Bank of Russia 57
7.3 Key Functions of the Central Bank of Russia 59
7.4 The Monetary Policy of the Central Bank of Russia 59
7.5 Implementation of the Monetary Policy 60
7.5.1 Liquidity Absorption 60
7.5.2 Liquidity Supply 61
7.6 The Independence of the Central Bank of Russia 61
7.7 Towards a Modern Central Bank of Russia 62

8 The Central Bank of Brazil 63
8.1 Introduction 63
8.2 The Organizational Structure of the Central Bank of Brazil 63
8.3 The Core Functions of the Central Bank of Brazil 65
8.4 The Monetary Policy of the Central Bank of Brazil 65
8.5 Implementation of the Monetary Policy 67

8.5.1 Interest Rates on Overnight Inter-bank Loans 67
8.5.2 Reserve Requirements 67
8.5.3 Market Operations 67
8.6 The Independence of the Central Bank of Brazil 67
8.7 Reforming the Central Bank of Brazil 68

9 The Saudi Arabia Monetary Agency 69
9.1 Introduction 69
9.2 The Organizational Structure of the Saudi Arabia Monetary Agency 69
9.3 The Core Functions of the Saudi Arabia Monetary Agency 70
9.4 The Monetary Policy of the Saudi Arabia Monetary Agency 70
9.5 Implementing the Saudi Arabia Monetary Agency's Monetary Policy 72
9.5.1 Minimum Reserve Requirements 72
9.5.2 Open Market Operations 72
9.5.3 Foreign Exchange Swaps 72
9.6 The Independence of the Saudi Arabia Monetary Agency 73

10 The Bank for International Settlements 74
10.1 Introduction 74
10.2 Organizational Structure of the Bank for International Settlements 75
10.2.1 The Governors 75
10.2.2 The Board of Directors 75
10.2.3 The Bank Management 75
10.3 The Functions of the Bank for International Settlements 76
10.3.1 Central Bank Functions 76
10.3.2 Investment Advisory Services 76
10.3.3 Gold Keeping Services 76
10.3.4 Insurance Supervisor 76
10.4 The Bank for International Settlements' Monetary and Banking Policies 79
10.5 Conclusion 79

Part II Capital Adequacy and Main Operations

Overview of Part II 82

11 Internationalization of Banking Business 84
11.1 Introduction 84
11.2 Representative Officers versus Correspondent Banks 84

11.2.1 Correspondent Banks 84
11.2.2 Representative Officers 85
11.3 Subsidiaries versus Branches or Joint Ventures 85
11.3.1 The Subsidiary 85
11.3.2 The Branch 85
11.3.3 Joint Ventures 85
11.3.4 Tax Considerations 86
11.4 The Edge Act Banks 86
11.4.1 The Edge Act and its ad hoc Federal Jurisdiction 86
11.5 Offshore Banking Centers 87
11.5.1 Weight of Offshore Banking Centers 88
11.5.2 Efforts to Crack Down on Offshore Banking Centers 88
11.5.3 Pitfalls for Investors using Offshore Banking Centers 89
11.6 International Banking Facilities 89
11.6.1 Activities of International Banking Facilities 89
11.7 Bank Holding Companies 90
11.7.1 Recent Changes under the Volcker Rule 90

12 Capital Adequacy: The Basels 95
12.1 Introduction 95
12.2 The Core Principles 95
12.3 The Basel I Accord 96
12.4 The Basel II Accord 99
12.4.1 Minimum Capital Requirement 99
12.4.2 Supervisory Review Process 104
12.4.3 Effective Use of Market Discipline 104
12.5 The Basel III Accord 105
12.6 Criticism of the System 107

13 Banking and Foreign Exchange Transactions 108
13.1 Introduction 108
13.2 Foreign Exchange Markets 111
13.2.1 The Spot FX Market 111
13.2.2 The Forward FX Market 112
13.2.3 The Swaps FX Market 112
13.2.4 The Futures FX Market 112
13.3 Foreign Exchange Market Participants 113
13.3.1 Commercial and Investment Banks 113
13.3.2 Multinationals and Big Corporations 113
13.3.3 Brokers 113

13.3.4 Non-commercial Banks 114
13.3.5 Central Banks 114
13.4 Strategies of Forex Hedge Funds 114
13.4.1 Macro 114
13.4.2 Carry Trade 115
13.4.3 Momentum 116
13.4.4 Volatility 118
13.5 Modern FX Trading 118
13.6 Foreign Exchange Risk 119
13.7 Measuring Foreign Exchange Risk 119
13.7.1 Hedging 119
13.7.2 Foreign Exchange Gap Analysis 120
13.7.3 Foreign Exchange Rate Duration Analysis 120
13.7.4 Foreign Exchange Rate Simulation Analysis 120
13.7.5 Foreign Exchange Rate Volatility Analysis 120
13.8 Taxation of Foreign Exchange Transactions 121
13.8.1 Taxation of Spot Forex 121
13.8.2 Taxation of Forward Forex 122
13.8.3 Taxation of Futures Forex 122
13.8.4 Taxation of Options Forex 123

14 Banking and Derivatives Transactions 125
14.1 Introduction 125
14.2 Forward Contracts 127
14.3 Futures Contracts 127
14.4 Options Contracts 128
14.4.1 Stock Options 129
14.4.2 Stock Index Options 129
14.4.3 Options on Futures Contracts 130
14.4.4 Exotic Options 130
14.5 Swaps 131
14.5.1 Interest Rate Swaps 132
14.5.2 Currency Swaps 132
14.5.3 Credit Swaps 133
14.5.4 Commodity Swaps 135
14.5.5 Equity Swaps 135

15 Banking and Underwriting Transactions 137
15.1 Introduction 137
15.2 Role and Functions of an Underwriter 138
15.2.1 Participants in the Transactions 139
15.2.2 The Underwriter's Compensation 140
15.2.3 Quick Underwriting under Alleviated Securities Laws Regulation 140

15.3 International Equity Markets 140
15.3.1 Depositary Agreement 142
15.3.2 Structure of ADRs 143
15.3.3 Benefits and Weaknesses of ADRs 144
15.3.4 Taxation Regime 145
15.4 International Bond and Debt Markets 145
15.4.1 Market Participants 145
15.4.2 Bond and Debt Underwriting 148
15.5 Asset Securitization 153
15.5.1 Securitization Participants 154
15.5.2 Securitization Structure 154
15.5.3 The Wall Street Reform and Consumer Protection Act, 2010 156
15.5.4 Advantages of Securitization 158

16 Mortgage Markets 159
16.1 Introduction 159
16.2 The Mortgage Primary Market 159
16.2.1 Types of Mortgages 160
16.3 Mortgage Amortization Schedule 164
16.4 Mortgage Secondary Market 165
16.5 Mortgage Markets' Risk Management 166
16.6 Reforming the Mortgage Market 167
16.7 New Opportunities for Private Investors 167

17 Mergers and Acquisitions Advisory Services 168
17.1 Introduction 168
17.2 Mergers and Acquisitions in Perspective 168
17.3 Supporting M&A Advisory Services 168
17.4 Valuation of the Target 170
17.4.1 Book Value 170
17.4.2 Liquidation Value 170
17.4.3 Discounted Future Cash Flows 170
17.4.4 Comparable Multiples 171
17.5 Advisor on M&A Deals' Protection 171
17.5.1 Classic Defensive Tactics 172
17.5.2 Poison Pills as a Defensive Tactic 173
17.6 Mergers and Acquisitions Structuring 174
17.6.1 Statutory Mergers 175
17.6.2 Consolidation 175
17.6.3 Regular Triangular 175
17.6.4 Reverse Triangular 175
17.7 Different Types of Mergers and Acquisitions 177
17.7.1 Tax-free Mergers and Acquisitions 177

17.7.2 Taxable Mergers and Acquisitions 182
17.7.3 Tax-free Advisory Considerations 183
17.8 International Tax-free Reorganization 185

18 Private Equity Business and Miscellaneous Services 187
18.1 Introduction 187
18.2 Venture Capital vs Buy-out 187
18.3 Structuring a Private Equity Deal 189
18.3.1 The Legal Form of the Fund 189
18.3.2 The Status of the Fund's Investors 190
18.3.3 Structuring a Buy-Out Deal 190
18.4 Financing Structure 194
18.5 Exit Strategy 194
18.5.1 Distribution of Earnings 194
18.5.2 Partial Sale of Portfolio Operations 194
18.5.3 Complete Liquidation of the Acquisition Vehicle 195
18.6 Miscellaneous Services 195
18.6.1 Trust Services 195
18.6.2 Processing Services 196
18.6.3 Wealth Management Services 196

Part III Risk Management

Overview of Part III 200

19 Analyzing Financial Statements 202
19.1 Introduction 202
19.2 JP Morgan Chase Balance Sheet 202
19.3 JP Morgan Chase Statement of Income 202
19.4 JP Morgan Chase Statement of Cash Flow 209
19.5 Analysis of the Statements 209
19.5.1 Overview of the Industry 209
19.5.2 Analysis of JP Morgan Chase Balance Sheets 212
19.5.3 Analysis of JP Morgan Chase Statement of Income 214
19.5.4 Analysis of the Cash Flows 219
19.5.5 Relevancy of the Notes 220
19.6 Conclusion 221

20 Corporate Governance, Risk Metrics, Liquidity, and Credit Risk 222
20.1 Introduction 222
20.2 Corporate Governance 222
20.2.1 Bank Board Fiduciary Duties 224
20.2.2 Duty to be Informed 224
20.2.3 Duty of Care 224

20.2.4 Duty of Loyalty 225
20.3 The BIS Corporate Governance Principles 225
20.3.1 Bank Boards' Lack of Financial Skills 225
20.3.2 Lack of Skills 225
20.3.3 Lack of Adequate Training 227
20.3.4 Bank Boards and Gatekeepers' Conflicts of Interest 227
20.3.5 Reforming the Corporate Governance Structure 228
20.4 Risk Metrics 228
20.4.1 Categories of Risk 229
20.4.2 Techniques to Manage Risk 231
20.5 Liquidity Risk 235
20.5.1 The Concept of Liquidity Management 236
20.5.2 Sources of Bank Liquidity 236
20.5.3 Components of Liquidity Risk 239
20.5.4 Approaches to Liquidity Risk Management 239
20.5.5 Measurement of Liquidity: Ratios 241
20.6 Credit Risk 242
20.6.1 Credit Risk Processing 242
20.6.2 Credit Risk Management 244

21 Conclusion 246

Appendices 247

Appendix 1: Four Federal Reserve Tabs 248

Appendix 2: Open Letter from the Monetary Policy Committee to the Chancellor of the Exchequer, UK Government 254

Appendix 3: Credit Ratings and their Interpretations 257

Appendix 4: Sample of Letter of Comfort 259

Appendix 5: Sample of Bank Capability Letter (BCL) 263

Appendix 6: Sample of Engagement Letter 264

Appendix 7: Sample of a Binding Letter of Intent 270

Appendix 8: Sample of Merger Agreement 272

Appendix 9: Sample of Due Diligence Checklist 275

Appendix 10: Sample of Term Sheet 283

Appendix 11: Sample of Capital Call Notice 289

Appendix 12: Sample of Certificate of Ownership 290

Appendix 13: Form 41-103F1 – Securitized Products Prospectus 291

Appendix 14: Financial Ratios 304

Appendix 15: Sample Business Plan Outline (Start-up) 307

Appendix 16: Selected IRC Sections (M&A) 312

Appendix 17: Report of the New York Stock Exchange Commission on Corporate Governance, September 23, 2010 321

Bibliography 326

Glossary of Terms 327

Notes 336

Reader's Notes 345

Index 346

List of Tables

2.1	Member states of the ECB that adopted the euro	20
10.1	BIS (reporting banks): Summary of International positions	77
10.2	BIS: Gold safekeeping services (as of 31 March 2010)	79
11.1	The top 50 bank holding companies (as of December 2009)	91
12.1	The Basel Core Principles	97
12.2	Example of risk-weighted capital requirements	98
12.3	JP Morgan Chase risk-based capital components	100
12.4	Beta factors under the standardized approach	101
12.5	The implementation schedule for Basel III	106
12.6	Basel III implementation in a nutshell	107
13.1	Top currency traders in 2007	114
15.1	Values of the world stock and bond markets, 2010	141
15.2	Ownership of privately-held US Treasury debt	147
15.3	State budget deficits	149
15.4	US states with AAA and AA+ ratings	150
15.5	State spending	151
16.1	US vs EU mortgage markets	161
16.2	Example of mortgage amortization	165
17.1	Global M&A volume ranking, 2010	169
17.2	Global M&A volume by industry	169
18.1	The ten largest private equity firms, 2010	188
18.2	Venture investment by stage, 2010	189
18.3	Venture investment by industry, 2010	189
18.4	Types of private equity deal	192
18.5	Top private equity company takeovers	193
19.1	JP Morgan Chase detailed balance sheet	203
19.2	JP Morgan Chase snapshot balance sheet	205
19.3	JP Morgan Chase off-balance sheet statement	206
19.4	JP Morgan Chase statement of income	208

19.5 JP Morgan Chase income by activity 209
19.6 JP Morgan Chase statement of cash flow 210
19.7 JP Morgan Chase balance sheet assets analysis 213
19.8 JP Morgan Chase liabilities analysis 215
19.9 JP Morgan Chase capital components 216
19.10 JP Morgan Chase lines of business 217
20.1 The eight principles of corporate governance 226
A1 Changes in balance sheet items, all US banks, 1999–2008 248
A2 Changes in notional value and fair value of derivatives, all US banks, 2003–2008 250
A3 Exposure of US banks to selected economies at year end relative to Tier 1 capital 251
A4 Report of income, all US banks, 1999–2008 252

List of Figures

1.1	The 12 US Federal Reserve districts	7
2.1	EU member states within the Eurozone	22
3.1	Structure of the Board of the Bank of Japan	33
4.1	The Bank of England divisional structure	38
4.2	Discount window facility structure	41
6.1	The structure of the Reserve Bank of India	52
7.1	The structure of the Central Bank of Russia	58
8.1	The structure of the Central Bank of Brazil	64
8.2	The Board of the Central Bank of Brazil	65
9.1	Structure of the Saudi Arabia Monetary Agency	71
13.1	Geographical distribution of FX market turnover, 2011	109
13.2	FX market turnover by instrument, 2011	110
13.3	FX average daily turnover	111
13.4	FX market participants	115
13.5	The FX market turnover by currency	117
14.1	Basic currency swap	133
14.2	CDS clearing	134
14.3	Basic swap structure	136
15.1	Top ten global underwriters, 2011	142
15.2	ADR scheme	143
15.3	ADR structures	143
15.4	Level of US Treasuries outstanding	146
15.5	Holders of US debt	147
15.6	Securitization	155
16.1	The prime and sub-prime mortgage models	160
16.2	The FHA securitization structure	166
17.1	The statutory merger	175
17.2	Consolidation	176
17.3	Triangular merger	176

17.4 Reverse triangular merger 177
18.1 Structure of a fund 190
18.2 Structure A: US investors 191
18.3 Structure B: A mix of US and non-US investors 191
19.1 JP Morgan Chase lines of business 218
19.2 JP Morgan Chase net revenue by line of business 218
19.3 JP Morgan Chase public sector activities 219
20.1 Risks per category 229
20.2 Standard Repo 238

Acknowledgements

Writing a book is always a challenge, but writing a book on the international banking system is a particularly daring intellectual exercise, especially in the area of international finance, international economics, and risk management, where rules and regulations have been barely implemented and with secretive central banks around the globe involved in obscure practices.

I would like to thank Professors W. Jean Kwon (Chairperson of the School of Risk Management, Insurance & Actuarial Science, St. John's University, New York) and Nicos A. Scordis (The Peter J. Tobin College of Business – School of Risk Management) for their cogent advice and friendly support throughout this project. I also extend my gratitude to Ismael Rivera-Sierra (the Director of the Kathryn & Shelby Cullom-Davis Library) who provided technical support. In addition, I thank all my students at St. John's University who inspired me through their challenging questions in search of sound, precise, and comprehensive answers.

Several good friends provided me with needed guidance and materials to complete this book, while others took valuable time to review, comb through the manuscripts, and support me in their thoughts and prayers (Pastor Roland Dalo, Aline Kabongo).

Last but not least, I am grateful to various organizations, including BIS and a number of US government agencies, including the Securities and Exchange Commission, for supplying the precious data used to illustrate my analyses.

Disclaimer

While the author has made every effort to ensure that the information in this book is correct at the time of publication, he does not assume and hereby disclaims any liability to any party for any loss, damage, or disruption caused by errors or omissions, whether such errors or omissions result from negligence, accident, or any other cause.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold on the understanding that the publisher is not engaged in rendering professional services. If professional advice or other expert assistance is required, the services of a competent professional should be sought.

Abbreviations

ADR	American Depository Receipt
ABS	asset-backed security
AIRB	advanced internal ratings-based approach
A/R	acid ratio
ARDC	American Research and Development Corporation
BHC	bank holding company
BIS	Bank for International Settlements
BoE	Bank of England
BoJ	Bank of Japan
BS	balance sheet
CAMELS	capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk
CBB	Central Bank of Brazil
CBR	Central Bank of Russia
CCS	Credit Card Services
CD	certificate of deposit
CDO	collateralized debt obligation
CFC	controlled foreign corporation
CPEC	convertible preferred equity certificate
CPI	Consumer Protection Index
CPM	comparable multiple method
CRR	cash reserve ratio
CVaR	conditional value-at-risk
DR	depository receipt program
EAD	exposure-at-default
ECB	European Central Bank
EL	expected loss
EMU	Economic Monetary Union
EPS	earnings per share

EU	European Union
ESCB	European System of Central Banks
Fed	Federal Reserve
FHA	Federal Housing Administration
FHC	financial holding company
FIDIC	Federal Deposit Insurance Corporation
FPHC	foreign personal holding company
FX	foreign exchange
GAAP	generally accepted accounting principle
GDP	gross domestic product
GO	general obligation (bonds)
GSE	government sponsored enterprise
HELOC	home equity line of credit
HUD	Department of Housing and Urban Development
IBF	international banking facility
IRA	individual retirement account
IRB	internal ratings-based approach
IRC	Internal Revenue Code
LAF	liquidity adjustment facility
LAVaR	liquidity-adjusted value-at-risk
LCR	liquidity coverage ratio
LGD	loss given default
LLC	limited liability company
LLP	limited liability partnership
M&A	mergers and acquisitions
MBS	mortgage-backed security
MPC	Monetary Policy Committee
MSS	Market Stabilization Scheme
NGO	non-general obligation (bonds)
NOL	net operating loss
NRSO	nationally recognized statistical rating organization
NSFR	net stable funding ratio
OBC	offshore banking center

OECD	Organization for Economic Development and Cooperation
OMO	open market operation
PBoC	People's Bank of China
PCAOB	Public Company Accounting Oversight Board
PD	probability of default
P/E	price-earnings ratio
PLS	private label securities
QSPV	qualified special purchase vehicle
RAROC	risk-adjusted return on capital
Repo	repurchase agreement
RBI	Reserve Bank of India
RFS	retail financial services
SA	Standarized approach
SAM	share appreciation mortgage
SAMA	Saudi Arabia Monetary Agency
SEC	Securities and Exchange Commission
SLR	statutory liquidity ratio
SPE	special purpose entity
SPV	special purpose vehicle
STRIPS	Separate Trading of Registered Interest and Principal Securities
TAAPS	Treasury Automated Auction Processing System
TIPS	Treasury inflation-protected securities
UFIRS	Uniform Financial Institutions Rating System
UK	United Kingdom
US	United States of America
VaR	value-at-risk

Cited Cases

1. Air Products and Chemicals, Inc., v. Airgas, Inc. (Del. Ch., C.A. NO. 5249-CC, 2/15/2011).
2. Francis v. New Jersey Bank, 432 A.2d 814 (NJ 1981)
3. Helvering v. Minnesota Tea Co., US 378 (1935)
4. Hort v. Commissioner of Internal Revenue, US S.Ct. 313 US 28 (1941)
5. Illinois Tool Works & Subs. v. Commissioner, 117 T.C., NO. 4, July 31, 2001
6. In Re Walt Disney Co. Derivative Litigation, Del. Ch.2003
7. Libson Shops, Inc. v. Koehler, S.Ct. 353 US 382 (1957)
8. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989)
9. Moran v. Household International , Inc., 500 A.2d 1346 (Del. 1985)
10. New Colonial Ice Co. v. Helvering, S.Ct. 292 US 435 (1934)
11. Omnicare v. NCS Healthcare Inc., 818 A.2d 914 (Del. 2003)
12. Paramount Communications, Inc. v. QVC Network, Inc. 637 A.2d 34 (Del. 1994)
13. Phelps Dodge v. Cyprus Amax Minerals Co.,CA NO. 17398 (Del. Ch. Ct. 27 September, 1999)
14. Revlon, Inc v. MacAndrews & Forbes Holding, Inc. 506 A.2d 173 (Del. 1985)
15. Roosvelt Hotel Co., v. Commissioner, T.C. 399 (1949)
16. Smith v. Van Gorkhom, 448 A.2d 858 (Del. Supr. 1985)
17. Unocal Corp. v. Mesa Petroleum Co. 493 A.2d 946 (Del. 1985)

Preface

Financial markets have become global, and are closely interrelated. Among the big players are commercial and investment banks. They perform core banking functions and underpin the main economy. They also provide efficient payment mechanisms, facilitating transactions and extending loans to those in need of liquidity, providing value in our economies as liquidity intermediaries. The landscape of the international banking system is rapidly changing, with the world's top three banks from China, and America's largest bank down to the fifth position.[1]

The first banking activities can be traced back to around 2000 BCE, in Assyria and Babylonia. Modern banking activities date back to Medieval and early Renaissance Italy, while the development of the banking industry we recognize today started in the 19th century, when banks evolved into large commercial entities extending loans to the general public. The internationalization of business in the 20th century facilitated the emergence of universal banking activities.

The demarcation line between commercial and investment banking has become blurred in recent decades. In the United States, for example, prior to the repeal of the Glass–Steagall Act on November 12, 1999, commercial and investment banks operated in two distinct arenas. Commercial banks focused on regular individual and business activities. They collected deposits from their clients and extended loans to businesses, both new and old, to start or develop an ongoing undertaking. Investment banks, meanwhile, assisted businesses in the raising of capital. The repeal of Glass–Steagall allowed commercial banks to engage in core activities formerly restricted to investment banks and vice versa. In so doing, the Gramm–Leach–Bliley Act, also known as the Financial Services Modernization Act, created a sharp conflict of interest among commercial banks and investment banks. It altered the culture of the US banks without putting in place a clear mechanism of control to secure, or at least monitor, the overall banking system. Through mergers and acquisitions or internal restructuring, US banks were allowed to operate as both commercial and investment banks. Juggernaut banking institutions, later referred to as too big to fail, escaped almost completely from being under sound supervision. The premises upon which Gramm–Leach–Bliley relied were revealed to be illusory. The fate of the international banking system is linked to the fate of the overall financial system.

The collapse of the Bretton Woods era was followed by unfettered deregulation among various banking authorities. The phenomenon and philosophy

would be accentuated in the 1990s under US Federal Reserve Chairman Alan Greenspan, who was a proponent of market fundamentalism.[2]

Non-banking institutions such as insurance companies were allowed to engage in banking operations. US banks thus become supermarket banks offering, under the same umbrella, retail and wholesale banking, investment banking and various intermediary financial institutions. Several regulatory authorities across the world followed the American path of deregulation, at the expense of their core economies. Five years after the onset of the financial crisis in 2007, the six largest American financial institutions are significantly bigger than they were before the crisis.[3] Supervising, or at least controlling, their activities has become a challenge. In the US, banks are under the supervision of at least four institutions: the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the State Bank Regulators. It was the Federal Reserve that failed to detect the 2007 crash, which would lead to the rescue of the well-known "too-big-to-fail" banking institutions despite the claimed rules of the free market.

We need to ask whether the financial crisis of 2007–2009 redrew the picture of the international banking system. Many US and European Union juggernaut banks have opened their capital structures to funds from Asian sovereign funds, but they still operate under the old corporate governance structures that led to the crisis. As the world financial center of gravity has shifted eastward, major international banks are rushing to the booming Asian markets – Hong Kong, Shanghai, Singapore – to stay financially afloat. Would they commit themselves to observing laws and regulations in their new territories? The international banking system is shaped by the laws and regulations of the main financial players, including the US Federal Reserve, the European Union Central Bank, The Central Bank of Japan, the Bank of England, the People's Bank of China, the Reserve Bank of India, the Central Bank of Russia, the Central Bank of Brazil, the Saudi Arabia Monetary Authority, and the Bank for International Settlements. The regulatory efforts shaped by the Bank for International Settlement – Basel I, II, and III – if properly followed could stabilize the international banking system. Compliance with these laws and regulations is vital to all players around the world.

This book is organized into three parts. Part I analyzes the role played by the main financial players already listed. It highlights the different monetary policies pursued and their effects on the banks' business. Part II investigates capital adequacy and the main banking operations. Bank capital is a proxy, especially in the securities marketplace, for public confidence in the banking system or any specific bank. The inadequacy of capital coupled with, in some cases, managerial fraud, has created a risky situation in the international banking system, especially where domestic banking supervision is weak.[4] Part III focuses on risk management, which has become a heated topic generally,

but has particular application to banking as a result of the internationalization of the system. As the trend continues, risk management becomes a core business in the banking field.

Notes

1. Joseph Stiglitz (2010) *Free Fall, America Free Markets, and the Sinking of the World Economy*, W. W. Norton & Company, p. 224.
2. Otto Hieronymi (2009) *Globalization and the Reform of the International Banking and Monetary System*, Palgrave Macmillan, p. 18.
3. Their assets are worth over 66% of the United States' GDP (US$94 trillion), 20% up from the GDP in the 1990s.
4. James C. Baker (2002) *The Bank for International Settlements*, Quorum Books, pp. 44–45.

Part I
Regulators

1
The US Federal Reserve Bank

1.1 Introduction

The Federal Reserve Bank is the central bank of the United States. It does not conduct commercial banking activities; rather, the Federal Reserve role consists of maintaining stable economic growth. The Federal Reserve originated from the Owen-Glass[1] bill introduced in both houses of Congress and became law in December 1913. From its inception, the Federal Reserve was assigned three key purposes: (a) to provide an elastic supply of currency; (b) to provide a means to discount commercial credits; and (c) to supervise and regulate the nation's banks. Later on, as a result of changes in our modern economy and needs, the Federal Reserve has been assigned to provide full employment as well. The US Federal Reserve System and its Federal Reserve Board is the most powerful central bank in the world.[2]

In order to gain a better understanding of the Federal Bank of the US, it is crucial to shed light on the historical facts that provided the framework for the Bank. The US financial industry went through several crises during the 19th and 20th centuries. Major businesses and banks faced bankruptcy during the economic turmoil. The failure of the nation's banking system to effectively provide funding to troubled depository institutions contributed significantly to the economy's vulnerability to financial panic.[3] In 1907, the economic crisis impelled Congress to establish the National Monetary Commission, which put forth proposals to create an institution that would help prevent and contain financial disruptions of this kind.[4] During this time, payments were disrupted throughout the country because many banks and clearinghouses refused to clear checks drawn on certain other banks, a practice that contributed to the failure of otherwise solvent banks.

After some consideration, Congress finally approved the Federal Reserve Act: to provide for the establishment of Federal Reserve banks; to furnish an elastic currency; to afford means of rediscounting commercial paper; to establish

a more effective supervision of banking in the United States; and for other purposes.[5] President Woodrow Wilson signed the Act into law on December 23, 1913.

The Federal Reserve System is generally regarded as an independent central bank because its decisions do not have to be ratified by the President or anyone else in the executive branch of government. It is, however, subject to supervision by the US Congress. The Federal Reserve must work within the framework of the overall objectives of economic and financial policy established by the government. Almost a century after President Andrew Jackson vetoed the rechartering of the Bank of the United States in 1832, the US government lacked a central mechanism for regulating the money supply to control inflation or deflation and to boost the economy in times of recession and depression. This resulted in conflict arising between creating a powerful private central bank and focusing on giving the job to a government agency. Finally, during the Progressive Era, President Woodrow Wilson proposed, and Congress enacted, the Federal Reserve Act of 1913, which combined private banks with government regulation.[6]

The Federal Reserve was created by Congress "to provide a safe, flexible, and stable monetary and financial system. The agency conducts the nation's monetary policies, supervises and regulates banks, guards the credit rights of consumers, and provides financial services and information to the government, financial institutions, and the general public."[7] This creates a financial system that has become the foundation of the US Federal Reserve System. The Federal Reserve Board has generally responded well to financial crises, although critics charged that the Board's tight-money policies following the stock market crash of 1929 worsened the subsequent depression. The Board's efforts to end double-digit inflation in the late 1970s triggered a severe recession. In the 1990s, the Board under Chairman Alan Greenspan was widely "credited" with keeping inflation down during the longest uninterrupted period of sustained prosperity in the nation's history.[8] Since the 2007–2009 financial crisis unfolded, many have come to express doubts concerning Mr Greenspan's monetary policy. Most economists came to vilify his actions as Chairman of the Board: the lax regulations and loose monetary policy developed under his chairmanship are seen as the direct causes of the current financial bubble.

To some economists, the Federal Reserve failed miserably to forecast the state of the US economy, and when it pretended to have a forecast, the model used was flawed. The Board of the Federal Reserve was not only discredited all around the world, but many expressed serious reservations about the intellectual capabilities of those in charge of our monetary policy. To many, the Federal Reserve is an opaque institution, not accountable to the nation for its actions. Most of the Federal Reserve's actions are and remain discretionary, and its monetary policy a mystery. As well as all these flaws, the Federal Reserve is