PART SEVEN

Managing the Future in a Global Marketplace

Financial institutions not only must be profitable, but they also must grow to better serve their customers. Otherwise, they may face a buyout from competitors and simply disappear. Growth is also an indicator of how well their customer base is being served. Financial firms that grow at a substantial pace tend to have a satisfied base of customers.

However, there are many ways for a financial firm to grow. As we saw in Part One, Chapter 4, a financial-service provider can grow by developing and launching new customer-service facilities in both old and new markets, increasing customer convenience by building new offices, networks of ATMs, call centers, Internet services, and so on. Most financial firms grow and expand this way, particularly early in their history. However, an important alternative for achieving growth in the modern world is through *acquisitions and mergers*.

Prominent examples of the acquisition and merger route to expansion include the recent amalgamation of J. P. Morgan Chase Bank and Bank One and the combination of Bank of America with FleetBoston Financial Group, creating two of the largest banking firms in the United States and around the world with thousands of offices and other service facilities. Inside Asia recently we have seen Dai-Ichi Kangyo, Fuji, and the Industrial Bank of Japan come together in Mizuho Holdings to create one of the world's largest banks. There have been close to 10,000 mergers among banks and thrift institutions in the United States alone in recent decades and scores more in Asia and Europe.

As a result of these combinations most financial-service industries are experiencing massive *consolidation*—fewer but much larger financial-service providers all over the globe. Historically, most of these acquisitions and mergers have involved firms of the *same type* joining with one another. Banks buying banks, insurance companies gobbling up other insurance companies, and security firms going on the hunt to buy other security firms. But this too is rapidly changing as we saw way back in Part One. *Convergence* of different kinds of financial firms, one with another, has been well under way for at least a quarter century. Prominent examples include the recent acquisition of Household Finance, one of the world's leading consumer finance companies, by HSBC of London, one of the largest commercial banks on the planet. At the same time security firms and insurance companies have acquired depository institutions, finance companies, and other financial firms. These consolidations and convergences have been facilitated by more lenient regulations and the rapid economic recovery and growth of the economies of Asia and Europe along with continuing expansion in the Americas.

In theory, financial-service customers may benefit from these mergers and acquisitions because of lower costs from economies of scale and scope and lower risk from diversification. However, there are nagging questions today about the practical, as opposed to the theoretical, benefits of industry consolidations and convergences. We will explore that issue in the first of the chapters in this final part of the text.

Growth of financial firms has also been achieved by breaking out of narrower regional market areas, crossing national boundaries, and entering international markets, sometimes by merger and acquisition and sometimes by setting up completely new facilities in foreign lands. Certainly financial firms can more easily reach around the globe today, establishing electronic communications links with their customers in distant markets or by acquiring financial firms abroad and inheriting an established customer base. International expansion offers numerous potential benefits to financial-service firms, including greater geographic diversification to lower risk and greater capacity to stay abreast of the needs of their customers trading overseas.

Of course, international expansion is not without its challenges—new cultures, new languages, new regulations, and new monetary standards must all be dealt with. In short, expansion into foreign markets solves some problems and gives rise to new problems as we will see in the concluding chapter of the text. We will also explore the *future* of banking and financial services in the concluding sections of the final chapter, getting a glimpse of where financial firms appear to be headed in a rapidly changing, increasingly automated, and increasingly globalized financial-services marketplace.

CHAPTER NINETEEN

Acquisitions and Mergers in Financial-Services Management

Key Topics in This Chapter

- Merger Trends in the United States and Abroad
- Motives for Merger
- Selecting a Suitable Merger Partner
- U.S. and European Merger Rules
- Making a Merger Successful
- Research on Merger Motives and Outcomes

19–1 Introduction

In many nations around the globe a wave of mergers involving both large and small banks, securities firms, insurance companies, and other financial-service providers has been under way for decades. In the United States banking and financial services has consistently ranked in the top five of all industries in the number of merger transactions taking place each year. Since 1980 close to 10,000 mergers among U.S.-insured depository institutions have occurred, dramatically reshaping the financial-services industry and the services it supplies to the public.

These numerous marriages among financial-service institutions reflect the great forces of *consolidation* and *convergence* that have been dramatically reshaping the financial-services industry in the current era, driven by intense competition, the lifting of restrictive government rules (deregulation), and the continuing search for the optimal size financial-services organization that will operate at lowest cost with sufficient geographic and product-line diversification to reduce risk.

Our purpose in this chapter is to more fully understand the merger process among financial firms. We will explore the legal, regulatory, and economic factors that financial-service managers should consider before pursuing a merger or acquisition. We will examine the available research evidence on the benefits and costs of these corporate combinations for both investors and the public.

19–2 Mergers on the Rise

While mergers and acquisitions have swept through the entire financial-services sector in recent years, banking mergers and acquisitions have been the most numerous and widely publicized of these transactions. Many of these mergers sweeping through banking reflect lower legal barriers that previously prohibited or restricted expansion.

For example, in the United States both state and federal laws prohibited or restricted interstate banking in the United States until the 1980s, when new state laws allowing banks and bank holding companies to cross state lines appeared. Then, in 1994, the U.S. Congress passed the Riegle-Neal Interstate Banking Act, which permitted holding companies to reach for bank acquisitions nationwide. These new federal and state laws opened the floodgates to true nationwide banking for the first time in American history.

The merger wave in financial services received yet another legislative boost inside the United States when the Gramm-Leach-Bliley (GLB) Act of 1999 was passed (discussed in more detail in Chapters 2 and 3). The GLB law opened wide the arena for bank–nonbank financial-service combinations. It permits banks, insurance companies, and security firms to acquire each other, increasing opportunities for relatively large financial firms to diversify their product lines and reduce their dependence upon a limited menu of services. However, as Rhoades [17] and Pilloff [10] have observed, while GLB may offer the prospect of reducing U.S. financial firms' risk exposure, it doesn't appear to hold great promise for major improvements in operating efficiency among banks and other financial firms.

A massive merger wave involving leading banks, insurance companies, securities firms, and other service providers also swept through Europe during the 1990s and in the opening years of the 21st century, accompanying the expansion of the European Community (EC). Competition among European financial firms is becoming ever more intense, leading to continuing mergers and acquisitions, particularly in France, Germany, Italy, and Spain. However, financial-service mergers in Europe have slowed from time to time due to a slowing economy and European governments attempting to protect their home banks from acquisition by outsiders.

Factoid
Where do most bank mergers take place in the United States?
Answer: In the southeastern United States (including such states as Alabama, Florida, Georgia, and the Carolinas).

Asia and Japan followed Europe with a growing number of mergers involving mainly banks, insurers, and securities firms. These corporate combinations were being pieced together in an effort to shore up credit quality problems, fend off the ravages of deflation and sluggish economies, and compete with powerful U.S. and European banks expanding across the Asian landscape. Table 19–1 lists other examples of recent international banking and financial-service mergers.

In the United States a similar convergence and consolidation trend has brought banks into common ownership with security and commodity broker-dealer firms, finance companies, insurance agencies and underwriters, credit card companies, thrift institutions, and numerous other nonbank service providers. Prominent examples include Citicorp's 1998 merger with Travelers Insurance, Inc., creating one of the largest financial-service providers in the world (until Citicorp sold off its Travelers units early in the new century); Bank One's

TABLE 19–1
Recent Leading International Financial-Service Mergers and Acquisitions

Acquiring Institution	Acquired Institution	Year
UniCredito Italiano SpA	HVB Group AG, Germany	2005
Banco Santander Central Hispano	Abbey National, U.K.	2004
Mizuho Holdings, Japan	Dai-Ichi Kangyo, Fuji, and Industrial Bank, Japan	2001
HSBC Holdings, U.K.	Credit Commercial de France	2001
Banco Santander, SA, Spain	Banco de Estado, Brazil	2000
Deutsche Bank AG, Germany	Bankers Trust Company, U.S.	1999

Insights and Issues

CONSOLIDATION AND CONVERGENCE IN THE FINANCIAL SERVICES MARKETPLACE

Two of the dominant trends in the banking and financial services sector in recent years have been consolidation and convergence. *Consolidation* refers to a declining population of businesses in any one industry. Banking, security brokering, insurance, and several other financial-service industries have experienced this trend in recent years as they become dominated by fewer, but much larger businesses, largely through mergers and acquisitions. *Convergence,* on the other hand, refers to the movement of two or more industries toward each other, so that different firms wind up offering many of the same services. Convergence also often occurs through mergers and acquisitions as firms reach across industry boundaries to acquire business units with different service menus, though it can also take place through innovation and service diversification within an individual financial firm.

Listed below are some of the largest mergers among financial firms in recent years, some leading to *consolidation* and some to *convergence* of bank and nonbank firms:

Examples of Consolidating Mergers and Acquisitions in Banking

Dai-Ichi Kangyo Bank, Fuji Bank, and Industrial Bank of Japan combined into Mizuho Holdings Inc. in 2001 to form the world's largest bank.

J. P. Morgan Chase & Co. acquired Bank One, Chicago in 2004, creating the second largest U.S. bank

Examples of Converging Mergers and Acquisitions among Bank and Nonbank Firms

Household Finance, a consumer-oriented finance company, was acquired by HSBC of London, one of the world's top five banks, in 2002.

Allianz AG, one of the world's largest insurance companies, acquired Dresdner Bank, one of Germany's largest commercial banks, in 2001.

Key URLs
For information and data about the most recent bank mergers, see SNL Financial at **www.snl.com/bank/manda**. For information on nonbank financial service mergers see **www.snl.com/financial_SVC/manda** and **www.snl.com/insurance**.

acquisition of credit card leader First USA; and Summit Bancorp's purchase of the thrift institution, Collective Bankcorp. Moreover, after passage of the Gramm-Leach-Bliley Act in 1999, nonbank financial-service firms have gobbled up some banks on their own. One example is the acquisition of U.S. Trust Corporation, then the 12th largest commercial banking organization in New York, by security broker/dealer Charles Schwab Corporation of San Francisco. Table 19–2 lists some of the largest financial-firm mergers in U.S. history.

The current merger wave among financial-service industries is unlikely to end soon, and its effects will be long lasting. The public will be confronted in the future with fewer, but larger, financial-service organizations that will pose stronger competition for other financial firms not joining the acquisition and merger trend. In this chapter, we examine the nature, causes, and effects of mergers and acquisitions. We will look at the laws and regulations that shape these corporate combinations and the factors that are important in selecting a merger partner.

TABLE 19–2
Some of the Largest Financial-Service Mergers and Acquisitions in U.S. History

Acquiring Institution	Acquired Institution	Year
J. P. Morgan Chase, New York	Bank One, Chicago	2004
Bank of America, North Carolina	FleetBoston Financial, Mass.	2003
Chase Manhattan Corp, New York	J. P. Morgan & Co., New York	2000
Fleet Financial, Massachusetts	BankBoston Corp, Mass.	1999
Citicorp, New York	Travelers Group, California	1998
NationsBank, North Carolina	Bank of America, California	1998

19–3 The Motives behind the Rapid Growth of Financial-Service Mergers

As Table 19–3 illustrates, mergers usually occur because (1) the stockholders (owners) involved expect to increase their wealth (value per share of stock) or perhaps reduce their risk exposure, thus increasing their welfare; (2) management expects to gain higher salaries and employee benefits, greater job security, or greater prestige from managing a larger firm; or (3) *both* stockholders and management may reap benefits from a merger. There may be other motives as well. Let's take a closer look at some of the most powerful merger motives that appear to have been at work in recent years in the financial-services sector.

Profit Potential

To most authorities in the field the recent upsurge in financial-service mergers—averaging several hundred a year in the United States alone—reflects the expectation of stockholders that **profit potential** will increase once a merger is completed. If the acquiring organization has more aggressive and skillful management than the firm it acquires, revenues and earnings may rise as markets are more fully exploited and new services developed. This is especially true of interstate or international mergers where many new markets are entered, opening up greater revenue potential. Moreover, if the acquiring firm's management is better trained than the management of the acquired institution, the efficiency of the merged

TABLE 19–3 Possible Motives for Mergers and Acquisitions among Financial-Service Firms

- Merger and Acquisition Motives for Financial-Service Firms
  - Maximization of shareholder wealth (increasing market value per share) or utility (welfare) through expected postmerger gains
    - Increased shareholder returns from target firm or from a combination of target firm and acquirer's existing affiliates through enhanced revenues
    - Increased efficiency of target firm or of both target and acquirer's existing affiliates (spreading of fixed costs and managerial skills over a greater volume of production and sales)
    - Reduction of total operating expenses through eliminating duplication of facilities and other productive resources
    - Risk reduction through greater diversification in revenues and costs, sources and uses of funds, or through accessing new sources of long-term capital
    - Increased market power by combining firms, eliminating competition, and gaining pricing or service delivery advantages
    - Avoidance of restrictive or costly regulations in jurisdictions already served by entering new and more liberal market areas
  - Maximization of management's utility (welfare)
    - Increased managerial compensation (salary, benefits, or both)
    - Reduced risk to employment tenure
    - Enhanced managerial reputations in the labor market from managing a larger or more successfully performing firm

organization may increase, resulting in more effective control over operating expenses. Either way—through reduced expenses or expanded revenues—mergers *can* improve profit potential. Other factors held equal, the value of a merging firm's stock may rise, increasing the welfare of its stockholders.

Key URL
For a discussion of merger trends and how they are reshaping the financial-services business, see **www.innercitypress.org/bankbeat.html.**

One of the most dramatic examples of *profit potential* as a merger and acquisitions motive has been happening in China as the 21st century began to unfold. Several of the world's leading banks—for example, Citicorp, Bank of America, and J. P. Morgan Chase from the United States and HSBC Holdings and the Royal Bank of Scotland, both based in the United Kingdom—have been forecasting sharply increased revenues from carving out a portion of China's vast financial-services marketplace. With a population of over a billion, most of whom are "underbanked" but hold estimated savings of more than $1.5 trillion, China seems to offer enormous potential profitability from sales of credit cards, business loans, retirement plans, and insurance services.

Accordingly, the Bank of America invested close to $3 billion in the China Construction Bank in 2005, while HSBC purchased a sizeable share of the China Bank of Communications, the fifth-largest Chinese banking firm, in 2004. During the summer of 2005 the Royal Bank of Scotland, the world's sixth largest bank, announced the acquisition of a significant share of the Bank of China, that nation's second-largest banking firm and top foreign exchange trader. The invasion of China's banking industry by Bank of America is especially noteworthy because that huge U.S. bank has been rapidly approaching its maximum allowable share of the deposit market in the United States (10 percent under the terms of the Riegle-Neal Interstate Banking Act). Bank of America sees China as an alternative avenue for future market expansion and greater profit potential.

Risk Reduction

Alternatively, many merger partners anticipate reduced **cash flow risk** and reduced **earnings risk.** The lower risk may arise because mergers increase the overall size and prestige of an organization, open up new markets with different economic characteristics from markets already served, or make possible the offering of new services whose cash flows are different in timing from cash flows generated by existing services. For example, many European bank mergers in recent years (pursued by such leading banks as ABN AMRO and Verenigte Spaar-Bank) appear to have been motivated by the search for "complementarity" in services. Thus, a wholesale-oriented bank pursues a retail-oriented bank or a bank allies itself with an insurance company in an effort to broaden the menu of services offered the public, thereby reducing risk exposure from relying upon too narrow a lineup of services. Therefore, mergers can help to *diversify* the combined organization's sources of cash flow and earnings, resulting in a more stable financial firm able to withstand fluctuations in economic conditions and in the competitive environment of the industry.

Filmtoid
What 1999 British film concludes with the ING Group of the Netherlands acquiring London's Barings Bank, which has gone "belly-up" due to the risk exposure of Nick Leeson's futures trading operation in Singapore? **Answer:** *Rogue Trader.*

Rescue of Failing Institutions

The failure of a company is often a motive for merger. For example, many bank mergers have been encouraged by the FDIC as a way to conserve scarce federal deposit insurance reserves and avoid an interruption of customer service when a depository institution is about to fail. One of the most prominent examples was the acquisition of First City Bancorporation of Texas in January 1993 by Chemical Bank of New York. In this case a well-managed and capital-strong banking company saw an opportunity to acquire substantial assets (nearly $7 billion) and deposits (close to $5 billion) with only a limited capital investment (less than $350 million). Following passage of the Garn–St Germain Depository Institutions Act (1982) and the Competitive Equality in Banking Act (1987), bank holding companies operating in the United States were allowed to reach across state lines to acquire failing banks and thrifts. Later, Congress voted to allow bank holding companies to acquire even healthy thrift institutions anywhere inside the United States, subject to regulatory approval.

Tax and Market-Positioning Motives

Many mergers arise from expected **tax benefits,** especially where the acquired firm has earnings losses that can be used to offset taxable profits of the acquirer. There may also be **market-positioning benefits,** in which a merger will permit the acquiring institution to acquire a base in a completely new market. For example, acquiring an existing financial firm, rather than chartering a new firm with new personnel, can significantly reduce the cost of positioning in a new market. Further expansion in the form of branching or future mergers can subsequently take place, with the most recently acquired bank as a base of operations. A good example of this merger motive is the 2003 acquisition of FleetBoston Financial Corp. in New England by Bank of America Corp., the latter seeking to purchase or open branches in numerous areas across the United States where there is strong market growth potential. The B of A/Fleet merger resulted in a single banking-facilities network of close to 6,000 branches and roughly 17,000 ATMs. Similar market-positioning objectives appeared to motivate the recent acquisitions of Golden West by Wachovia Corp. and North Fork Bancorp and Hibernia Corp. by Capital One.

These market-positioning mergers are likely to continue to move forward in the future as a result of passage of the Riegle-Neal Interstate Banking Act in the United States and recent banking directives issued by the European Economic Community to more freely allow banks and their competitors to cross state and national boundaries, make acquisitions, and purchase or establish new branch offices. Moreover, Germany's Commerzbank, ING Group of the Netherlands, and Allianz AG Holdings have recently bought sizeable ownership shares in Chinese and Korean banks to further position themselves in the developing financial markets of Asia, opening up potential new sources of revenue and earnings.

The Cost Savings or Efficiency Motive

Large-scale staff reductions and savings from eliminating duplicate facilities have followed in the wake of some of the largest mergers in the financial-services sector. For example, when insurer Allianz acquired Germany's Dresdner Bank in 2001, Dresdner's staff was cut by 8,000 (or about 16 percent of its labor force) in an effort to save money. The search for **cost savings** was also uncovered in a survey by Lausberg and Rose [13, 14] of the massive merger wave occurring in European banking during the 1980s and 1990s. Of the 107 European bank merger events examined, the single most important merger motivation was the desire to reduce operating costs, followed by a plan to diversify into new markets as part of an internationalization strategy.

We must be cautious about making too much of this efficiency or cost savings factor in explaining the recent rash of financial-services mergers, however. Most mergers are of the *market extension* type, which means the institutions involved don't overlap much or at all in terms of geographic area served. Thus, closing duplicate office facilities is less possible. In fact, to the surprise of many experts, branch offices are expanding in the banking industry, not contracting, even as the merger wave continues to unfold. For example, as Rhoades [17] points out, while the number of banks operating in the United States fell from about 14,400 in 1980 to less than 8,000 as the 21st century opened, the number of branch offices swelled to more than 70,000, and the number of ATMs soared even higher. What these numbers suggest is that some customers, especially households and smaller businesses, appear to demand a local banking connection. This limits how far financial-service managers can go in closing down what they feel is "unneeded" service space.

Mergers as a Device for Reducing Competition

Yet another possible explanation for hundreds, if not thousands, of recent mergers may be the wish to lower the degree of competition in the marketplace. When two competitors are allowed to merge, the public is served by fewer rivals for their business. Service quality may diminish, and prices and profits may rise. At least consistent with this merger explanation is the rapid rise in financial-services industry concentration under way all over the globe, including the United States nationally and in some American towns and cities. For example, as Rhoades [17] observes, the 100 largest U.S. banks jumped from just under 50 percent of total industry deposits in 1980 to more than 70 percent as the 21st century approached. While much less of an overall increase in concentration is evident in local markets, there are reports of greater concentration in the largest U.S. metropolitan areas and in some urban and rural communities. If true, there is the potential from this merger motive for damage to the public. More aggressive prosecution of the antitrust laws, as we will discuss later in this chapter, may need to be considered.

Mergers as a Device for Maximizing Management's Welfare

Some experts in this field see mergers as primarily driven by the interests of management. Managers are supposed to be the agents of a firm's stockholders, guiding the firm toward its goals for the stockholders' benefit. However, management may view a prospective acquisition as a way to increase salaries and employee benefits, lower the risk of being fired, and enhance managers' reputation in the labor market from working for a bigger firm. To the extent that managers reap these benefits at the expense of company stockholders an **agency problem** emerges. Higher management benefits can raise the merging firm's operating costs, lower its profits, and decrease returns to its shareholders. Many analysts see maximizing the welfare of management as one of the most important (and at times most perverse) of all merger motives.[1]

Other Merger Motives

Management may believe a merger will result in increased capacity for growth, maintaining the acquiring institution's historic growth rate. Moreover, a merger enables a lending institution to expand its loan limit to better accommodate large and growing corporate customers. This is particularly important in markets where the lender's principal business customers may be growing more rapidly than the lending institution itself (as noted by Peek and Rosengren [11]).

Mergers often give smaller institutions access to capable new management, which is always in short supply. For example, large banking firms recruit on college campuses and often hire through employment agencies in major metropolitan areas. Smaller, outlying banks have fewer market contacts to help find managerial talent, and they may not be able to afford top-quality personnel. The same is true of access to costly new electronic technology. For example, the merger of First Union Corp. of North Carolina and CoreStates Financial Corp. of Pennsylvania in 1998 appeared to be driven, in part, by CoreStates' need for upgraded computer systems to more efficiently handle its retail consumer accounts.

Merger Motives That Executives and Employees Identify

In a study by Prasad and Prasad [16], senior executives from 25 of the largest banking firms in the United States were asked what factors they consider in choosing target banks to acquire. The most prominent feature mentioned was *quality of management*. Several officers of leading banks said they preferred merger partners whose managements were compatible with their own. Other key factors mentioned in identifying desirable institutions to acquire were profitability (especially return on assets), efficiency of operations, and maintenance of market share.

[1]A dramatic example of managerial benefits from a merger appeared in 2006 when Capital One Financial Corp. proposed to buy North Fork Bancorp in order to gain access to an extensive branch office network in Connecticut, New Jersey, and New York. To sweeten the deal North Fork's top executives were promised close to $300 million in payouts and the company agreed to cover a portion of their tax bill in a so-called "tax gross up."

Concept Check

19–1. Exactly what is a merger?

19–2. Why are there so many mergers each year in the financial-services industries?

19–3. What factors seem to motivate most mergers?

19–4 Selecting a Suitable Merger Partner

How can management and the owners of a financial firm decide if a proposed merger is good for the organization? The answer involves measuring both the costs and benefits of a proposed merger. Because the acquiring and acquired institutions may have different reasons for pursuing a merger, this is not an easy cost–benefit calculation. Even so, the most important goal of any merger should be to increase the *market value* of the surviving firm so that its stockholders receive higher returns on the funds they have invested. Stockholders deserve a return on their investment commensurate with the risks they have taken on.

For example, a merger is beneficial to the stockholders in the long run if it increases stock price per share. The value (price) of a financial firm's stock, like the stock of any other corporation, depends upon these factors:

1. The expected stream of future dividends flowing to the stockholders.
2. The discount factor applied to the future stock dividend stream, based on the rate of return required by the capital markets on investments of comparable risk.

Specifically,

$$\text{Market price per share of stock} = \sum_{t}^{\infty} \frac{D_t}{(1 + c)^t} \qquad \textbf{(19–1)}$$

where annual expected dividends per share are represented by D_t and c is the opportunity cost rate on capital invested in projects that expose investors to comparable risk. Clearly, if a proposed merger increases expected future stockholder dividends or lowers investors' required rate of return from the organization by reducing its risk, or combines the two, the financial institution's stock will tend to *rise* in price and its stockholders will benefit from the transaction.

How might a merger increase expected future earnings or reduce the level of risk exposure? One possibility is by *improving operating efficiency*—that is, by reducing operating cost per unit of output. A financial firm might achieve greater efficiency by consolidating its operations and eliminating unnecessary duplication. Thus, instead of two separate planning and marketing programs, two separate auditing staffs, and so forth, the merged institution may be able to get by with just one. Existing resources—land, labor, capital, and management skills—may be used more efficiently if new production and service delivery methods (such as automated equipment) are used, increasing the volume of services produced with the same number of inputs.

Another route to higher earnings is to enter new markets or offer new services via merger. Entry into new markets can generate *geographic diversification* if the markets entered have different economic characteristics from those markets already served. Alternatively, a merger may allow financial firms with different packages of services to combine their service menus, expanding the service options presented to their customers. This is *product-line diversification*. As we saw in Chapter 14, both forms of diversification tend to stabilize cash flow and earnings, presenting stockholders with less risk and perhaps increasing the market value of their stock. Ideally, merger-minded managers want to find an acquisition target whose earnings or cash flow is negatively correlated (or displays a low positive correlation) with the acquiring organization's cash flows.

For many financial-service managers, a major consideration in any proposed merger is its probable impact on the earnings per share (EPS) of the surviving firm. Will EPS improve after the merger, making the new combined institution's stock more attractive to investors? Stockholders of the firm being acquired are usually asking the same question: If we exchange our stock in the old institution for the stock of the acquiring firm, will our EPS rise?

Generally speaking, stockholders of both acquiring and acquired institutions will experience a gain in earnings per share of stock if *(a)* a company with a higher stock-price-to-earnings (P-E) ratio acquires a company with a lower P-E ratio and *(b)* combined earnings do not fall after the merger. In this instance, earnings per share will rise even if the acquired institution's stockholders are paid a reasonable premium for their shares.

For example, suppose the stockholders of Bank A, whose current stock price is \$20 per share, agree to acquire Bank B, whose stock is currently valued at \$16 per share. If Bank A earned \$5 per share of stock on its latest report and B also earned \$5 per share, they would have the following P-E ratios:

$$\text{A's P-E ratio} = \frac{\$20 \text{ price per share}}{\$5 \text{ earnings per share}} = 4$$

$$\text{B's P-E ratio} = \frac{\$16 \text{ price per share}}{\$5 \text{ earnings per share}} = 3.2$$

Suppose, too, that these two banks had, respectively, 100,000 shares and 50,000 shares of common stock outstanding and that Bank A reported net earnings of \$500,000, while B posted net earnings of \$250,000. Thus, their combined earnings would be \$750,000 in the most recent year.

If the shareholders of Bank B agree to sell out at B's current stock price of \$16 per share, they will receive 4/5 (\$16/\$20) of a share of stock in Bank A for each share of B's stock. Thus, a total of 40,000 shares of Bank A (50,000 Bank B shares × 4/5) will be issued to the stockholders of Bank B to complete the merger. The combined organization will then have 140,000 shares outstanding. If earnings remain constant after the merger, stockholders' earnings per share will be

$$\begin{matrix}\text{Earnings}\\ \text{per share}\end{matrix} = \frac{\begin{matrix}\text{Combined}\\ \text{earnings}\end{matrix}}{\begin{matrix}\text{Shares of}\\ \text{stock outstanding}\end{matrix}} = \frac{\$750{,}000}{140{,}000} = \$5.36 \qquad \textbf{(19–2)}$$

which is clearly higher than the \$5 per share that Bank A and Bank B each earned for their shareholders before they merged.

As long as the acquiring institution's P-E ratio is larger than the acquired firm's P-E ratio, there is room for paying the acquired company's shareholders at least a moderate **merger premium** to sweeten the deal. A merger premium expressed in percentage terms can be calculated from:

$$\begin{matrix}\text{Merger premium}\\ \text{(in percent)}\end{matrix} = \frac{\begin{matrix}\text{Aquired firm's}\\ \text{current stock}\\ \text{price per share}\end{matrix} + \begin{matrix}\text{Additional amount}\\ \text{paid by the acquirer}\\ \text{for each share of the}\\ \text{acquired firm's stock}\end{matrix}}{\text{Acquired firm's current stock price}} \times 100 \qquad \textbf{(19–3)}$$

For example, suppose that despite the difference in current market value between Bank A's and Bank B's stock (i.e., \$20 versus \$16 per share), Bank A's shareholders agree to offer

B's shareholders a bonus of $4 per share (i.e., a merger premium of [$16 + $4]/$16 = 1.25, or 125 percent). This means B's stockholders will exchange their stock for Bank A's shares with an **exchange ratio** of 1:1. Therefore, B's shareholders, who currently hold 50,000 shares in Bank B, will wind up holding 50,000 shares in Bank A. The combined organization will have 150,000 shares outstanding. If earnings remain at $750,000 following the merger, the consolidated banking organization will be able to maintain its earnings per share at the current level of $5 (i.e., $750,000/150,000 shares).

Unfortunately, paying merger premiums can easily get out of hand. Premiums ranging from 150 to 250 percent have sometimes emerged. High-premium deals often yield disappointing results for the stockholders of the acquiring firm long after these mergers are consummated.

In general, **dilution of ownership**—spreading the firm's ownership over more stockholders so that the average shareholder's proportion of firm ownership declines—results from offering the acquired firm's stockholders an excessive number of new shares relative to the value of their old shares. **Dilution of earnings**—spreading a fixed amount of earnings over more shares of stock so that the earnings per share (EPS) of the combined firm declines—will occur if the ratio of stock price to earnings (P-E) of the firm to be acquired is greater than the ratio of stock price to earnings (P-E) of the acquiring firm. The combined firm's EPS will fall below its original level. The amount of decrease is a function of the differential in price-earnings ratios of the two firms and the relative size of the two merging companies in terms of their total earnings.

The financial success of a merger, then, depends heavily on the comparative dollar amounts of earnings reported by the two participating organizations and their relative price-earnings ratios. For example, the immediate change in earnings per share from the merger of Bank A and Bank B depends on this ratio:

$$\frac{\begin{array}{c}\text{Price per share}\\ \text{of Bank A's stock}\end{array}}{\begin{array}{c}\text{Current net earnings}\\ \text{of Bank A}\end{array}} \div \frac{\begin{array}{c}\text{Price per share}\\ \text{of Bank B's stock}\end{array}}{\begin{array}{c}\text{Current net earnings}\\ \text{of Bank B}\end{array}} \qquad \textbf{(19–4)}$$

Of course, even if EPS goes down right after the merger, the transaction may still be worth pursuing if future earnings are expected to grow faster as a result of the acquisition. If significantly greater efficiency and cost savings result over the long run, the effects of paying a higher price (in new stock that must be handed over to the acquired institution's shareholders) will be more than made up eventually. Standard financial management practice calls for analyzing what will happen to the combined organization's EPS under different possible scenarios of future earnings and stock prices. If it takes too long to recover the cost of an acquisition according to the projected path of EPS, management of the acquiring institution should consider looking elsewhere for a merger target.

19–5 The Merger and Acquisition Route to Growth

Whatever its motives, each merger is simply a financial transaction that results in the acquisition of one or more firms by another institution. The acquired firm (usually the smaller of the two) gives up its charter and adopts a new name (usually the name of the acquiring organization). The assets and liabilities of the acquired firm are added to those of the acquiring institution.[2] A merger normally occurs after managements of the acquiring and

[2]Two or more firms may also *consolidate* their assets to form one institution, with all participating firms giving up their former identities to become parts of a larger organization. Consolidations are much less common in the financial services field than mergers, however.

acquired organizations have struck a deal. The proposed transaction must then be ratified by the board of directors of each organization and possibly by a vote of each firm's common stockholders.[3]

If the stockholders approve (usually by at least a two-thirds majority), the unit of government that issued the original charter of incorporation must be notified, along with any regulatory agencies that have supervisory authority over the institutions involved. For example, in the United States the federal banking agencies have 30 days to comment on the merger of two federally supervised banks and there is a 30-day period for public comments as well. Public notice that a merger application has been filed must appear three times over a 30-day period, at approximately two-week intervals, in a newspaper of general circulation serving the communities where the main offices of the banks involved are located. The U.S. Justice Department can bring suit if it believes competition would be significantly reduced after the proposed merger.

In deciding whether or not to merge, management and the board of directors of the acquiring firm often consider many characteristics of the targeted institution. The principal factors examined by most merger analysts fall into six broad categories: (1) the firm's history, ownership, and management; (2) the condition of its balance sheet; (3) the firm's track record of growth and operating performance; (4) the condition of its income statement and cash flow; (5) the condition and prospects of the local economy served by the targeted institution; and (6) the competitive structure of the market in which the firm operates (as indicated by any barriers to entry, market shares, and degree of market concentration).

In addition to the foregoing items, many acquirers will look at these factors as well:

1. The comparative management styles of the merging organizations.
2. The principal customers the targeted institution serves.
3. Current personnel and employee benefits.
4. Compatibility of accounting and management information systems among the merging companies.
5. Condition of the targeted institution's physical assets.
6. Ownership and earnings dilution before and after the proposed merger.

A thorough evaluation of any proposed corporate merger *before* it occurs is absolutely essential, as recent experience has shown.

19–6 Methods of Consummating Merger Transactions

Mergers usually take place employing one of two methods: *(a) pooling of interests* or *(b) purchase accounting*. For mergers begun before July 1, 2001, the Financial Accounting Standard Board (FASB) permitted use of the *pooling of interests* approach in which the merger partners merely sum the volume of their assets, liabilities, and equity in the amounts recorded just before their merger takes place. The result is a merged firm displaying a simple combined total of all the merger partners' assets, liabilities, and equity in one combined balance sheet. The income statement of the newly consolidated firm will reflect the income and expenses of both firms added together for the full period of time covered by the income and expense statement as though the merging businesses had been one company when the income statement began.

[3]In a purchase and assumption transaction, two-thirds of the shareholders of the acquired firm must approve; however, often no shareholder vote of approval is required by stockholders of the acquiring institution, nor is shareholder approval usually required when a firm engages in a partial liquidation of its assets (e.g., a bank or thrift institution selling some of its branch offices).

In contrast, under *purchase accounting* the firm to be acquired is valued at its purchase price and that price is added to the total assets of the acquirer. The purchase method requires that acquiring and acquired firms be handled on a different basis so it is important to know who is acquiring whom. The acquirer records the acquisition at the price paid to the stockholders of the acquired company, first valuing the acquired firm at market plus goodwill, if the acquisition price and market value are different.

Goodwill is an intangible asset usually arising from a merger transaction where the purchase price of the merger target is larger than the difference between the fair value of its assets minus any liabilities taken on. The Financial Accounting Standards Board (specifically, in FASB 142) labels goodwill as the "intangible synergies" of a combined firm resulting from a merger. As Carlson and Perli [20] observe, with the rapid pace of banking industry consolidation in recent years goodwill on bank balance sheets has exploded, growing at more than 30 percent annually to climb above 1 percent of total industry assets. While FASB used to require goodwill to be amortized (and, thus, gradually disappear) over its useful life (not to exceed 40 years), the Standards Board recently changed its mind and now goodwill need not be amortized as long as it doesn't become impaired due to deterioration in a merging company's financial strength. In contrast to the purchase accounting approach where goodwill *is* permitted, no goodwill is figured in when using the pooling of interests approach. However, after 2001 the pooling-of-interest method for merger accounting was eliminated for U.S. financial firms.

Another way to view the merger process is to determine exactly what the acquirer is buying in the transaction: assets or shares of stock. Mergers are generally carried out by using either (1) the purchase of assets or (2) the purchase of common stock. With the **purchase-of-assets method,** the acquiring institution buys all or a portion of the assets of the acquired institution, using either cash or its own stock. In purchase-of-assets mergers, the acquired institution usually distributes the cash or stock to its shareholders in the form of a liquidating dividend, and the acquired organization is then dissolved. With some asset purchase deals, however, the institution selling its assets may continue to operate as a separate, but smaller, corporation.

With the **purchase-of-stock method,** on the other hand, the acquired firm ceases to exist; the acquiring firm assumes *all* of its assets and liabilities. While cash may be used to settle either type of merger transaction, in the case of commercial banks regulations require that all but the smallest mergers and acquisitions be paid for by issuing additional stock of the acquirer. Moreover, a stock transaction has the advantage of not being subject to taxation until the stock is sold, while cash payments are usually subject to immediate taxation. Stock transactions trade current gains for future gains that are expected to be larger if everything goes as planned.[4]

The most frequent kind of merger among depository institutions involves **wholesale** (large metropolitan) **banks** merging with smaller **retail banks.** This lets money center banks gain access to relatively low-cost, less interest-sensitive consumer accounts and channel those deposited funds into profitable corporate loans. Most financial-firm takeovers are friendly—readily agreed to by all parties—although a few are *hostile*, resisted by management and stockholders. Not long ago in the acquisition of Irving Trust by Bank of New York, for example, the management and directors of Irving created obstacle after obstacle, legal and financial, to this corporate marriage before the courts finally cleared it to proceed.

[4]Merger transactions involving banks and other financial firms generally must be accounted for in accordance with Accounting Principles Board Opinion No. 16 (APB No. 16). The difference between the purchase price and the fair value of net assets acquired in mergers should be treated as an intangible asset in accordance with generally accepted accounting principles (GAAP).

19–7 Regulatory Rules for Bank Mergers in the United States

Mergers have transformed the banking industry perhaps more than any other financial-services industry. In this section we take a close look at government rules applying to bank mergers in the United States.

Two sets of rules generally govern the mergers of banks and other financial firms: (1) decisions by courts of law and (2) statutes enacted by legislators, reinforced by regulations. In the United States, for example, the Sherman Antitrust Act of 1890 and the Clayton Act of 1914 forbid mergers that would result in monopolies or significantly lessen competition in any industry. Whenever any such merger is proposed, it must be challenged in court by the U.S. Department of Justice.

Inside the United States the foundation law affecting the mergers and acquisitions of banks is the **Bank Merger Act of 1960.** This law requires each merging bank to request approval from its principal federal regulatory agency before a merger can take place. For national banks, this means applying to the Comptroller of the Currency for prior approval. For insured state-chartered banks that are members of the Federal Reserve System, the Fed's approval is required. Insured, state-chartered nonmember institutions must gain permission from the Federal Deposit Insurance Corporation.

Under the terms of the Bank Merger Act, each federal agency must give top priority to the **competitive effects** of a proposed merger. This means estimating the probable effects of a merger on the pricing and availability of financial services in the local community and on the degree of concentration of deposits or assets in the largest financial institutions in the local market. Thus, current merger laws in banking rest on three premises: (1) the *cluster of products* offered by a bank is the relevant product line to be considered in a merger or acquisition; (2) the relevant market to be concerned about, in most instances, is *local* (counties or metropolitan areas); and (3) the *structure* of the local market (usually measured by degree of concentration) is the principal determining factor in how much competition exists and how a merger might damage or aid competition. Where concentration is high—where the largest institutions control a dominant share of local deposits or assets—the risk of damaging competition is greater, and the merger is less likely to win regulatory approval unless the merging institutions agree to *divest* some of their affiliated banks and branches. For example, in 1992 Bank America was allowed to acquire Security Pacific Corp. only after agreeing to divest itself of 213 branch offices in five states, holding almost $9 billion in deposits.

Key URL
To learn more about law and regulation in the banking sector, see, for example, **http://library.findlaw.com/finance-and-banking/index.html.**

Moreover, the *trend* in concentration also comes under close scrutiny from the regulatory agencies. Markets that have recently experienced increasing concentration ratios or declining numbers of financial-service suppliers are less likely to see mergers approved than are markets where concentration is falling. Other factors that must be weighed include the financial history and condition of the merging institutions, the adequacy of their capital, their earnings prospects, strength of management, and the convenience and needs of the community to be served. Mergers with anticompetitive effects cannot go unchallenged by federal authorities unless the applicant can show that such combinations would result in significant **public benefits.** Among the possible benefits are providing financial services where none are conveniently available and rescuing a failing financial institution whose collapse would have damaging effects on the public welfare.

The federal supervisory agencies prefer to approve mergers that will enhance the financial strength of the institutions involved. Regulators repeatedly emphasize the need for improving management skills and strengthening equity capital. The existence of such laws and regulations creates a barrier for any merger that would lead to substantial changes in market share and market concentration, possibly damaging competition in the local market. This creates a dilemma for aggressive financial firms. Expansion-minded management and stockholders must distinguish proposed combinations that are likely to be challenged by government, resulting in expensive legal battles, from those that are likely to sail through with few problems. It should be noted that the large majority of merger applications filed—usually more than 90 percent—are approved. However, this high approval rate reflects a good deal of screening out of unacceptable mergers through informal conferences between merger-minded financial institutions and regulatory officials.

Justice Department Guidelines

To reduce legal uncertainties the U.S. Department of Justice issued formal guidelines for merger applicants in 1968. The initial **Justice Department Merger Guidelines** were quite restrictive. They required firms operating in markets judged to be highly concentrated, with only limited competition, to acquire primarily *foothold businesses* (i.e., those having a small or insignificant market share) or to enter such markets *de novo* (i.e., start a new firm). In June 1982, the Reagan administration authorized more liberal merger guidelines. These rules permitted combinations that would probably have been challenged by the Justice Department under the old guidelines. The Justice Department further modified its merger guidelines in 1992, including special guidelines for the mergers of banks and selected other financial institutions that we operate under today.

The degree of *concentration* in a market is measured by the proportion of assets or deposits controlled by the largest institutions serving that market. Presumably, if the largest firms control a substantial share of market assets or deposits, anticompetitive behavior (including collusive agreements) is more likely, resulting in damage to the public from excessive prices and poor service quality. The Justice Department guidelines require calculation of the **Herfindahl-Hirschman Index** (HHI) as a summary measure of *market concentration*. HHI reflects the proportion of assets, deposits, or sales accounted for by each firm serving a given market. Each firm's market share is squared, and HHI is calculated as the sum of squared market shares for all firms serving a specific market area. Thus, the Herfindahl-Hirschman index is derived from this formula:

$$\text{HHI} = \sum_{i=1}^{k} A_i^2 \qquad \textbf{(19–5)}$$

where A_i represents the percentage of market-area deposits, assets, or sales controlled by the *i*th financial firm in the market, and there are k financial firms in total serving the market. We note that the Herfindahl index reflects *both* the number of institutions in the market and the concentration of deposits, assets, or sales in the largest institutions and assigns heavier weight (by squaring each firm's market share) to those institutions commanding the biggest market shares.

For example, suppose that a small local market contains four banks having the deposits and deposit market shares shown in the following table:

Deposits and Market Shares in Edgecroft County

Name of Financial Firm	Deposits in Latest Annual Report	Market Shares of Total Deposits (A_i)	Square of Each Firm's Market Share (A_i^2)
First Security National Bank	**$245 million**	**50.8%**	**2,580.6**
Edgecroft National Bank	113 million	23.4	547.6
Lincoln County State Bank	69 million	14.3	204.5
Edgecroft State Bank and Trust Co.	55 million	11.4	130.0
Totals	$482 million	100.0%	3,462.7

In this case:

$$\text{HHI} = \sum A_i^2 = 3{,}462.7 \text{ points}$$

HHI may vary from 10,000 (i.e., 100^2)—a monopoly position, where the leading firm is the market's sole supplier—to near zero for unconcentrated markets. In theory, the smaller the value of HHI, the less one or a few firms dominate any given market and the more equally are market shares distributed among firms. The more nearly firms are equal in size, the more competitive the relevant market is assumed to be and the less likely is anticompetitive behavior.

Under Department of Justice guidelines, any merger that would (*a*) result in a post-merger HHI of less than 1,800 or (*b*) change the value of the HHI in the relevant market by less than 200 points would not likely be challenged by the Justice Department because, in the government's view, the merged firm would not gain enough market power to significantly damage public welfare. However, when a proposed merger appears to yield a Herfindahl index exceeding these guidelines (i.e., the HHI in the relevant market would be more than 1,800 and rise by more than 200 points), the Justice Department considers such a market "highly concentrated." Proposed mergers in highly concentrated markets may draw a Justice Department challenge in federal court unless the department's lawyers and economists find evidence of extenuating circumstances.

Consider the above example in which we calculated the market shares of banks serving Edgecroft County, where HHI equaled 3,462.7 points. According to the Justice Department's guidelines, Edgecroft would be a "highly concentrated market" (provided that Justice confined its definition of the relevant banking market to the local county itself and did not bring in surrounding areas that have more financial-service providers, as often happens where cities span several counties). The biggest bank in Edgecroft, First Security National, holds a 50.8 percent market share. First Security would have a difficult time gaining approval for a merger with any other Edgecroft bank. (The largest bank in the county is more than twice as large as its nearest competitor.)

Indeed, it would be difficult for *any* bank mergers to take place inside the Edgecroft market because of its highly concentrated status and because no matter which two of the four banks might wish to merge with each other, the resulting change in HHI would be relatively large. (As an example, if the two smallest banks merged, their combined market share would be 25.7 percent, which, when squared, is 660.5 points. The HHI for the market would climb more than 300 points, from 3,462.7 to 3,788.7, following this merger.) However, a bank outside the Edgecroft market might well be able to merge with one of the Edgecroft banks in what is known as a *market extension merger*. This would leave the local market's HHI unchanged and would not reduce the number of alternative suppliers of services to the public.

Extenuating circumstances are frequently considered in approving those mergers that lead to only moderate increases in market concentration. These mitigating factors may include the ease with which new firms can enter the same market, the conduct of firms already present in the market, the types of products involved and the terms under which they are being sold, and the type and character of buyers in the relevant market area.

In recent years the Justice Department has liberalized its standards for judging the anticompetitive effects of mergers. One device Justice has used to carry out this more liberal attitude is to include *nonbank financial institutions* in the calculation of some concentration ratios for local markets. Including at least a portion of the deposits held by savings and loans, credit unions, and other financial institutions in the total deposits of a local market area lowers the market share held by each bank. Thus, fewer financial-services mergers will appear to damage competition and more mergers will receive federal approval, other factors held equal. However, recent research suggests that in most local markets banks continue to be the principal financial-service provider to households and small businesses, especially for checking, savings, and credit services.

The Merger Decision-Making Process by U.S. Federal Regulators

U.S. bank regulatory agencies must apply the standards imposed by the Bank Merger Act and the Justice Department Merger Guidelines to *all* merger proposals. Each merger application is reviewed (*a*) by staff economists and attorneys working for the federal banking agencies to assess the potential impact of the proposed merger on competition and (*b*) by officials of the agencies' examination department to assess the merger's probable impact on the financial condition and future prospects of the banks involved.

The Bank Merger Act also requires the federal agency that is the merging banks' principal supervisor to assess the effect of the proposed merger on public convenience and the public's need for an adequate supply of financial services at reasonable prices. The agency involved must review the banks' records to determine if they have made an affirmative effort to serve all segments of the population in their trade area without discrimination. This assessment is required under terms of the Community Reinvestment Act (CRA), which forbids depository institutions from *redlining*—that is, marking off certain neighborhoods within their trade area and declining to extend financial services (especially credit) to residents of those neighborhoods.

19–8 Merger Rules in Europe

The formation of the European Union (EU) has resulted in a wave of mergers. Partly as a result, the European Commission—an executive body of the EU currently based in Brussels—has emerged as a key arbiter of mergers involving European businesses. Because the European Commission cannot break apart a merger after that combination has already occurred (unlike the U.S. Justice Department), the Brussels commission has been somewhat more aggressive than in the United States in denying some companies permission to merge if the proposed combination would lead to "collective dominance" in a given market.

The doctrine of *collective dominance* suggests that if a significant European market would become so concentrated as a result of a proposed merger that only about four firms would come to dominate that market, then the European Commission might well vote to block any further market concentration, even if non-European firms were involved. While, thus far, financial services in Europe do not appear to be as concentrated as are several other European industries, there is little question that a strong consolidation trend in financial services is under way in the EU and may soon lead to significant regulatory challenges. A prominent example was UniCredito Italiano's $20 billion bid for Germany's HUB Group AG in 2005—then Europe's largest cross-border financial services merger.

In 2002 the United States and the European Union agreed to work toward *joint review* of mergers involving multinational businesses in order to avoid conflicting merger decisions when a U.S. and a European firm propose to combine their ownership and resources. Subsequently, the EU's antitrust division announced that it wouldn't block mergers simply because competing firms might be harmed, but only if *consumers* might be damaged—a rule the United States generally follows under its antitrust laws.

19–9 Making a Success of a Merger

Many mergers simply do not work. A variety of factors often get in the way of mergers' success, including poor management, a mismatch of corporate cultures and styles, excessive prices paid by the acquirer for the acquired firm, a failure to take into account the customers' feelings and concerns, and a lack of strategic "fit" between the combining companies so that nothing meshes smoothly with minimal friction and the merged institution finds that it cannot move forward as a cohesive and effective competitor.

Recent experience has suggested a few helpful steps that improve the chances for a desirable merger outcome:

1. Acquirer, know thyself! Every financial-service company intent on growth through merger must thoroughly evaluate its own financial condition, track record of performance, strengths and weaknesses of the markets it already serves, and strategic objectives. Such an analysis can help management and stockholders clarify whether a merger would help to magnify each participating institution's strengths and compensate for its weaknesses.
2. Get organized for a detailed analysis of possible new markets to enter and institutions to acquire. Financial firms that are merger focused should create a management/shareholder team (including outside consultants, such as investment banking specialists) with the skills needed to successfully evaluate potential new markets and potential acquisitions.

   Favorable markets to enter typically show a track record of above-average, but stable growth in incomes and business sales, a somewhat older-than-average population with a high proportion of professional workers and business owners and managers, moderate to low inflation with stable currency prices, moderate competition, and a favorable regulatory environment that does not hinder expansion or the development of new services. Desirable institutional targets, on the other hand, show evidence of persistent earnings growth and market acceptance of the services they offer (as measured by the growth of assets and a rising market share), a strong capital base, facilities and equipment that are functioning well and are up to date, evidence of close control over operating costs, and complementary goals between acquiring and acquired institutions.
3. Establish a realistic price for the target firm based on a careful assessment of its projected future earnings discounted by a capital cost rate that fully reflects the risks of the target market and target firm and reflects all prospective costs that will have to be met by the acquiring firm (such as closing or upgrading poorly located or inadequately equipped branch offices, replacing outdated or incompatible management information systems, educating inadequately trained staff to handle new services, and correcting salary disparities that may exist between the two merging organizations).
4. Once a merger is agreed upon, create a combined management team with capable managers from both acquiring and acquired firms that will direct, control, and continually assess the quality of progress toward the consolidation of the two organizations into a single effective unit.
5. Establish a reporting and communications system between senior management, branch and line managers, and staff that promotes rapid two-way communication of operating problems and ideas for improved technology and procedures so that employees feel involved in the merger, are convinced that effort and initiative will be rewarded, and believe they have a contribution to make toward the merger's ultimate success.
6. Create communications channels for both employees and customers to promote (*a*) understanding of why the merger was pursued, and (*b*) what the consequences are likely to be for both anxious customers and employees who may fear interruption of service, loss of jobs, higher service fees, the disappearance of familiar faces, and other changes. This may require setting up customer and employee "hot lines" to calm concerned people and give them the direction and assurances they seek.
7. Set up customer advisory panels to evaluate the merged institution's community image, service and marketing effectiveness, efforts to recognize loyal customers, pricing schedules, and general helpfulness to customers.

Key URL
Additional information about choosing the right merger target may be found at numerous Web locations, such as **www.yaledailynews.com/article.asp?AID=8420**.

Real Banks, Real Decisions

SELLING OFF BRANCH OFFICES TO GAIN APPROVAL FOR A MERGER: *DIVESTITURE*

For several decades now banks and thrift institutions that operate branch offices in local neighborhoods have sometimes been asked to *divest* themselves of some of their offices in order to secure regulators' approval for their proposed merger with other depository institutions. This type of request typically has come from such agencies as the U.S. Department of Justice, the Federal Reserve Board, the Comptroller of the Currency, and the Federal Trade Commission in an effort to promote competition.

For example, in a market dominated by three commercial banks, if two of them merge, all of their branches then become part of one banking firm. Consumers in that market now have only two banking alternatives. Worse still, in a given local neighborhood there may only be branch offices of the two merging institutions present which, after the merger, results in neighborhood residents having just one local service option.

Accordingly, in recent years several bank and thrift mergers have been approved by regulators only if some of the branch offices of the acquired depository institution are sold off to a third party. Examples of banks confronted with this divestiture decision have included BankAmerica Corporation in its merger with Security Pacific Corporation in 1992, NationsBank Corporation in its acquisition of Barnett Banks, Inc. in 1998, and Banc One Corporation in its acquisition of First Chicago NBD, also in 1998. In the BankAmerica–Security Pacific merger case, 187 branches were sold to other banks not involved in that merger.

What happened to the branch offices disposed of? Did they survive or did all of their depositors leave? A recent study by Pilloff [12] of the Federal Reserve Board finds that, in general, the branch offices disposed of did well. Initially, they faced a "runoff" around the time of their sale because some depositors apparently wanted to follow their old bank even after it was acquired by a larger institution, didn't trust the new owner of the branches, or perhaps used the occasion to make a change they may have been planning all along.

After the initial "runoff," growth in deposits resumed at a pace comparable to that of other branch offices. Interestingly, the larger the bank purchasing these branches, the faster the divested branches tended to grow, perhaps because larger depositories are more familiar to the public, offer more services, or manage their new offices more effectively. Overall, the *divestiture* requirement to promote competition appears to have worked reasonably well.

The foregoing steps, even if faithfully followed, do not promise successful mergers, but they will increase the probability that a merger will proceed smoothly and possibly achieve its goals.

Concept Check

19–4. What factors should a financial firm consider when choosing a good merger partner?

19–5. What factors must the regulatory authorities consider when deciding whether to approve or deny a merger?

19–6. When is a market too concentrated to allow a merger to proceed? What could happen if a merger were approved in an excessively concentrated market area?

19–7. What steps that management can take appear to contribute to the success of a merger? Why do you think many mergers produce disappointing results?

19–10 Research Findings on the Impact of Financial-Service Mergers

What is the track record of mergers involving banks and other financial firms? What impact do they have on the public and stockholders? A number of studies over the years have addressed these questions. In general, the results are mixed—some positive and some negative effects. Other challenging problems—such as establishing a solid base in a new market—are often resolved successfully through the merger route, however.

The Financial and Economic Impact of Acquisitions and Mergers

Do mergers always increase profits? Do they result in clear benefits for stockholders of merging financial-service companies? For many mergers the answers to these two questions appear to be "no" at worst and "not necessarily" at best.

A substantial number of studies suggest that, on average, there are no statistically significant differences in profitability between financial firms pursuing merger strategies versus firms that are not merger active. Acquiring financial firms are usually not more profitable (and often less profitable) than the firms they acquire. However, there is some evidence that acquired financial-service companies are often significantly less profitable than nonmerging institutions serving the same markets. Perhaps the reason for this last finding is that stockholders and managements of acquiring financial firms *believe* they can improve the performance of the companies they have targeted for merger. Unfortunately this belief in postmerger gains is often *not* justified. Another possible explanation for mediocre postmerger profit results may be the sizeable premiums acquirers often wind up paying shareholders of acquired firms.[5]

Factoid

Do mergers seem to improve firm performance? Not according to the Federal Reserve Bank of San Francisco, which finds only that, in some instances, operating costs are lowered when banks merge. See especially **www.frbsf.org/econrsrch/workingp/wp99-10.pdf**.

When interstate banking became legal in the United States during the 1980s and 1990s many industry analysts thought that interstate acquisitions would surely yield positive results for shareholders and improved performance overall, especially because these interstate transactions had been prohibited for so long. Once again, research findings were mixed, though generally favorable. Stockholders of interstate banking companies and shareholders of firms they acquired frequently scored positive abnormal returns when these acquisitions were first announced. Moreover, in the wake of these interstate combinations some studies found evidence of postmerger earnings gains, improved cost control, higher employee productivity, and more rapid growth. However, there was also evidence from the earliest interstate acquisitions that market shares and profitability were little different after large interstate banks bought out smaller banking firms across state lines.[6]

Concept Check

19–8. What does recent research evidence tell us about the impact of most mergers in the financial sector?

19–9. Does it appear that most mergers serve the public interest?

Do the managers of financial firms involved in mergers generally regard their efforts as successful? A survey by Rose [9] of nearly 600 U.S. bank mergers asked that very question of the CEOs involved. Overall, no more than two-thirds of the merging institutions believed they had fulfilled their merger expectations. For example, in only about half the cases did profits, growth, market share, or market power actually increase and risk and operating costs fall. Roughly one-third of those seeking more qualified management apparently did *not* find it. However, CEOs at a majority of these merging institutions (at least 80 percent) believed their banks' capital base had improved and they were now more efficient.

Unfortunately, there are absolutely *no* guarantees any merger will be successful, just as there is never any guarantee for any other type of capital investment. A study by Rose [5] of 572 U.S. acquiring banking institutions, purchasing nearly 650 other banks, found a nearly *symmetric distribution* of earnings outcomes from mergers—roughly half registering positive earnings gains and about half displaying negative earnings results. Among those institutions

[5]See especially the studies on mergers and profitability by Pettway and Trifts [4] and Rose [9].

[6]See, for example, Goldberg and Hanweck [2], Millon-Cornett and Tehranian [3], and Spong and Shoenhair [7].

experiencing positive earnings gains, lower operating costs, greater employee productivity, and faster growth appeared to account for at least a portion of the greater earnings achieved. Moreover, part of the higher postmerger returns seemed to be related to increases in postmerger market concentration. This latter outcome suggests that, in some cases, the public may be paying higher prices for services than would prevail in less concentrated (more competitive) markets. If so, regulatory agencies need to take a closer look at proposed mergers for possible evidence of adverse changes in the competitive climate.

Finally, an extensive study on an international scale by Amel, Barnes, Panetta, and Salles [1], published by the Federal Reserve Board, examined the effects of mergers among banks, insurance companies, and securities firms in leading industrialized countries. They found that mergers and acquisitions in the financial sector often seemed to yield operating cost savings (economies of scale), though only for relatively small firms. However, there was little evidence of substantial cost reductions among larger financial firms or of improvements in management quality.

Public Benefits from Mergers and Acquisitions

In what ways does the *public* benefit from mergers? Generally research has found few real benefits from the public's perspective. For example, a survey by Rose [8] asked the CEOs of merging U.S. banks whether there had been any increase in hours of operation in order to provide the public with better access to services. Fewer than 20 percent reported any increase in hours of operation. About one-third changed their pricing policies, but the most common change was a price *increase* following a merger, particularly in checking-account service fees, loan rates, deposit interest rates, and safe-deposit box fees. Research generally finds that financial firms absorbed in a merger change their prices, sooner or later, to match those of the acquiring organization.

One factor that appears to keep price increases following mergers under *some* control at least is *population migration*. For example, loan and deposit interest rates tend to be more favorable for customers in areas where substantial numbers of households and businesses are relocating and, because of this movement, are compelled to seek out new providers for the financial services they need. Unfortunately, the majority of businesses and households move infrequently and usually to a nearby location, generally keeping their working relationship with the same financial firms. This fact of life appears to give merging institutions more latitude to raise prices and limit competition.

On the positive side there is *no* convincing evidence that the public has *suffered* from a decline in service quality or in service availability flowing from most mergers. And there is some evidence that bank failure rates decline in the wake of merger activity. Moreover, crossing state lines seems to be somewhat effective in helping to stabilize asset and equity returns, reducing the chances of insolvency and resulting in lower operating costs. Some smaller businesses may suffer a bit if their principal bank is acquired and they don't yet have a relationship with the new owners (unless they have the clout and flexibility to switch service providers).

Finally, there may be an unexpected procompetitive aspect to merger activity. A recent study by Seelig and Critchfield [18] explores an apparent connection between bank and thrift mergers inside a given market area and an increase in charters to form *new* depository institutions in that same market. In short, mergers and acquisitions tend to stimulate *de novo* entry, suggesting, perhaps, that new competitors are more likely to appear in those markets where merger activity appears to be changing the balance of power. No one is exactly sure why this increase in new financial-firm entry occurs—perhaps mergers anger some customers who quickly look around for new service providers or maybe mergers lead to cost cutting, including firing some employees who then start up new financial firms to challenge their former employers. Whatever the reasons, mergers and acquisitions usually have multiple outcomes and generate a mixture of winners and losers.

Summary

Mergers and acquisitions of financial firms have been a major vehicle for change in the financial-services industry for many decades. This chapter has explored these key points regarding the merger and acquisition process in financial services:

- Mergers and acquisitions in the financial-services field have absorbed thousands of depository institutions, securities firms, insurance companies, finance companies, and other financial firms in recent years. Among the driving forces behind these corporate combinations are changes in legislation and regulation, intense competition, and the continuing search for greater operating efficiency and reduction of risk exposure.
- Mergers in the banking industry, in particular, have been powerfully influenced by changing legislation and regulation as governments around the world have moved to loosen the rules governing the financial marketplace. In the United States the passage of the Riegle-Neal Interstate Banking Act opened up the possibility of nationwide banking through mergers and acquisitions. Subsequently, the Gramm-Leach-Bliley Act permitted merger combinations among banks, security firms, and insurance companies. Parallel financial-service mergers and acquisitions unfolded at about the same time in Europe as the European Union established a common currency and financial system.
- While government deregulation has opened up substantial opportunities for financial-service mergers, key economic and financial forces have encouraged the managers and owners of financial firms to take advantage of these new opportunities. Among the powerful economic and financial forces at work has been the movement of customers to distant markets, encouraging financial firms to expand in order to follow and retain those customers. Moreover, mergers and acquisitions have proven to be a less expensive route for expansion than has the creation of new financial firms or the construction of chains of new branch offices. Finally, the possibility of risk reduction through the processes of geographic diversification (expansion into new market areas) and product-line diversification (expansion into new types of services) has lured many financial-service managers to seek out promising acquisition targets.
- Despite recent deregulation, significant government rules still surround the merger process. A prominent example in the United States is the Bank Merger Act which stipulates that proposed mergers involving banking firms must be approved or denied by each institution's principal federal regulatory agency—the Comptroller of the Currency for national banks, the Federal Deposit Insurance Corporation for U.S.-insured banking firms not members of the Federal Reserve System, or the Federal Reserve for state-chartered banking companies that have established membership in the Federal Reserve System.
- Merger laws in the United States require the Department of Justice (DOJ) to evaluate the competitive effects of any proposed merger. The Department can file suit in federal court to stop any proposed merger that, in its judgment, would have an adverse impact on competition, thereby harming the public interest.
- Mergers and acquisitions are capital investment decisions and, as such, must be carefully examined for their potential economic benefits and costs. If the expected returns are less than the minimum returns sought by each firm's stockholders, the proposed transaction is not likely to be pursued unless other mitigating factors intervene. The key to successful mergers among financial firms involves carefully assessing the strengths and weakness of both the acquirer and the proposed acquisition target and designing a strategy to maximize any synergies that may emerge once the merger is under way.
- Current research on the impact of mergers among financial-service providers comes to very mixed conclusions. While most mergers appear to be profitable, many are either unprofitable or fall disappointingly short of their premerger objectives. Moreover, the

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majority of cases offer meager evidence of public benefits. For example, service charges and fees often rise, rather than fall, following the completion of a merger transaction. However, the menu of financial services offered to the public frequently increases once a merger or acquisition takes place.

Key Terms

profit potential, *626*
cash flow risk, *627*
earnings risk, *627*
tax benefits, *628*
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Problems and Projects

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1. Evaluate the impact of the following proposed mergers upon the *postmerger earnings per share* of the combined organization:
   a. An acquiring bank reports that the current price of its stock is $20 per share and the bank earns $6 per share for its stockholders; the acquired bank's stock is selling for $17 per share and that bank is earning $5 per share. The acquiring institution has issued 200,000 shares of common stock, whereas the acquired institution has 100,000 shares of stock outstanding. Stock will be exchanged in this merger transaction exactly at its current market price. Most recently, the acquiring bank turned in net earnings of $1,200,000 and the acquired banking firm reported net earnings of $300,000. Following this merger, combined earnings of $1,600,000 are expected.
   b. The financial firm to be acquired is currently earning $14 per share, and its acquirer is reporting earnings of $12 per share. The acquired firm's stock is trading in today's market at $27 per share, while the acquiring firm's stock exchanges today for $24 per share. The acquired institution has 75,000 shares outstanding; the acquiring institution, on the other hand, has issued 80,000 shares of common stock. The combined organization is expected to earn $900,000; before the merger, the acquired firm posted net earnings of $400,000 and the acquiring firm tallied net earnings of $600,000.

excel

2. Under the following scenarios, calculate the *merger premium* and the *exchange ratio:*
   a. The acquired financial firm's stock is selling in the market today at $10 per share, while the acquiring institution's stock is trading at $16 per share. The acquiring firm's stockholders have agreed to extend to shareholders of the target firm a bonus of $5 per share. The acquired firm has 30,000 shares of common stock outstanding, and the acquiring institution has 50,000 common equity shares. Combined earnings after the merger are expected to remain at their premerger level of $1,250,000 (where the acquiring firm earned $1,000,000 and the acquired institution $250,000). What is the postmerger EPS?
   b. The acquiring financial-service provider reports that its common stock is selling in today's market at $25 per share. In contrast, the acquired institution's equity shares are trading at $20 per share. To make the merger succeed, the acquired firm's shareholders will be given a bonus of $1 per share. The acquiring institution has 120,000 shares of common stock issued and outstanding, while the acquired firm has issued 40,000 equity shares. The acquiring firm reported premerger annual earnings of $850,000, and the acquired institution earned $150,000. After the merger, earnings are expected to decline to $900,000. Is there any evidence of dilution of ownership or earnings in either merger transaction?

3. The Goldmore metropolitan area is presently served by five depository institutions with total deposits as follows:

	Current Deposits
Goldmore National Bank	$840 million
Goldmore County Merchants Bank	600 million
Commerce National Bank of Silverton	395 million
Rocky Mountain Trust Company	200 million
Security National Bank and Trust	107 million

Calculate the Herfindahl-Hirschman Index (HHI) for the Goldmore metropolitan area. Suppose that Rocky Mountain Trust Company and Security National Bank propose to merge. What would happen to the HHI in the metropolitan area? Would the U.S. Department of Justice be likely to approve this proposed merger? Would your conclusion change if the Goldmore County Merchants Bank and the Rocky Mountain Trust Company planned to merge?

4. Space Savings Association has just received an offer to merge from Courthouse County Bank. Space's stock is currently selling for $58 per share. The shareholders of Courthouse County agree to pay Space's stockholders a bonus of $10 per share. What is the merger premium in this case? If Courthouse County's shares are now trading for $85 per share, what is the exchange ratio between the equity shares of these two institutions? Suppose that Space has 10,000 shares and Courthouse County has 30,000 shares outstanding. How many shares in the merged firm will Space's shareholders wind up with after the merger? How many total shares will the merged company have outstanding?
5. The city of Gertrude is served by three banks, which recently reported deposits of $230 million, $180 million, and $65 million, respectively. Calculate the Herfindahl index for the Gertrude market area. If the second and third largest banks merge, what would the postmerger Herfindahl index be? Under the Department of Justice guidelines discussed in the chapter, would the Justice Department be likely to challenge this merger?
6. In which of the situations described in the accompanying table do stockholders of both acquiring and acquired firms experience a gain in earnings per share as a result of a merger?

	P-E Ratio of Acquiring Firm	**P-E Ratio of Acquired Firm**	**Premerger Earnings of Acquiring Firm**	**Premerger Earnings of Acquired Firm**	**Combined Earnings after the Merger**
A.	5	3	$ 750,000	$425,000	$1,200,000
B.	4	6	$ 470,000	$490,000	$ 850,000
C.	8	7	$ 890,000	$650,000	$1,540,000
D.	12	12	$1,615,000	$422,000	$2,035,000

7. Please list the steps you believe should contribute positively to success in a merger transaction in the financial-services sector. What management decisions or goals? On average, what proportion of mergers among financial firms would you expect would be likely to achieve the goals of management and/or the owners and what proportion would likely fall short of the mergers' objectives? Why?

Internet Exercises

1. You are interested in the mergers and acquisitions that are reshaping the financial services industry. Visit **www.innercitypress.org/bankbeat.html** and you will get more recent news than you want to read in one sitting. If you are using Internet Explorer, click Edit button, then use the Find command to look for the word *merger*. What are the newsworthy merger announcements?

Assignment for Chapter 19

A LOOK AT YOUR BANK'S USE OF MERGERS FOR EXPANSION

The overall number of BHCs and banks is decreasing due to consolidation within the industry and convergence across different financial-services industries. In this assignment we will examine the history of your bank in the context of mergers and acquisitions. With mergers and acquisitions, the acquisition may take place through the BHC or one of its subsidiary banks.

An Examination of How Your Bank Evolved

A. You will need to go back to your informational spreadsheet created in Chapter 2 and view the names of the banks listed as part of your BHC. You will want to check the history of the BHC and each bank. Go to the National Information Center at **www.ffiec.gov/nic/pubweb/nicweb/nichome.aspx** and click on the "Top 50" BHC link. Focus on all mergers occurring since January 1, 2000. Collect information on your BHC and each bank within your BHC, who acquired whom and when, noting the state of the target institution.

B. Choose one or more acquisitions and search for press releases on your BHC's Web site.

C. Focusing on the chosen acquisition, go to a search engine such as **www.alltheweb.com** and do a news search.

D. Using the data you found and the press releases and any news articles collected, compose several paragraphs describing your BHC's acquisitions and providing inferences concerning your BHC's merger strategy. Remember to reference your sources of information.

2. *Consolidation* refers to a declining population of businesses in any one industry. Visit **www.financialservicesfacts.org/financial/**, click the Financial Services Industry Button, and explore the link for mergers. Discuss the number of financial-service mergers by industry.
3. *Convergence* refers to the movement of two or more industries over time toward each other, resulting in different firms offering many of the same services. Visit **www.financialservicesfacts.org/financial/** and explore the link on convergence. How do the service offerings of large banks compare with securities firms? How do banks compare with insurance firms?
4. Which ingredients appear to be associated with a successful merger or acquisition? Go to **www.snl.com/bank/manda/** and read everything available on the SNL merger model. What are the important factors?
5. Which ingredients appear to be associated with a successful nonbank financial-services merger or acquisition? Go to **www.snl.com/financial_svc/manda/** and read one of the latest merger and acquisition stories from the M&A story archives. What are the important factors?

S&P Market Insight Challenge (www.mhhe.com/edumarketinsight)

STANDARD &POOR'S

1. The banking and thrift industries have been in a consolidation mode—fewer but larger companies—for years. Recent information concerning acquisitions and mergers in these industries may be found using the Industry tab in S&P's Market Insight, Educational Version. A drop-down menu displays such industry groups as Diversified Banks, Regional Banks, and Thrifts & Mortgage Finance. By choosing these particular industry groups you will be able to find the S&P Industry Survey on Banking as well as the survey covering savings and loans. Please download both of these industry surveys and explore the parts labeled "Industry Profile" and "Industry Trends." Please describe the most recent trends in mergers and discuss their underlying motivations.

STANDARD &POOR'S

2. Please examine closely the list of bank holding companies, investment banking or security/broker dealer firms, finance companies, and life and property/casualty insurers listed on S&P's Market Insight, Educational Version. Which of these companies have engaged in a significant merger or acquisition within the past three years? Which have

been acquired themselves within that time span by a bank or nonbank business? (Prominent examples include Citigroup, HSBC Holdings PLC, Bank of America, Salomon Smith Barney, Aetna Life and Casualty, and Household International among many others on the Insight list.)

3. As this chapter relates, business mergers and acquisitions, including those in the financial sector, frequently result in disappointing financial and operating performance. Can you cite any examples in the financial-services group of firms on Standard & Poor's Market Insight experiencing disappointing postmerger or postacquisition performance? What reasons can you cite for the disappointing performance results?

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CHAPTER TWENTY

International Banking and the Future of Banking and Financial Services

Key Topics in This Chapter

- Types of International Banking Organizations
- Regulation of International Banking
- Foreign Banking Activity in the United States
- Services Provided by International Banks
- Managing Currency Risk Exposure
- Challenges for International Banks in Foreign Markets
- The Future of Banking and Financial Services

20–1 Introduction

Banks were not only among the first financial institutions to appear in history but also were among the first financial firms to venture into international markets and offer their services in distant locations. The first banks were located principally in global trading centers around the Mediterranean, including Athens, Cairo, Jerusalem, and Rome, aiding merchants in financing shipments of raw materials and goods and exchanging one nation's coin for that of another to assist travelers. Much later, during the colonial period of American history, foreign banks based in Europe entered the Americas and met a large share of the financing needs of American businesses.

United States banks established a significant beachhead in Europe and elsewhere around the globe as the 20th century opened. This was followed by a dramatic expansion in the 1950s and 1960s as U.S. banks set up branch offices, subsidiaries, and joint ventures with local firms in hundreds of foreign markets. This period of foreign expansion was directed mainly at the commercial centers of Western Europe, the Middle East, and South and Central America. During the 1970s and 1980s American banks expanded their presence around the Pacific Rim, especially in Japan, Hong Kong, and Singapore. American, European, and Japanese multinational banks played a key role in investing the huge amounts of funds flowing to petroleum producers as world oil prices

Key URLs
To stay abreast of developments in international banking around the globe financial managers often consult such sources as the Bank for International Settlements at **www.bis.org** and the World Bank and International Monetary Fund libraries at **jolis.worldbank imflib.org/external.htm.**

rose. American banks were also called upon to help finance the huge trade deficits that the United States has incurred in purchasing a growing number of goods and services from abroad.

For a time, the torch of leadership in international banking passed to the Japanese, whose banks established strong beachheads in London, New York, and other financial centers around the globe. At the same time, growth of international banking firms in the United States and Western Europe slowed markedly. Intensified competition, spurred on by deregulation among the governments of Great Britain, the United States, and other leading nations and by significant advances in communications technology, forced many international financial firms to reduce their physical presence in foreign markets in order to cut operating expenses. Moreover, many of their principal credit customers, especially nations like Argentina and Brazil, were experiencing serious problems, fueling the retrenchment of international banking around the globe.

As the 21st century approached, leadership in financial services passed once again to American and European banks and many of their nonbank financial-service competitors, led by such giants as Citigroup, Bank of America, HSBC, UBS, J. P. Morgan Chase, Barclays PLC, ING Group, and Deutsche Bank. These banking giants began to carve out a major share of the rapidly developing Asian markets, especially China, thus circling the globe. International financial services today continue to be vitally important sources of revenue and earnings for leading financial firms around the world.

In this chapter we take a close look at the organizational forms, services, problems, and challenges facing large international banking and financial-service organizations today.[1]

20–2 Types of International Banking Organizations

Filmtoid
What 2001 action film starring John Travolta and Halle Berry concludes with the transfer of billions of dollars to a Credit Suisse account in a Grand Cayman branch as a result of cyber crime meeting the fight against terrorism?
Answer: *Swordfish.*

In their pursuit of business around the world, banks use a wide variety of *organizational structures* to deliver services to their customers (as illustrated in Exhibit 20–1).

Representative Offices

The simplest organizational presence for a bank active in foreign markets is the **representative office**—a limited-service facility that can market the services supplied by the home office and identify new customers but does not take deposits or book loans. These offices supply support services both to the parent bank and its customers.

Agency Offices

Somewhat more complete than the representative office is an **agency office,** which in many jurisdictions does not take deposits from the public, but extends commitments to make or purchase loans, issues letters of credit, provides technical assistance and advice to customers, administers their cash accounts, and assists with customer security trading.

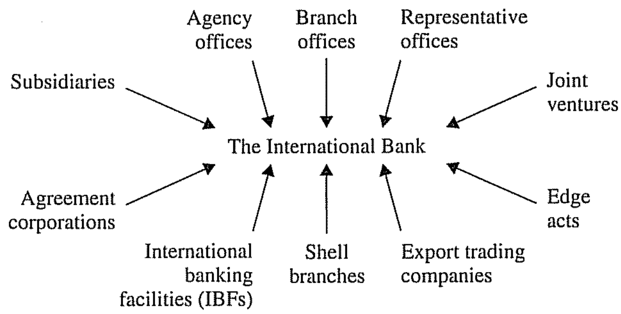
Branch Offices

The most common organizational unit for most international banks is the **branch office,** normally offering a full line of services. Foreign branches are *not* separate legal entities, but merely the local office that represents a single large financial-service corporation. They can accept deposits from the public subject to regulations of the country where they are located and may escape some of the rules for deposit taking faced by branches of the same bank in its home country. For example, the branch offices of U.S. banks overseas do not have to post legal reserve requirements or pay FDIC insurance fees on the deposits they accept abroad.

[1]Portions of this chapter are based on Peter S. Rose's article in *The Canadian Banker* [2] and are used with the permission of the publisher.

EXHIBIT 20–1
Types of International Banking Organizations and Facilities

International Banking Service Options



Subsidiaries

When an international bank acquires majority ownership of a separate, legally incorporated foreign bank, the foreign bank is referred to as a **subsidiary.** Because a subsidiary possesses its own charter and capital stock, it will not necessarily close down if its principal owner fails. Similarly, a subsidiary can be closed without a substantial adverse effect on the international bank that owns it (as happened in the Philippines when a subsidiary of New York's Citicorp closed several years ago). Subsidiaries may be used instead of branches because local regulations may prohibit or restrict branching or because of tax advantages. Also, many international banks prefer to acquire an existing firm overseas that already has an established customer base.

Joint Ventures

A bank that is concerned about risk exposure in entering a new foreign market, lacks the necessary expertise and customer contacts abroad, or wishes to offer services prohibited to banks alone may choose to enter into a **joint venture** with a foreign financial firm, sharing both profits and expenses.

Edge Act Corporations

Edge Acts are domestic U.S. companies owned by a U.S. or foreign bank, but located outside the home state of the bank that owns them. These subsidiary corporations are limited primarily to international business transactions. Federal legislation passed at the end of World War I permitted banks large enough to post the required capital to apply for Edge Act charters from the Federal Reserve Board.

Agreement Corporations

These business corporations are subsidiaries of a bank organized under Section 25 of the Federal Reserve Act. Agreement corporations must devote the bulk of their activities to serving international customers, similar to Edge Act corporations.

IBFs

An **international banking facility (IBF)** is a creation of U.S. banking regulations, first authorized by the Federal Reserve Board in 1981. IBFs are computerized account records that are not part of the domestic U.S. accounts of the bank that operates them. They must be domiciled inside U.S. territory and focus upon international commerce. Deposits placed in an IBF are exempt from U.S. deposit reserve requirements and deposit insurance fees. IBFs may be operated by either U.S.-chartered banks or by banks foreign to the United States.

Factoid
Of the roughly 8,000 U.S. insured banks, how many actually operate foreign offices?
Answer: Only about 100 or less than 2 percent of the industry.

Shell Branches

In order to escape the burden of regulation, many international banks have established special offices that merely record the receipt of deposits and other international transactions. These **shell branches** may contain little more than a desk, a telephone, fax machine, and computer where deposits from the worldwide Eurocurrency markets are booked to avoid deposit insurance assessments, reserve requirements, and other costs incurred when a domestic bank accepts deposits. Many international banks have operated shell branches for years in such attractive offshore locations as the Bahamas and the Grand Cayman Islands.

Export Trading Companies (ETCs)

In 1982, the U.S. Congress passed the **Export Trading Company Act** (ETCA), which allowed U.S. banking firms and Edge Act corporations to create **export trading companies** (ETCs). According to Federal Reserve regulations, these specialized firms must receive over half their income from activities associated with exporting goods and services from the United States. An ETC can offer such services as export insurance coverage, transportation and warehousing of salable products, trade financing, and research into markets abroad.

Concept Check

20–1. What organizational forms do international banks use to reach their customers?

20–2. Why are there so many different types of international organizations in the financial institutions' sector?

20–3 Regulation of International Banking

International banking activities are closely regulated by both home and host countries all over the globe. However, a strong trend today is toward deregulation of banking and the related fields of securities brokerage and securities underwriting. An increasing number of nations today recognize the necessity of coordinating their regulatory activities so that eventually all financial firms serving international markets will operate under similar rules, called *harmonization*.

Goals of International Banking Regulation

International banking activities are regulated for many of the same reasons that shape domestic banking regulations. There is an almost universal concern for *protecting the safety of depositor funds*, which usually translates into laws and regulations restricting risk exposure and rules specifying minimum amounts of owners' equity capital to serve as a cushion against operating losses. Regulations frequently limit nonbanking business activities to avoid excessive risk taking and criminal activity, as in the famous Bank of Credit and Commerce International (BCCI) case in the early 1990s. Then, too, to the extent international banks can create money through lending and deposit-creating activities, international banking activity is regulated to *promote stable growth in money and credit* in order to avoid threats to economic health in individual nations.

Key URL
If you are interested in exploring the job opportunities in international banking, see, for example, **www.bankstaffers.com**.

However, many international banking regulations are unique to the international field itself—they don't apply to most domestic banking activity. For example, *foreign exchange controls* prohibit the export of domestic currency in order to protect a nation against loss of its foreign currency reserves, which might damage its prospects for repaying international loans and purchasing goods and services abroad. Another instance would be rules that *restrict the outflow of scarce capital* that some governments see as vital to the health of their domestic economies. There is also a strong desire in many parts of the world to *protect domestic financial institutions and markets from foreign competition*. Many countries prefer to avoid international entanglements and excessive dependence on other countries for vital raw materials and other goods and services. This isolationist philosophy often leads to outright prohibition of outsiders from entry.

U.S. Banks' Activities Abroad

American banks operate large numbers of agencies, branches, and other service facilities in overseas markets. According to data provided by the Federal Reserve Board—the chief regulator of both U.S. bank activities overseas and foreign bank activities inside the United States—there were 71 U.S. chartered banks operating 768 full-service branch offices in foreign markets by the end of 2005. When U.S. banks' foreign subsidiaries and other international facilities were combined with their full-service branches more than 100 American banks held nearly a trillion dollars in assets and almost $900 billion in deposits through their overseas offices.

Loans extended to foreigners and foreign deposits received by U.S.-based international banks were concentrated most heavily in Europe (especially in Great Britain, Germany, and Switzerland), in Asia (particularly in China and Japan), and in the Caribbean (especially in the Bahamas and the Cayman islands). These areas of the world represented the richest sources of loan demand, deposit growth, and fee income for America's multinational banking firms.

Expansion and Regulation of Foreign Bank Activity in the United States

Key URLs
Two of the chief sources of international banking statistics today are the Bank for International Settlements at **www.bis.org/publ** and the Federal Reserve System at **www.federalreserve.gov**.

In recent years foreign bank expansion inside the United States has been about as extensive as American banks reaching abroad. Foreign banking entities have sought solid footholds inside U.S. territory for decades, attracted by the huge size of the common market formed by the 50 states, the economic and political stability inside the United States, and the migration of foreign banks' own customers toward the Americas (e.g., foreign-owned auto and electronic firms setting up manufacturing plants on American soil).

By year-end 2005 183 foreign banks headquartered in 54 different countries operated close to 300 agency, branch, and representative offices as well as other financial-service facilities inside the United States. In addition, foreign banks held an ownership (equity) interest of at least 25 percent in about 70 U.S. commercial banks. The U.S. offices of foreign banks accounted for 18 percent (or about one-fifth) of the total assets held by all U.S. banks combined.

Foreign banks operating in the United States are controlled by more than 200 corporate families, led by such international giants as Barclays and HSBC of Great Britain, Credit Lyonnais from France, and Germany's Deutsche Bank. Most of these foreign-owned facilities are based in New York with substantial additional units centered in San Francisco, Los Angeles, Chicago, and Atlanta. These facilities are examined at least once every 18 months by U.S. federal and state regulators to determine if they pose substantial risks to the American banking system.

Recently foreign bank expansion in the United States has slowed somewhat, especially in the years following the 9/11 terrorist tragedy. Some of the slowdown has been traceable to slower growth in the world economy, particularly in Europe. Then, too, government deregulation of domestic U.S. banking has permitted American financial firms to be more aggressive competitors and recapture some of the market share they had previously lost to foreign financial firms.

The International Banking Act of 1978

The expansion of foreign banking activity inside America's borders led to strong pressure on the U.S. Congress by domestic banking groups and, eventually, to passage of the **International Banking Act** (IBA) of 1978—the first major federal law regulating foreign bank activity in the United States. The IBA's key components included:

- It required branches and agency offices of foreign banks to secure federal licenses for their U.S. operations.
- It restricted foreign branching within the United States, requiring each bank to designate a home state and follow that state's branching rules just as American banks had to do.
- It stipulated that deposits accepted at the U.S. branch or agency offices of foreign banks holding $1 billion or more in consolidated assets are subject to legal reserve requirements determined by the Federal Reserve Board.
- It made U.S. branches of foreign banks eligible for deposit insurance under stipulated conditions and granted them access to certain Federal Reserve services, such as the ability to borrow from the Federal Reserve banks.

The Foreign Bank Supervision Enhancement Act of 1991

Key URL
To learn more about the activities of foreign banks in the United States see, for example, the Institute of International Bankers at **www.iib.org**.

On December 19, 1991, Congress amended the IBA with passage of the **Foreign Bank Supervision Enhancement Act.** This law placed tighter controls on foreign bank operations in the United States. Applications from foreign banks to expand their U.S. banking activities must be approved by the Federal Reserve Board. Service offerings of foreign banks are basically limited to the same list of banking services that U.S. national banks are permitted to offer. Moreover, no foreign bank can accept retail deposit accounts of less than $100,000 from the public unless it first obtains insurance coverage from the FDIC. Any foreign bank desiring to acquire more than 5 percent of the voting shares of a U.S. bank company must first seek Federal Reserve Board approval.

The Federal Reserve must also review how thoroughly foreign banks are supervised by their home countries. If the Fed determines that regulation of a foreign bank by that bank's home nation is inadequate, it can deny that foreign bank permission to establish a branch, agency, or representative office inside United States territory or to start or acquire any U.S. subsidiary firms. Moreover, the Fed can terminate the operations of a foreign bank if it finds that bank has violated U.S. laws, engaged in unsafe or unsound banking practices, or is not being operated in a manner consistent with the public interest. The 1991 law empowered the Fed to examine the U.S. offices and affiliates of *any* foreign bank and stipulated that the Fed must be notified a minimum of 30 days in advance if a foreign bank wishes to close any of its U.S. offices.

New Capital Regulations for Major Banks Worldwide

Key URL
To learn more about the Russian banking system see, for example, the Web site of the Russian Federation's Central Bank at **www.cbr.ru/eng**.

The spread of international banking coupled with international debt problems soon led to new regulatory standards for the capital that international banks must hold as a buffer against risk. First, in November 1983, the U.S. Congress passed the **International Lending and Supervision Act,** which required federal regulatory agencies to prepare capital and lending rules for U.S.-supervised banks. The 1983 law required American banks to restrict the size of fees charged for rescheduling payments on loans made overseas in order to avoid excessive burdens on debtor countries, report their foreign loan exposures to bank examiners, and hold adequate reserves to protect depositors against possible losses on foreign loans.

Soon after these rules were implemented, negotiations began between the United States and other leading nations to determine if international cooperation in banking regulation was possible. Finally, on July 15, 1988, representatives of 12 nations announced an agreement in Basel, Switzerland, on common bank capital standards.

Real Banks, Real Decisions

RUSSIAN BANKING: RECOVERY AND RENEWAL

The Russian banking system experienced the equivalent of a Chernobyl nuclear meltdown in 1998. Hundreds of banks failed and thousands of depositors lost confidence in the banking system, many stashing their cash in the proverbial "cookie jar" rather than risking the loss of still more of their savings. If this were not enough, another crisis appeared in 2004 as several banks closed and depositors lined up demanding their funds, while the Bank of Russia rushed to inject liquidity into the system.

Today the Russian banking system has several problems: too many banks (about 1300), too much government control, too little public trust, too few business loans, and a general lack of quality employee training. However, a *new* banking system continues to evolve out of the ashes of the old as aggressive managers pursue what remains of a potentially lucrative market, especially among young adults, many of whom have high-paying jobs and need credit and an efficient way to pay for their purchases (including credit and debit cards). New banking market leaders have emerged, such as Alfa Bank, MDM Bank, and Rosbank as well as Citibank from the United States. There is also an expansion of customer-service facilities under way, including new branch offices, more ATMs, and the growing use of online banking. Russia's great size and "underbanked" population appear to offer great marketing opportunities for international banks.

The **Basel Agreement,** as we saw earlier in Chapter 15, called for all banks to achieve a minimum total-capital-to-total risk-adjusted assets ratio of 8 percent. The announced purpose of the Basel Agreement was twofold: (1) to strengthen international banks, thereby strengthening public confidence in them; and (2) to remove inequalities in regulation between nations that contribute to competitive inequalities between their banks. In the wake of the Basel Agreement, many leading banks announced plans to raise new capital and sell off assets to improve their capital positions. Most recently a second phase of the Basel Agreement has appeared, requiring leading international banks to develop risk models to determine their individual risk exposures and capital needs.

Concept Check

20–3. What are the principal goals of international banking regulation?

20–4. What were the key provisions of the U.S International Banking Act of 1978 and the International Lending and Supervision Act of 1983?

20–5. Explain what the Basel Agreement is and why it is so important.

20–4 Services Supplied by Banks in International Markets

Customers active in foreign markets require a wide variety of services, ranging from credit and the execution of payments to the provision of marketing assistance (see, for example, Table 20–1). The variety of services international banks and their strongest competitors offer has expanded significantly in response to evolving customer needs and intense international competition.

Making Foreign Currencies Available to Customers

International banks supply foreign currency—**FOREX**—to their customers. Many customers require sizable quantities of spendable currencies to pay for imported goods and raw materials, to purchase foreign securities, and to complete mergers and acquisitions.

TABLE 20–1
Key Customer Services Offered by International Banks

Key Elements of The International Bank Service Menu	
Supplying foreign currencies to customers	Supplying long- and short-term credit and credit guarantees
Hedging against foreign currency risk	Payments and cash management services
Security underwriting for corporations	Savings or thrift instruments
Hedging against interest rate risk	Foreign marketing assistance for customers

Other customers may receive large amounts of foreign currency or foreign-currency–denominated deposits from businesses and individuals abroad who buy their products or purchase their securities. These foreign funds must be exchanged for domestic currency and deposits to help the customer meet his or her own cash needs. International banks routinely hold working balances of those foreign currencies most in demand.

Top Trading Firms Operating in Today's Global Currency Markets

Citigroup, Inc.	UBS Warburg	J. P. Morgan Chase & Company
Deutsche Bank AG	Morgan Stanley Group	Goldman Sachs Group, Inc.
Credit Suisse-First Boston Corp.	ABN AMRO Bank	HSBC Holdings PLC

Recently there has been a sharp increase in FOREX trading activity among leading commercial and investment bank dealers due to volatility among leading currencies, especially the U.S. dollar, the pound, and the euro. Trading volume now exceeds a trillion dollars a day and is climbing, making this market one of the largest on the planet. Somewhat unique is the recent upsurge in *proprietary trading* where dealers speculate on trends in the prices of selected currencies. Revenues from currency trading seem to behave somewhat differently than revenues from other services, frequently improving while other markets are down. However, bid-ask spreads among dealers have narrowed substantially in today's marketplace, which favors high-volume trading businesses.

Hedging against Foreign Currency Risk Exposure

Customers who deal with large amounts of foreign currencies look to international banks for protection against *currency risk*—the potential for loss due to fluctuations in currency prices (exchange rates). But customers are not the only ones who face currency risk; international banks themselves must deal with currency risk.

Currency risks arise most often in international banking when (*a*) making foreign-currency–denominated loans to customers, (*b*) issuing foreign-currency–denominated IOUs (such as deposits) to raise new funds, (*c*) purchasing foreign-issued securities, or (*d*) trading in foreign currencies for a bank's own currency position as well as the currency needs of its customers. The *net exposure* of a bank or its customers to fluctuations in currency values can be determined from the following equation:

$$\begin{array}{c}\text{Net exposure to}\\ \text{risk from any}\\ \text{one currency}\end{array} = \overbrace{\left[\begin{array}{c}\text{Assets held that are}\\ \text{denominated in the}\\ \text{currency}\end{array} - \begin{array}{c}\text{Liabilities issued in}\\ \text{the currency}\end{array}\right]}^{\text{Net foreign-currency–denominated assets}} \quad \textbf{(20–1)}$$

$$+ \overbrace{\left[\begin{array}{c}\text{Volume of the}\\ \text{currency purchased}\end{array} - \begin{array}{c}\text{Volume of the}\\ \text{currency sold}\end{array}\right]}^{\text{Net position in foreign currency}}$$

THE JAPANESE FINANCIAL SYSTEM STILL FACES BIG PROBLEMS

The Japanese financial system is one of the largest in the world with more than a thousand depository institutions (including banks and cooperatives), nearly a hundred insurance companies, and well over 200 securities firms. But despite its great size and complexity the Japanese system continues to struggle after more than a decade of faltering consumption and investment spending, rising unemployment, price deflation, and deterioration in the viability of many of its financial institutions.

Desperate to find effective countermeasures to these problems the Bank of Japan pushed key domestic interest rates down toward zero in an effort to stimulate borrowing and spending and set in motion an economic recovery. As the 21st century began to unfold some signs of recovery began to appear, though Japan still has a long way to go.

These economic and financial problems have been especially perplexing because more than a decade ago the Japanese system was the envy of the world. Its economy was characterized by surging property values and a massive balance of payments surplus with the rest of the world, which couldn't get enough Japanese cars, TVs, and other electronic devices. A high domestic savings rate fueled massive Japanese investment abroad, including the acquisition of huge amounts of U.S. property. By the late 1980s at least 16 of the world's top 20 banks were Japanese.

All of these positive trends were turned around during the 1990s and early in the 21st century. Japanese stocks fell to less than a quarter of their peak values, while land prices plummeted to a third of their earlier heights. These massive declines led to the collapse of hundreds of bank and nonbank firms, which were pulled down by the combined assault of bad loans, falling stock and real estate prices, and rapidly eroding capital cushions. Because many Japanese banks hold a huge volume of corporate stock associated with loans to their borrowing customers and also have large amounts of "paper" capital in the form of estimated future tax credits, they have relatively weak defenses against economic adversity. Moreover, Japanese banks seem to attract somewhat riskier borrowers than do competing foreign banks. This risk-exposure problem appears to be exacerbated by weak marketplace disciplining of Japanese bank behavior (in part, because most deposits are fully covered by insurance).

In need of more capital to offset loan losses several of Japan's leading banks have pulled back somewhat from international banking activities and declared themselves to be domestic banking firms once again. Pleas for government help in the form of injections of new bank capital led the Japanese government to become proactive in using taxpayer funds to shore up the domestic financial system. Financial firms receiving aid had to pledge to make fundamental changes in their operations and financing, including cleaning up bad loans and searching for new sources of private capital.

At the same time, the Japanese government began borrowing heavily to flood the economy with liquidity and shore up depressed stock and bond markets. The Bank of Japan purchased the depressed stock of some Japanese companies from the banks that held these shares. In the wake of these expensive measures to rescue Japan's economy, the nation's public debt mushroomed to over 100 percent of its GDP.

Troubled Japanese banks have been asked to scale back their overseas ventures in hopes of shoring up the domestic supply of credit. However, in today's open international economy this has had the effect of transferring some of Japan's problems to other nations, especially in Asia. On the other side of the coin, however, if the Japanese economy continues to recover as the 21st century unfolds, it will not only greatly strengthen the domestic banking system, but it will also help recapitalize much of the remainder of Asia and foster economic growth there and in other parts of the world.

An international bank or bank customer with a *positive* net exposure in a given foreign currency—that is, whose net foreign-currency–denominated assets plus its net foreign-currency position is greater than zero—is said to be *net long* in that particular currency. This condition may arise because the bank or its customer has more foreign-currency–denominated assets than liabilities, has purchased more of a foreign currency than it has sold, or both. If the foreign currency involved declines in value relative to the value of the domestic currency, the bank or its customer will suffer a loss due to its net long position in that particular currency.

Key URL
To learn about the Japanese banking and financial system, see especially **www.zenginkyo.or.jp/en/index.html**.

For example, suppose J. P. Morgan Chase holds assets denominated in euros of 100 million and liabilities of 60 million. Its euro purchases in the most recent period amounted to 50 million while its euro sales reached 40 million. This represents an exposure to fluctuations in the exchange value of euros of:

Net exposure to risk from a position in euros
= (100 million euros − 60 million euros) + (50 million euros − 40 million euros)
= + 50 million euros

Should the euro decline in value relative to U.S. dollars, for example, J. P. Morgan would experience a loss from its sizeable net long position in euros unless offset by the use of currency hedging tools, such as currency futures or options. On the other hand, a bank or bank customer may have a *negative* net exposure in a given foreign currency, indicating that its net foreign-currency–denominated assets plus net foreign-currency position is less than zero. This may occur because the bank's or the customer's liabilities in a given foreign currency are greater than its assets denominated in that same currency, or the volume of the currency sold exceeds the amount purchased or both. In this instance the international bank or its customer is said to be in a *net short* position in that particular currency. If the currency involved increases in value against the international bank's or customer's home currency, a loss will occur in a net short position. In general, the more volatile a currency is, the greater the possibility for scoring gains or for experiencing losses from any given currency position.

Factoid
Internet-based banks got their start in Japan in the year 2000 with the creation of *Japan Net Bank*, backed by Sumitomo Mitsui Banking Corporation, Fujitsu, and Nippon Life Insurance. Less than a year later Sony Bank and eBank were formed, with the latter communicating with customers both over the Internet and through portable phones.

Research evidence (see, for example, Hopper [9]) suggests that currency exchange rates are not consistently predictable and show no reliable connection to such fundamental factors as money supply growth and output in different countries—two forces that finance theory suggests should help to explain relative currency-price movements. Accordingly, international banks typically employ a wide variety of currency-hedging techniques to help shelter their own and their customers' risk exposure. The most widely used of these currency-risk management techniques include forward contracts, currency futures and option contracts, currency warrants, and currency swaps.

Forward Contracts

For example, international banks may use **forward contracts,** in which a customer anticipating a future need to make currency purchases will work through the bank to negotiate a contract calling for the delivery of currency at a stipulated price on a specific future date. On the other hand, customers expecting to *receive* currency will often seek out contracts to sell that currency at a prespecified price. Because the price is set at the opening of a forward contract, the customer is protected from currency risk no matter which way currency prices go. If the customer is uncertain of the future date and the amount of currency involved, the international bank may provide an *option forward contract*, in which the customer receives the right, but not the obligation, to deliver or take delivery of specific currencies on a future date at an agreed-upon exchange rate.

Currency Futures Contracts

An increasingly popular alternative to the forward contract among banks and their customers is a **currency futures contract.** These contractual agreements promise delivery of stipulated currencies at a specified price on or before a terminal date. The two basic futures contract types are long hedges and short hedges.

Long hedges in currency futures are designed to protect an international bank's customer from increases in the price of the currency the customer must eventually acquire. They are particularly useful for *importers*, because payment for goods received often must be made in the foreign exporter's home currency, and a rise in the exchange rate between the exporter's home currency and the importer's home currency can quickly eliminate any profit on the sale of goods. Under a long hedge contract, the customer pledges to take delivery of currency at contract maturity for price X. If currency prices subsequently rise, the customer can go back to the currency futures market and sell similar currency futures contracts at the new higher price, Y. This cancels out the customer's obligation to take delivery of currency and, at the same

Factoid

In Japan, the second largest economy in the world, banks play a considerably larger role than in the United States and in many other industrialized economies as well, accounting for about 60 percent of all fund-raising and all loans made in Japan. Therefore, troubles in the Japanese banking industry can have very profound effects on the rest of the Japanese economy.

time, generates a trading profit on each contract equal to the price difference (Y – X) less any commission charged and taxes. Profits made on currency futures help to offset any loss that arises when the customer must actually acquire the currency and pay for the imported goods.

Alternatively, many international customers, especially those *exporting* goods, find *short-hedge* futures contracts useful. These agreements require the customer to pledge delivery of a stipulated currency at a guaranteed price, X, to a counterparty on the maturity date. If currency prices subsequently fall, the customer can enter the futures market again on or before the first contract's maturity date and buy similar contracts at the lower price, Y, thus eliminating the responsibility to deliver currency. A profit is earned on each contract first sold and then bought equal to X – Y (minus taxes and transactions costs).

Other Tools for Reducing Currency Risk

The Development of Currency Options

The **currency option** gives a buyer the right, though not the obligation, to either deliver or take delivery of a designated currency or foreign-currency–denominated futures contract at a set price any time before the option expires. Thus, unlike the forward market, where delivery must take place on a certain date, actual delivery may not occur in the option market. Currency options include both spot and futures options.

Exchange-traded currency options on futures contracts have been growing rapidly in recent years. These contracts depend for their value on the underlying futures contract, which in turn depends on the price of the currency itself. When the price of a currency rises, the nearest-term currency futures contract also rises in price. An international bank holding sizable assets denominated in that currency can reduce the risk of loss from falling currency spot prices by selling currency futures or by buying put options or selling call options for that same currency.

Call currency options give their holder the right to purchase currency or currency futures contracts at a fixed price any time before the option expires. *Put* currency options represent the right to sell currency or currency futures contracts at a specified price on or before the published expiration date. For example, a call on euro futures contracts at a strike price of $0.92 gives the buyer of this call option the right to buy a contract calling for delivery of euros at a price of $0.92 to the buyer. If the market price of euro futures climbs above $0.92 per euro, the call option is said to be "in the money," and its buyer will exercise his or her option and take delivery of euro futures contracts at a price of $0.92. On the other hand, if euro futures stay below a strike price of $0.92, the call option will go unexercised because the buyer of the call can purchase futures contracts more cheaply in the market; in this case, the call option would be "out of the money." Generally, a put option is needed to protect against a fall in currency prices, whereas call options protect against loss from rising currency prices.

The advantage of the currency option is that it limits downside risk but need not reduce upside profits. The purchase price of a currency option is normally low enough to permit even small firms to participate in currency-hedging activities.

Currency Swaps

Finally, currency risk can be reduced with **currency swaps.** A currency swap is a contract between two parties—often two borrowers who have borrowed money denominated in different currencies—to exchange one currency for another and thereby help reduce the risk of loss as currency prices change. For example, suppose a U.S. corporation (Company A) has received a loan denominated in pounds and will need pounds when it must make payments on its loan. A's swap partner is Company B—the *counterparty* to the currency swap. B is based in Great Britain but has a loan in dollars from a U.S. bank. Clearly, Company A has easy access to dollars but needs pounds when its loan payments come due, while Company B has easy access to pounds but needs dollars to make its loan payments. Under the terms of a straight currency swap B pays out pounds to A and receives, in turn, dollars from Company A when loan payments must be made. (See Exhibit 20–2.)

What's the great advantage of a currency swap? It makes it easier and more efficient for a borrower to tap the international financial markets for loanable funds, borrowing through whatever type of currency-denominated loan results in the best deal. Another advantage, unlike so many other currency risk-hedging tools, is that currency swaps can be set up to cover long periods of time (stretching into years, if necessary) as opposed to other risk-hedging tools, like futures and options, which generally have short horizons. Moreover, while other hedging tools are often highly standardized in form and, therefore, rigid and inflexible, a currency swap can be tailored to conform to the two swap partners' specific needs.

For an international bank currency swaps offer several advantages:

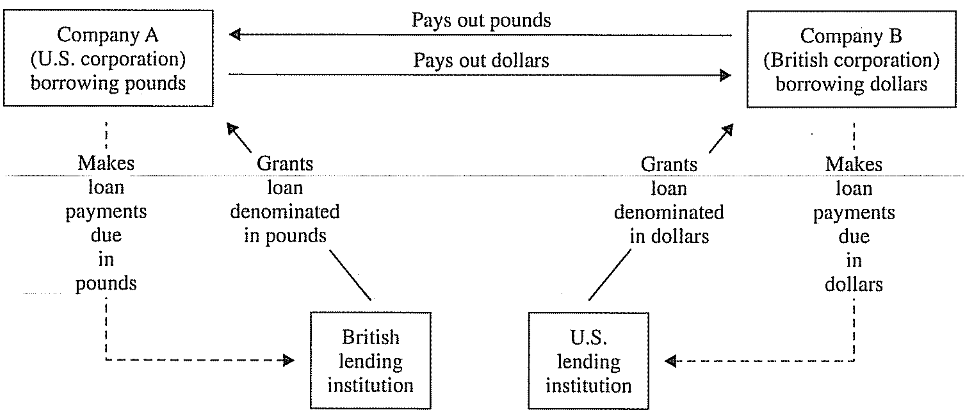
- International banks are heavy borrowers in a variety of foreign currencies and can enter into swap contracts to reduce their own currency risk exposure.
- International banks can generate fee income by arranging currency swaps for their customers, serving as a swap dealer and ensuring that either or both swap partners fulfill the terms of their contract, serving as a swap guarantor.

The swap market has become one of the largest financial markets in the world. It has helped thousands of businesses and governments hedge risk and given some of the world's largest central banks a new instrument to trade in and help shape money and credit conditions in order to strengthen their home nations' economies. Thus, swap contracts have become a global financial instrument, fostering trade, managing risk, and assisting policymakers.

Supplying Customers with Short- and Long-Term Credit or Credit Guarantees

International banks are the leading source of credit for multinational corporations and many governmental units at home and abroad. They provide both short- and long-term financing for the purchase of raw materials and for meeting payrolls, constructing buildings, and other important projects.

EXHIBIT 20–2
A Straight Currency Swap



Factoid
What type or category of loan held by the foreign offices of U.S. banks has the biggest dollar volume?
Answer: Commercial and industrial (business) loans, which account for more than half of all loans held by U.S. banks' foreign offices. Loans to individuals are a distant second.

Note Issuance Facilities

Most international bank loans are short-term business credits carrying floating interest rates usually tied to some international base rate. The most popular rate of this type is LIBOR, the London Interbank Offer Rate on borrowings of short-term Eurodollar deposits between banks. Increasingly in recent years, however, international banks have provided *credit guarantees* for their customers' borrowings in the open market. One of the most popular is the **note issuance facility (NIF).** NIFs are primarily medium-term credit agreements between international banks and their larger corporate and governmental customers. The NIF customer is authorized to periodically issue short-term notes, each of which usually comes due in 90 to 180 days, over a stipulated period (such as five years). International banks pledge to either buy up any notes not bought by other investors or to grant supplemental loans. In most cases, the customer's notes are in large denominations (e.g., $1 million U.S. or larger).

Europaper

International banks have also played a key role in the **Eurocommercial paper (ECP)** market, where multinational corporations raise short-term credit covering weeks or months. This short-term loan market is centered in London's financial district and has attracted international banks and nonfinancial corporations as investors. While most ECP borrowers are based outside the United States, a growing cadre of U.S. companies whose credit ratings are not strong enough to crack the U.S. commercial paper market or who need to sell longer-maturity paper are successfully placing their notes in the Europaper market. A recent spur to this market has come from financial deregulation in Japan, which permits Japanese bank affiliates abroad to underwrite international commercial paper, while both Japanese and non-Japanese firms have recently been allowed to issue and buy yen-denominated commercial paper. International banks are heavy buyers of ECPs for themselves and their investing customers and are also among the leading sellers of ECP issues.

Issuing and Managing Depository Receipts

Key URLs
To explore more fully the characteristics of depository receipts (DRs) see especially **www.adr.com/**, **www.adrbny.com**, and **invest-faq.com/articles/stock-adrs.html**.

A related form of assistance that international banks provide domestic and foreign customers is the issuance of **depository receipts (DRs).** A DR is a negotiable instrument representing an ownership interest in the stock or debt securities of a foreign company or other foreign institution. This instrument usually arises when a broker purchases securities issued by a foreign entity and delivers them to a custodian who, in turn, instructs a depository bank to issue DRs representing the securities.

Depository receipts are usually denominated in a leading international currency—most prominently the U.S. dollar but also in euros today. This transformation into dollars or euros makes it easier for a foreign borrower to sell its securities in the global marketplace. To date DRs have been issued representing companies in more than 70 countries.

When the borrowing company issuing securities approves of such an arrangement the DR is said to be "sponsored" by the issuer. However, a broker can simply choose to package *any* foreign securities that might be of interest to international investors and request a bank to issue and distribute DRs without the approval of the issuing company, resulting in an "unsponsored" DR. Today sponsored DRs are generally popular with investors while unsponsored DRs appear to be fading due, in part, to lack of control. Quality sponsored DRs that meet the rules often trade on major securities exchanges.

One of the principal attractions of depository receipts for international investors is the *absence of currency risk*. For example, through an American depository receipt (ADR) the value of a foreign security is literally converted into U.S. dollars. Another advantage is that international investors can *geographically diversify* their portfolios and thereby reduce country risk. Moreover, an investor usually can recover his or her funds more quickly by liquidating a DR than by attempting to sell a foreign-issued security.

ETHICS IN BANKING AND FINANCIAL SERVICES

ETHICS IN LENDING: THE CHINESE LOAN MARKET

The Chinese banking industry is one of the world's largest and most complex, embracing large state-owned banks (such as China Construction Bank and the Industrial and Commercial Bank), thousands of bank branch offices, smaller regional banks, and local credit cooperatives as well as more than 200 offices representing banks from nearly 40 nations. Indeed, the People's Republic of China today represents one of the most promising markets on the planet for making loans and providing other financial services.

The rapid industrialization of China's economy, coupled with the migration of millions of Chinese workers from the countryside into higher-paying city jobs, has led to soaring growth in business and consumer loans. Unfortunately some of these loans have been accompanied by scandal and poor management.

In the past Chinese banks were often compelled by government to support projects that did not meet the discipline of the private marketplace. Frequently local government officials had more pervasive influence over the decisions of loan officers in thousands of bank branches scattered across China than did senior bank management. Local bank offices often granted loans on the basis of political connections, not based on expected profitability. The result was that the banking system became one of the real problem areas in China's economy, while the industrial sector became plagued with overproduction.

As the Chinese banking system opens itself up to foreign investors in the new century these damaging practices seem to be fading somewhat. Increasingly, new managers with training in foreign banks and business schools are coming home to China and taking over. Written loan policies and risk assessment software are gradually replacing older lending methods. Moreover, paralleling many leading U.S. banks, Chinese bankers are centering more major lending decisions at bank headquarters where skilled loan officers decide what loans to approve.

Meanwhile, leading international banks see great potential in China's financial-service markets. Already Citigroup from the United States and HSBC and Standard Chartered from the United Kingdom have branch offices in China, while Bank of America has a strategic alliance with China Construction Bank. Other international banks, such as the Royal Bank of Scotland and Merrill Lynch, are not far behind. Bank managers from America and Europe see profit opportunities not only in making new loans to Chinese businesses and consumers, but also in packaging China's troubled loans into pools and selling claims against those pools to international investors.

Supplying Payments and Thrift (Savings) Instruments to International Customers

Payments Services

International banks are essential to the functioning of global commerce through the offering of *payments and thrift instruments*. Not only do they provide foreign currencies for a customer making cash payments overseas, but they also issue and accept drafts in payment for purchases of goods and services across national borders. These irrevocable commitments of an international bank to pay may be in the form of *sight drafts*, due and payable upon presentation, or *time drafts*, payable only on a specific future date, usually just long enough for goods to be shipped to another country. Time drafts usually arise when an importer requests its bank to issue a *letter of credit*, guaranteeing that the bank will pay an exporter of goods if the importer fails to do so. The exporter may then draw through one of its correspondent banks a bill for payment, which is presented to the importer's bank for acceptance and eventual payment. International banks also issue traveler's checks denominated in foreign currencies and will wire funds anywhere a customer designates.

Savings (Thrift) Services

International banks encourage *thrift*—short-term and long-term savings—by their customers. Most of these savings instruments are certificates of deposit (CDs)—interest-bearing receipts for funds deposited in a bank. While CDs were developed to be fixed-rate savings instruments, a sizable portion carry floating interest rates tied to movements of a specific

Factoid
Which do you suppose is biggest—the revenue from loans held at the foreign offices of U.S. banks or the interest expense on the deposits held at these foreign offices? **Answer:** They are often close in amount but deposit interest has often outstripped loan revenue at U.S banks' foreign offices in recent years, quite unlike the situation inside the United States where loan revenue received usually outstrips deposit interest paid out to customers.

base rate (such as LIBOR). Each day, major international banks post CD rates for the most popular deposit maturities, posting higher or lower rates depending on their need for funds.

The tremendous success of this bank funds-raising instrument led to an expansion of the CD concept around the world in the form of the EuroCD, a deposit sold in million-dollar units, first in London and eventually reaching all major financial centers. Today, most EuroCDs are issued by branches of the largest U.S., Japanese, Canadian, European, and British clearing banks. Large-denomination EuroCDs traded in the interbank market are often called *tap CDs*, while packages of smaller-denomination EuroCDs sold to a wide range of investors are called *tranche CDs*. While most Eurodollars are fixed-rate deposits, floating-rate CDs (FRCDs) and floating-rate notes (FRNs) are also issued to protect investors and borrowers against interest rate risk. These flexible-rate investments tend to be medium- to long-term in maturity, ranging from about 1 year to about 5 years in the case of FRCDs and up to about 20 years for FRNs, with the attached interest rates typically adjusted every three to six months to reflect current market conditions.

Underwriting Customer Note and Bond Issues in the Eurobond Market

The development of note issuance facilities (NIFs) by international banks, discussed earlier, is but one example of the growing role of international banks in *underwriting new securities issues* in the open market. Another example is the **Eurobond market,** where borrowers issue bonds outside their home country. One reason for the growth of such a market was the increasing number of U.S. corporations, led by firms the size of Ford Motor Co. and Campbell Soup Co., that decided to tap Eurobonds to fund their overseas ventures. When U.S. interest rates rise, even purely domestic firms may find that Eurobond borrowings look cheaper by comparison. Leading international banks active in this market include Lloyds Bank PLC, J. P. Morgan Chase, and Citigroup. In an effort to broaden the market's appeal for the future, recent innovations have appeared. Among them are debt securities denominated in European currency units (ECUs), representing currencies issued by various European countries.

Protecting Customers against Interest Rate Risk

International banks help protect their customers against *interest rate risk*—the risk of loss due to adverse interest rate movements. Rising interest rates can increase a customer's borrowing cost and threaten to erode the profit margin on investment projects supported by borrowing. Conversely, an international bank's customer may suffer a loss in the event interest rates fall if the customer's funds are placed in investments with floating interest yields or in other short-maturity investments that must be renewed at lower interest rates. Similarly, a customer with a fixed-rate loan fails to benefit from lower market interest rates unless steps are taken to cover that eventuality.

Interest-Rate Swaps

International banks can help their customers limit interest rate risk exposure by arranging **interest-rate swaps.** As described in Chapter 8, these contractual agreements require each party to pay at least a portion of the interest bill owed on the other party's loan. Not only can interest-rate swaps reduce interest expense for each party, but they also permit each swap partner to more accurately balance cash inflows generated by its assets with cash outflows traceable to its liabilities.

Interest-Rate Caps

International banks also limit the interest-rate risk exposure of borrowing customers by imposing caps (maximum rates) on a customer loan in return for a fee. For example, the customer requesting a $100 million loan with an interest rate based on LIBOR may ask for an 8 percent interest-rate cap so that a rise in market interest rates does not send the loan rate above 8 percent. Such caps transfer interest rate risk from the borrowing customer to the international bank and often carry a stiff fee to compensate the bank for its added risk exposure.

Financial Futures and Options

International banks are also active in assisting their customers with trading in financial futures and option contracts. For example, if the customer faces substantial loss from a *rise* in interest rates, then a *short* futures hedge (as described in Chapter 8) can be used to offset any loss due to a higher loan rate; alternatively, a *put* option could be employed. The prospect of customer losses from *falling* interest rates, on the other hand, could be hedged through a *long* (or buying) futures hedge or through the use of a *call* option.

Helping Customers Market Their Products through Export Trading Companies

An increasingly popular device for aiding customers to sell their goods abroad is the *export trading company* (ETC), developed originally by the Japanese. ETCs research foreign markets, identify firms in those foreign markets that could distribute products, and then provide or arrange the funding, insurance, and transportation needed to move goods to market. While larger manufacturers often have extensive foreign trading operations, thousands of smaller firms have not maximized their opportunities in export markets, in part due to a lack of adequate market research and few contacts abroad.

Inside the United States ETCs have been developed by leading money center banks and by several smaller regional and community banks. Leading U.S. institutions launching ETCs at various times include Bank of America, Bankers Trust Co. (now affiliated with Deutsche Bank), J. P. Morgan Chase Corp., Citigroup, and Fleet Boston (now part of Bank of America). Despite widespread interest, however, the growth of export trading activity via ETCs based in the United States has been somewhat disappointing. To be sure, external developments have played a major role in limiting ETC activities, particularly the difficulties many less-developed countries have faced in finding resources to pay for imports from the United States and in servicing their international debt. Lack of management experience with the ETC form and lack of distribution channels and market data from abroad have proven to be major hurdles, especially for smaller banks.

Concept Check

20–6. Describe the principal customer services supplied by international banks serving foreign markets.

20–7. What types of risk exposure do international banks strive to control in order to aid their customers?

20–8. What is an NIF? A DR?

20–9. Of what benefit might NIFs and DRs be to international banks and their customers?

20–10. What are ETCs? What services do they provide and what problems have they encountered inside the United States?

20–11. What do the terms *Europaper* and *Eurobonds* refer to? Why are these instruments important to international banks and to their customers?

20–12. What types of tools have international banks developed to help protect themselves and their customers against currency and interest rate risk? How does each tool accomplish its purpose?

Key URLs
What trends are reshaping international banking today and in the future? See, for example, **www.bis.org/review** and **www.lacefinancial.com**.

U.S. banks have also complained of heavy capitalization requirements, regulatory limits on credit extended from banks to their ETC affiliates, and legal restrictions on the proportion of income that must come from exporting activities. For example, at least 51 percent of ETC income must come from U.S. exporting activities, and a U.S. international bank can invest no more than 5 percent of its consolidated capital in an ETC nor lend more than 10 percent of its capital to its own ETC.

20–5 Challenges for International Banks in Foreign Markets

Growing Customer Use of Securities Markets to Raise Funds

All banks—both domestic and international banking firms—today face an ongoing challenge to their business—namely growing competition from securities markets and securities dealers for the fund-raising needs of their customers. When many international loans developed severe repayment problems during the 1980s and 1990s, many international banks withdrew substantial resources from the global credit markets. Securities houses were quick to seize this opening and provide a conduit for borrower offerings of notes and bonds in the Eurocurrency markets. Later, large insurance companies, finance companies, and other nonbank financial institutions joined the competition to attract borrowers away from banks and assist them in their access to the open market to sell securities and raise new capital. While international banks have purchased many of these securities themselves, they have been forced to settle for slower growth in their credit-providing business, with smaller earnings margins on the credit they do extend to international borrowers.

Whether international banks can regain or even maintain their share of the global business credit market depends on current and future regulations that control their risk-taking worldwide, changing public attitudes regarding the safety and soundness of these multinational institutions, and the aggressiveness of their principal competitors in the international marketplace—securities dealers, insurance firms, and finance companies—who are also intent on widening their shares of the lucrative international corporate financing market. Indeed, several of the world's largest securities dealers (such as Merrill Lynch, Nomura Securities, Goldman Sachs, and Lehman Brothers), insurance companies (such as Allianz, AXA, Prudential, and Swiss Reinsurance), and finance companies (such as GE Capital and Household Finance—an affiliate of HSBC Holdings in Great Britain) have grown and expanded their service menus to compete with many of the globe's biggest banks. Challenged as never before, international banks today must work hard to find new sources of revenue and capital to meet the potent competition posed by other financial-service institutions—for example, by selling their superior ability at credit evaluation, at packaging loans and securities for resale, and at issuing credit guarantees in support of their customers' financial-service needs.

Developing Better Methods for Assessing Risk in International Lending

International Loan Risks

The greatest source of risk for most international banks lies in granting foreign loans. Foreign lending is generally more risky than domestic lending because information sources overseas are often less reliable than those at home, it's easier to monitor a loan made nearby rather than one made thousands of miles away, and the court systems needed to enforce contracts and conduct bankruptcy proceedings are often absent in the international arena. This form of risk is often called *country risk*. A related type of risk, usually called *sovereign risk*, occurs when a foreign government takes actions that interfere with repayment of an international loan, such as by repudiating all foreign debt, appropriating private property, or suspending loan payments to conserve the home government's foreign exchange reserves. The result is that financial institutions choosing to lend abroad must analyze *both* the individual borrower and the country and government where the borrower resides.

Possible Solutions to Troubled International Loans

Troubled foreign loans, like problem domestic loans, may be *restructured* so that a new loan agreement is put together to replace the old loan agreement. The new loan may assesses the borrower a lower interest rate and grant a longer maturity until final payment in return for a restructuring fee. The net cost (*concessionality*) to the lender is usually measured by the difference in present value of the original loan versus the (usually lower) present value of the newly restructured loan. Alternatively, a troubled loan can be sold in the secondary market for international loans that has grown up since the early 1980s and is centered around commercial banks and security dealers in New York and London. Many international banks have found buyers for discounted foreign loans among large corporations, other banks, and wealthy investors seeking speculative investments with the potential for high return. Selling international loans removes these credits from the balance sheet, provides funding for new assets, and may raise the value of the selling bank's stock.

Still another method used to deal with troubled international credits is to write off all or a portion of a foreign loan, recognizing that loan as a probable loss. The result is a credit against taxes that, in effect, shares the loan loss between the international bank's shareholders and the government.

Another alternative is for international banks to accept *exit bonds* in lieu of loan repayments. These debt securities are typically valued below the loans they replace and usually require lower or longer-term debt-service payments. Exit bonds may be backed by government securities or other acceptable collateral. For example, during the 1990s the U.S. Treasury Department announced plans to sell zero-coupon U.S. government bonds to Mexico at prices below their market value in order to support a refinancing agreement worked out between the government of Mexico and leading international banks. Mexico could use these bonds, issued as part of the Brady Plan, to pay off exit bonds issued to international banks lending to that nation. Other nations, including Argentina, Brazil, and the Philippines, converted some of their loans into Brady bonds bearing longer maturities and lower interest rates than the original loans. These swaps of Brady bonds for international loans were frequently supported by the central bank of the country where the borrower resides, providing a quality loan guarantee.

In most cases, a *combination* of remedies for troubled international loans has been used. The package of remedies may include restructuring delinquent loans and rescheduling their interest and principal payments, supplemental financial support by the International Monetary Fund (IMF) and other international agencies, stimulation of exports, and reduction of imports by indebted nations in an effort to buy time so these countries can move toward debt retirement and a stronger domestic economy.

International Loan Risk Evaluation Systems

There is little argument today with the proposition that banks engaged in international lending need to develop improved methods for analyzing the quality and soundness of international loans before they are made and better methods for monitoring borrower performance after loans are granted. Several risk evaluation systems are in use today.

For example, the *checklist approach* lists economic and political factors believed to be correlated with loan risk, such as military conflicts, balance-of-payments deficits, and rising unemployment. Comparative weights may be applied to each factor on the list, or all may be equally considered in the international loan evaluation process. The weights may take the form of statistical or mathematical probabilities, leading to the calculation of an index value for default risk. Changes in the index then become part of an early warning loan evaluation system. The listed items may be supplemented by field reports from bank personnel with first-hand knowledge of the debtor country.

Factoid
Which nation today seems to promise both the most rapid economic growth but also the greatest barriers to foreign bank entry?
Answer: The Peoples' Republic of China.

An alternative approach, which uses expert opinion, is the *Delphi method*. Business analysts, economists, and experts in international law are assembled, and their separate, independently derived risk evaluations of a country are compiled and shared with each member of the expert panel. Panel members are then given an opportunity to revise their earlier assessments of a country's risk exposure. The final report is prepared as a consensus view of an individual country's risk exposure.

One serious problem with both of these approaches is *timeliness*. Significant changes in default-risk exposure may occur well before any of the calculated indexes or group opinion surveys pick it up. More recently, advanced statistical methods (including discriminant analysis) have been applied to country risk problems. Linear modeling techniques have been constructed that attempt to classify international loans into those that will be successfully repaid versus those that will require debt rescheduling or will be defaulted outright based upon preselected predictor variables.

Among the most popular predictor variables to measure the risk exposure of loans to a particular country are growth of the domestic money supply (an indicator of possible future inflation and currency devaluations), the ratio of real investment to gross domestic product (which measures a nation's future ability to be productive), the ratio of interest and debt amortization payments to total exports (which compares required debt payments to the principal source for generating foreign exchange reserves to repay debt—a nation's exports), and the ratio of total imports to a nation's foreign exchange reserves (which measures a country's spending abroad relative to the availability of its foreign exchange reserves to pay for that spending). However, controversy has continued to swirl around the usefulness of these advanced statistical models due to delays in the reporting of data, the importance of hard-to-capture random events (such as labor strikes or political revolutions), and instability over time in the relative importance of the different predictor variables used in country-risk models.

Key URLs
For an analysis of risks and opportunities across different regions of the globe, see **www.euromoney.com**; **www.institutionalinvestor.com**; and **www.icrgonline.com**.

Recently published country-risk indicators have become popular aids for bank loan officers trying to evaluate an international loan. One such widely used indicator is the *Euromoney Index*, published by *Euromoney* magazine. *Euromoney*'s country-risk index is based upon a variety of economic and political variables, including access to financing sources, credit ratings, and the international borrower's default history. A second popular indicator of country risk today is the *Institutional Investor Index* (III), published by *Institutional Investor* magazine. The III is derived from a survey of loan officers from multinational banks and other institutions who submit their rankings of each nation as to its probability of default.

Finally, one of the newest and most comprehensive country-risk indicators is provided by the *International Country Risk Guide* (ICRG), developed in 1980 to assess the probability of a successful venture in a particular marketplace around the globe. The ICRG supplies political, economic, and financial risk ratings and an overall composite rating (between 0 and 100) for 140 countries monthly and also prepares one- and five-year risk forecasts for the period ahead. A nation's composite rating is based on 22 factors, including government stability, corruption, ethnic and religious tensions, quality of bureaucracy, per-capita gross domestic product (GDP), real GDP growth, annual inflation rate, foreign debt as a proportion of GDP, and the stability of exchange rates. Users of this country-risk index are granted access to the underlying data so they can assign their own risk weights, if need be, in order to reach a credit decision.

THE EXPANDING EUROPEAN UNION (EU) AND ITS IMPLICATIONS FOR INTERNATIONAL BANKERS

The unification of Europe has been a lengthy historical drama, following centuries of political and economic turmoil. A key milestone in the decades-long process of establishing the European Union (EU) took place in 1992 when the Maastricht Treaty on European Union was adopted. Among the most controversial of its provisions was a call for the creation of a single currency; a common central bank; and the integration of foreign policies, judicial and legal systems, and domestic affairs. Maastricht set in motion rules for each nation to become a member state of the European Community (EC), provided it could jump over the tough hurdles Maastricht laid down.

Initially, in January 1999, 11 nations joined the European Union (EU), establishing the *euro* as the Union's common currency, and creating a national banking system led by a new European Central Bank. The 11 nations forming the initial common monetary system (later expanding to 12 nations) included Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Eventually other nations—such as Denmark and the United Kingdom—that made up the original European Union formed under the Maastricht Treaty are expected to join the new common money and credit system. Moreover, several other nations inside Europe and on its fringes have applied to join the EU, including the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Malta, Lithuania, Poland, Slovakia, Slovenia, and Turkey.

Perhaps the greatest consequence of the EU for international bankers is the creation of a single banking market. The new European *single banking market* is shaped by several guiding rules that govern all member states:

A. Each member country will keep its own regulatory agencies and will be the chief supervisor of banks headquartered in its territory, no matter how far these banks extend into other EU member states.

B. While regulatory rules may differ, all member states must maintain minimal regulatory standards so that banks from each country face a level playing field and will not have a strong incentive to leave a European nation with tough rules and migrate to another with more lenient rules.

C. The principle of "national treatment" generally applies: regardless of what EU member country a bank uses as its headquarters, when it enters a new EU state, it is subject to the same rules as domestic banks operating there. An individual EU member state can impose restrictions on international banks entering its territory, but its own banks then may be subject to the same restrictions. The principle of national treatment gives nations a powerful incentive to keep regulations as simple and equal as possible.

D. The principle of "mutual recognition" was also adopted by selected nations. A nation can allow an entering foreign bank to continue offering the same services it is allowed to offer in its home country even if domestic banks are not allowed to do so. This principle tends to give foreign banks a competitive edge over domestic banks if there are great differences in rules from nation to nation.

E. Under the Second Banking Directive of 1993, the term *banking* was defined in one way across the whole EU so that all European banks can offer a common set of services (*universal banking*). These common services include deposit taking; lending; financial leasing; payments services; guarantees and credit commitments; trading in money market instruments, currencies, financial futures, options, and other interest-bearing or interest-rate hedging instruments; aiding issuers of new securities; advising on acquisitions and mergers; brokering funds; supplying portfolio advice, management services, and safekeeping services; and providing credit references.

F. All EU states agree to a *single passport* so that any international bank from a member nation can conduct business in any other member nation in whatever form it views as giving it the best advantage, including the possibility of setting up a new branch or subsidiary firm or possibly merging with another bank.

G. All EU states must offer some form of deposit insurance, which may be government run or supervised, as in Belgium, Finland, France, and Italy, or privately owned, as in Austria, Germany, Ireland, Luxembourg, the Netherlands, Portugal, and Spain. Depositors of failed banks must be reimbursed within three months. A member nation may establish an insurance system where insurance fees are assessed against all banks and funds are accumulated to deal with future bank failures (as in the United States) or a different system could be adopted where member banks are assessed charges only after a failure occurs.

H. All banks within the EU are to have identical capital standards that mirror the Basel International Capital Standards (discussed more fully in Chapter 15) in order to avoid giving some EU banks significant advantages over others.

I. No EU bank is permitted to loan to a single client more than 25 percent of its capital, a provision designed to ensure that each bank has a diversified loan portfolio with limited risk exposure.

Overall, research studies suggest that competition has increased and at least some banking services now seem to be available at lower prices. However, many steps still need to be taken to level the playing field throughout the EU, particularly in such areas as taxation, governmental subsidies, labor laws, and excess capacity in the banking industry. Moreover, several European nations have shown a tendency to protect their domestic businesses from foreign takeover.

Adjusting to New Market Opportunities Created by Deregulation and New International Agreements

International financial markets are passing through dramatic change as deregulation in one nation after another and international treaties open up new financial service opportunities. Inside the United States the federal government moved in 1994 to allow nationwide acquisitions of American banks by holding companies to open up the opportunity for interstate branch banking. Five years later, the U.S. Congress voted to permit banks, insurance companies, and security dealers to acquire each other through the creation of financial holding companies (FHCs). These same privileges were extended to foreign banks, making the United States a more attractive market for expanding international banks, security dealers, insurance companies, and other global financial-service providers.

Key URLs
One of the most interesting dimensions of the recent expansion of international banking has been the growth of Islamic banking in Europe, the Middle East, Asia, and other parts of the globe. See, for example, **www.islamic-banking.com** and **http://islamicbankingandfinance.com**.

Opportunities Created by NAFTA and CAFTA

In November 1993 the U.S. government gave final approval to the North American Free Trade Agreement (NAFTA), setting in motion a gradual opening up of Mexico's financial system to outside entry by financial-service firms from Canada and the United States. The Mexican financial marketplace has become attractive for entry from outside the country because Mexico's financial firms have not moved aggressively to serve such important customer groups as small businesses and households. In contrast, leading banks in Canada and the United States have benefited from NAFTA because Mexico's restrictions on foreign banks' market share recently have been lifted. International investors are now free to be a part of the Mexican financial system through the direct acquisition of existing financial firms or through the establishment of foreign-owned subsidiaries. Meanwhile, member nations of NAFTA are considering expansion to include Chile and other countries, creating still more opportunities for leading international banks.

Also centered upon the Americas is the Central American Free Trade Agreement (CAFTA), approved by the U.S. Congress in 2005. Central America is the second biggest U.S. export market in the Americas after Mexico, especially for agricultural products and fabrics. CAFTA calls for the gradual lowering of trade barriers between the United States, Guatemala, El Salvador, Honduras, Nicaragua, Costa Rica, and the Dominican Republic. Proponents of this newest trade agreement argue that it will increase living standards, improve trade volume, enhance the availability of financial services and capital investment in Central America, and reduce illegal immigration into the United States.

Opportunities in the Expanding European Community

An even larger and more challenging expansion opportunity lies in the continuing integration of the European Union (EU) and the opening up of Eastern Europe and nations from the former Soviet Union to privatization and free markets. By 2006 there were 25 nations in the EU, with Bulgaria and Romania expected to join in 2007 and Croatia and Turkey negotiating possible future membership. Trade barriers within the EU are due for further reduction and eventual elimination as the 21st century continues to unfold. EU supporters boast of great marketing potential for sales of financial services because of a combined population of more than 370 million, significantly larger than that of the United States.

However, marketing success across Europe demands a significant local presence throughout the area. Merely setting up a financial firm on the continent without building a local network of financial-service distributors seems to carry little chance of long-term success, particularly in wresting market share from established European-owned competitors and from leading U.S. and Canadian financial firms that have had a significant presence there for many years.

Insights and Issues

INDIA'S FINANCIAL-SERVICES MARKETPLACE

Like China, India represents a tremendous opportunity for international financial firms if these institutions can break through domestic barriers, mainly due to its population of roughly a billion people, rapid economic growth, high gross savings rate, and growing need for auto and home loans and credit cards. However, entry by foreign banks into the retail market is largely restricted in an effort to allow India's state-owned banks to strengthen themselves against foreign competition. The foreign leader is Citigroup with close to 40 branches, though India's leading domestic banks operate hundreds of branches. Foreign finance companies (notably GE Finance) and investment banks (such as Merrill Lynch, Goldman Sachs, and Barclays) appear to have made substantial inroads due to the pressing need of many Indian corporations for new capital. At the same time Citigroup, ABN AMRO, HSBC Holdings, and other foreign companies have become active supporters of India's rapidly expanding micro lending industry in which millions of very small loans are made to individual entrepreneurs trying to escape poverty.

Factoid
Which Asian nation has the greatest number of separately incorporated commercial banks relative to the size of its population?
Answer: Taiwan with more than 50 different banking companies.

Opportunities in Asia as Barriers Erode

Finally, perhaps the most promising geographic area for future expansion is Asia, especially such rapidly growing nations as China, India, Hong Kong, Indonesia, South Korea, Thailand, and Vietnam. The huge populations of these countries represent business opportunities of historic proportions for those international financial-service providers positioned to take advantage of them. Moreover, the cultural and legal barriers that have prevented Asia's consumers and businesses from buying financial products popular in the Western World—such as credit cards, life insurance policies, and retirement plans—appear to be eroding as several international banks have moved aggressively to establish strong toeholds with these financial products in the Asian marketplace.

One example of this foreign "invasion" of Asian Markets is J. P. Morgan's recent successful effort to secure licenses in order to trade in China's national monetary unit, the yuan, on behalf of foreign businesses seeking deals inside China. Moreover, China is committed under a recently signed agreement with the World Trade Organization (WTO) to allow foreign banking firms to sell a full menu of services throughout that nation as 2007 approaches. Already such leading financial firms as Citigroup, HSBC Holdings, Standard Chartered Bank of Great Britain, and the Carlyle Group in the United States have purchased significant interests in China, Korea, and neighboring Asian nations in preparation for lower entry barriers into one of the world's largest commercial and consumer markets.

Concept Check

20–13. This chapter focuses on several major problem areas that international banks must deal with in the future. What are these problem areas?

20–14. What different approaches to country-risk evaluation have international banks developed in recent years?

20–15. What different regions around the globe today appear to offer the greatest opportunities for expansion for international banks? Why do you think this is so?

20–6 The Future of Banking and Financial Services

As we end this book it seems appropriate to peer briefly into the *future*, to try to anticipate where the financial-services industry may be headed. No one knows for sure what the fate of this vital service industry will be, but we can at least make some "educated guesses" based on what we have learned from the pages of this text.

Insights and Issues

HOW BANKERS KEEP TRACK OF GLOBAL EVENTS

Today there are numerous sources of data on international markets and institutions that bankers can use to stay up to date and make critical decisions. Prominent examples include:

The Economist, Economist Newspaper Limited in London (**www.economist.com**)
The Banker, London (**www.thebanker.com**)
Euromoney, London (**www.euromoney.com**)
Institutional Investor (**www.institutionalinvestor.com**)
BusinessWeek (**www.businessweek.com**)
Scotiabank Group, *Global Economic Research* (**www.scotiabank.com**)
US-ASEAN Business Council, Washington, D.C. (**www.us-asean.org**)
U.S. International Trade Commission, Washington, D.C. (**www.usitc.gov**)
Office of the U.S. Trade Representative, Washington, D.C. (**www.ustr.gov**)
World Bank, *World Development Report,* Washington D.C. (**www.worldbank.org**)
International Monetary Fund, *World Economic Outlook,* Washington, D.C. (**www.imf.org/external**)
Board of Governors of the Federal Reserve System, *International Finance Discussion Papers,* Washington, D.C. (**www.federalreserve.gov/pubs/ifdp**)
Federal Reserve Bank of San Francisco, *Pacific Basin Notes and Economic Letter* (**www.frbsf.org**)
Federal Reserve Bank of St. Louis, *International Economic Trends* (**research.stlouisfed.org/publications**)

Convergence

Some future trends seem fairly obvious. As we saw in Chapters 1–4, 14, and 19 banking all over the globe is *converging* with other financial-service industries. Institutions like Citibank of New York operate security broker/dealer firms, while security dealers like Merrill Lynch operate banks. Insurance companies such as Axa and MetLife own and operate their own banks, while giant universal banks like Deutsche Bank sell insurance. Despite some recent setbacks this convergence trend seems likely to continue (though probably at a somewhat slower pace) as bankers and their closest competitors continue to invade each other's territory and grow in both size and diversity.

Consolidation

As we saw repeatedly in earlier chapters, financial-service firms are also *consolidating* into fewer, but much larger, service providers all over the globe. This trend, whose roots go back nearly a century, seems to be continuing. For example, U.S. banking's 100 largest firms hold more than 90 percent of the industry's total assets, and the European and Japanese banking industries are even more concentrated in a handful of huge banks than is presently the case in the United States. Many experts see this consolidation trend as a map of the industry's future—eventually all the big fish will gobble up all the little ones and banking and financial services will become exclusively an ocean dominated by giants.

Are these two powerful trends in financial services—*convergence* and *consolidation*—really *inevitable* for the future?

Not necessarily! For example, the consolidation trend appears to be slowing in the early years of the new century. There are still in excess of 7,000 U.S. banks and thousands more in Europe and Asia, most of them small. While the industry population continues to decline, the rate of decline has definitely slowed. Some experts believe this is due to a lack of good acquisition targets—the best targets, allegedly, have already been bought out. Others suggest, however, that there is still a profitable niche for many small financial-service providers.

Moreover, as Citigroup's recent sloughing off of its ownership interest in two Traveler's Insurance affiliates suggests, the surge toward giant multiservice companies has also slowed somewhat. Banking today is highly profitable, but bankers have discovered that not all financial-service companies are as profitable as they are and do not necessarily make good partners to pursue. Moreover, larger and more diverse companies are more difficult to manage successfully than are smaller, more sharply focused financial firms.

Survival of Smaller Community Financial-Service Institutions

Thus, the "small fry"—financial firms of a few hundred million to perhaps a few billion dollars in asset size, centered in a single community, with a relatively narrow menu of services (such as loans, credit cards, deposits, and investment advice)—may well survive. Research evidence accumulated over several decades suggests that economies of scale in financial services are relatively *modest*. Small and moderate-size community-oriented financial firms don't need to grow very big before they reach the point of lowest production cost per unit of service. A financial-service firm that has reached its most efficient size can compete with *anyone*, even with the giants of the industry.

Indeed, smaller community banks have been able to maintain their share of the industry's population and their returns to stockholders despite intense competition from industry giants. They remain a viable business model as reflected by their sustained profitability and the continued chartering of new financial firms each year. They possess unique strength in personalized lending to small businesses and households and often possess superior knowledge of their customers.

Reaching the Mass Media

Where the small fry may struggle—and some *will* continue to disappear—is on the revenue side of the business, advertising to attract customers. Only a firm with nationwide or global service capacity normally can make efficient use of the mass media. It is the largest financial firms who tend to be the most aggressive advertisers, reaching out over the Internet, through cell phones, and on television networks to fight for sales. Industry leaders like Wells Fargo and Bank of America are using their branch offices as sales-focused "stores," each with a similar appearance and each intent on selling their clients as many different services as possible. Also, it is the largest financial firms who are best able to follow an increasingly mobile population and retain their customers who may be migrating into distant markets.

Can the smallest, community-oriented financial-service providers find a way to contend effectively with mass advertising and aggressive sales practices? That remains to be seen, though the Internet and the telephone are open to all in an electronic world where headquarters' location doesn't matter the way it used to for many products. Moreover, the continuing expansion of smaller suburban communities may well continue to provide a platform for smaller financial firms to compete successfully, even against the industry's leaders.

Invasion by Industrial and Retailing Companies

One of the great imponderables for the future is how effectively conventional financial firms will be able to stand up against aggressive nonfinancial companies (including, for example, General Electric, GM, Target, etc.). These firms have been chipping away at banking's market share for decades. And waiting in the wings *may* be, perhaps, one of the toughest nonfinancial competitors of them all—the largest retailer on the planet, Wal-Mart, with thousands of neighborhood stores.

American and Japanese banking laws, as well as the rules followed by many other nations, erect walls to separate nonfinancial firms from financial-service providers. These legal barriers have been erected to protect financial firms from ruinous affiliations with more risky ventures. For example, banks affiliated with industrial firms and retail chains might make cut-rate, unprofitable loans to their parent company or transfer their losses from an industrial or retail firm to the affiliated bank, threatening it with collapse. However, these laws can never be strong enough to stop all those who search for loopholes and who want to be in the financial-services industry in the worst way.

The Wal-Mart Challenge

The biggest distributor of groceries and other household goods, Wal-Mart, has recently explored several avenues for expanding its current beachhead in the financial-services industry. For example, when 1999 rolled around Wal-Mart attempted to purchase a savings bank in Oklahoma until the Gramm-Leach-Bliley (GLB) Act closed the door on that avenue. Today Wal-Mart is taking a serious look at states that issue industrial bank charters because in 1987 the U.S. Congress okayed the ownership of industrial banks by any type of business. (Industrial banks are similar to small finance companies, credit unions, and savings banks, offering small loans and deposits and issuing credit cards.) Wal-Mart *may* be attempting to follow the lead of several other huge companies—notably American Express, GM, GE, Merrill Lynch, and Target—that had previously received industrial bank charters and set up banking operations, though Wal-Mart has declared that it is not interested in setting up a nationwide branch banking system even if it is eventually awarded an industrial bank charter.

Nevertheless, Wal-Mart seems to be increasing its financial-service menu through its affiliate, Wal-Mart Financial Services. It already sponsors credit card and money transfer programs, marketed to its customers in high volume and at characteristically low prices. Couldn't Wal-Mart do the same thing with business and consumer loans through its thousands of retail outlets? with insurance policies? with sales of stocks, bonds, and mutual funds?

Currently the world's leading retailer invites selected financial-service providers to rent space in its retail stores and has pursued joint financial-services arrangements with GE Consumer Finance, SunTrust Banks, and MoneyGram. These programs would seem to represent one more step in moving Wal-Mart into the role of a major player in the global financial-services marketplace. After all, what could be more convenient than buying groceries, hardware, clothing, jewelry, and hundreds of other products under the same roof as loans, credit cards, deposits, and insurance policies, all marketed at bargain-basement prices?

Might this trend mixing industry and commerce with financial services be damaging, even devastating, to smaller community banks and credit unions? Indeed, this *may* be banking and financial services' biggest challenge for the future as more and more commercial and industrial companies scramble to plant their feet firmly in financial services. The financial sector is an industry vital to the public interest, but one that faces drastic structural and technological changes. It will be fascinating to watch the future unfolding story of the financial-services marketplace as it reaches out to better serve millions of businesses, individuals, and families, spanning continents and bringing together cultures and resources from all over the globe.

Concept Check

20–16. In looking at the future of the banking and financial-services industry does it appear likely that the powerful trends of *convergence* and *consolidation* will continue into the future? Why or why not? Is this likely to occur at the same pace as in the past?

20–17. What appears to be the future of *community banking?* What significant threats does community banking seem to face?

20–18. Are banking and commerce—financial *and* nonfinancial firms—on a collision course for the future? What challenges do companies like Wal-Mart pose for small community banks? For the largest financial firms? For regulation? For ongoing efforts to maintain a safety net to protect the public's deposits and preserve public confidence in the financial system?

Summary

In this chapter we have explored the development of international banking and the many services that financial firms offer in international markets today. Among the key points covered in the chapter are the following:

- International banking has been practiced for centuries in the Middle East and Western Europe as bankers emerged to provide business loans and exchange currencies to aid merchants and foreign travelers. Within the past century U.S., European, and, more recently, Japanese and Asian banks have grown to play leading roles on the international scene, competing with security dealers, insurance companies, and other nonbank providers to reach across national borders.
- In order to expand abroad, international banks and many of their closest competitors have used a wide variety of different organizational forms. Examples include *representative offices* (which facilitate the flow of information between financial firms and their overseas customers), *agencies* (which provide selected financial services such as credit and cash management), *branch offices* (which offer many of the same services that an international bank's home office provides), and *affiliated companies* and *joint ventures* (which often supply key supporting services such as insurance, marketing, and security trading). Frequently the different organizational forms are used to avoid burdensome regulations in a particular country.
- International banking services today include supplying foreign currencies, providing hedging services to deal with currency and interest-rate risk, supplying credit and credit guarantees to fund trade and capital expansion, helping customers tap the Eurocurrency and Eurobond markets to raise new capital, supplying cash management services, and providing assessments of foreign marketing opportunities.
- The *regulation* of international banking and financial services remains a powerful force shaping global finance and trade. Nations vary greatly in the scope and content of their laws and regulations surrounding the financial-services sector. The managers of internationally focused financial firms have often taken advantage of these regulatory discrepancies between nations, entering those markets where regulation is less of a burden (referred to as *regulatory arbitrage*).
- One of the most significant regulatory trends is *government deregulation* among leading industrial nations, giving international financial firms more latitude to expand abroad. Prominent examples include passage of the Gramm-Leach-Bliley (GLB) Act in the United States, allowing banks to combine with insurance and securities firms, and the opening of a common financial system in Europe, facilitating mergers within the European financial sector.
- Recently *international regulatory cooperation* among nations has become more common so that all financial firms may eventually face the same set of rules. One of the best examples is the Basel Agreement, enforcing common capital standards among the world's leading banks.
- Nevertheless, serious problems confront the international financial-services sector today due to the inherent risks in this field. Foreign expansion often presents financial-service providers with new government restrictions; new credit, currency, and interest-rate risks; new cultural standards and practices; and less quality information upon which to base business decisions than often is available in domestic markets. New emerging trade blocs and more open economies in Europe, North America, and Asia are creating new marketing opportunities today, but also major new challenges for international financial-service providers.

- Finally, whether international or domestic in scope, banks and other financial firms continue to undergo substantial change, led by *consolidation* and *convergence* trends that are resulting in fewer, larger, and more diverse financial-service providers. Yet, numerous smaller financial firms continue to operate, compete, and remain profitable in many nations around the globe, principally because they successfully keep their production costs comparatively low. However, a significant challenge to the future of *both* large and small financial-service firms is powerful retail and manufacturing companies entering or threatening to enter the financial marketplace, intensifying competition and narrowing profit margins.

Key Terms

representative office, *650*
agency office, *650*
branch office, *650*
subsidiary, *651*
joint venture, *651*
Edge Acts, *651*
international banking facility (IBF), *651*
shell branches, *652*
Export Trading Company Act, *652*
export trading companies, *652*
International Banking Act, *654*
Foreign Bank Supervision Enhancement Act, *654*
International Lending and Supervision Act, *654*
Basel Agreement, *655*
FOREX, *655*
forward contracts, *658*
currency futures contract, *658*
currency option, *659*
currency swaps, *659*
note issuance facility (NIF), *661*
Eurocommercial paper (ECP), *661*
depository receipts (DRs), *661*
Eurobond market, *663*
interest-rate swaps, *663*

Problems and Projects

1. Pacific Trading Company purchased Canadian dollars yesterday in anticipation of a purchase of electric equipment through a Canadian supply house. However, Pacific was contacted this morning by a Japanese trading company that says equipment closer to its specifications is available in 48 hours from an electronics manufacturer in Osaka. A phone call to Pacific's bank this morning indicated that another of the bank's customers, a furniture importer located in San Francisco, purchased a comparable amount of yen in order to pay for an incoming shipment from Tokyo, only to discover that the shipment will be delayed until next week. Meanwhile, the furniture company must pay off an inventory loan tomorrow that it received 30 days ago from Toronto-Dominion Bank.

   Which of the instruments described in this chapter would be most helpful to these two companies? Construct a diagram that illustrates the transaction you, as an international banker, would recommend to these two firms to help solve their current problems.
2. Art's Sporting Goods has ordered a shipment of soccer equipment from a manufacturer and distributor in Munich. Payment for the shipment (which is valued at $3.5 million U.S.) must be made in euros that have changed in value in the last 30 days from .8198 euros/$ to .8419 euros/$. If this trend is expected to continue, would you as Art's banker recommend that this customer use a currency futures hedge? Why or why not?
3. Pinochio Corporation will import new wooden toys from a French manufacturer this week at a price of 200 euros per item for eventual distribution to retail stores. The current euro–dollar exchange rate is .8538 euros per U.S. dollar. Payment for the shipment will be made by Pinochio next month, but euros are expected to appreciate significantly against the dollar. Pinochio asks its bank, Southern Merchants Bank, N.A., for advice on what to do. What kind of futures transaction could be used to deal with this problem faced by Pinochio? Futures contracts calling for delivery of euros

next month are priced currently at .8769 euros per dollar and are expected to be priced next month at .8376 euros per dollar.

4. Watson Hardware Corporation regularly ships tools to the United States to retail outlets from its warehouse in Stuttgart, Germany. Its normal credit terms call for full payment in U.S. dollars for the hardware it ships within 90 days of the shipment date. However, Watson must convert all U.S. dollars received from its customers into euros in order to compensate its local workers and suppliers. Watson has just made a large shipment to retail dealers in the United States and is concerned about a forecast just received from its local bank that the U.S. dollar–euro exchange rate will fall sharply over the next month. The current euro–U.S. dollar exchange rate is 0.81 euros per dollar. However, the local bank's current forecast calls for the exchange rate to rise to .86 euros per dollar, so that Watson will receive substantially less in euros for each U.S. dollar it receives in payment. Please explain how Watson, with the aid of its bank, could use currency futures to offset at least a portion of its projected loss due to the expected change in the euro–dollar exchange rate.

5. Johanna International Mercantile Corporation has made a $15 million investment in a stamping mill located in northern Germany and fears a substantial decline in the euro's spot price from $1.21 to $1.15, lowering the value of the firm's capital investment. Johanna's principal U.S. bank advises the firm to use an appropriate option contract to help reduce Johanna's risk of loss.

   What currency option contract would you recommend? Explain why the contract you selected would help to reduce the firm's currency risk.

6. Ebi International Bank of Japan holds U.S. dollar-denominated assets of $416 million and dollar-denominated liabilities of $479 million, has purchased U.S. dollars in the currency markets amounting to $166 million, and sold U.S. dollars totaling $14 million. What is Ebi's *net* exposure to risk from fluctuations in the U.S. dollar relative to the bank's domestic currency? Under what circumstances could Ebi lose if dollar prices change relative to the yen?

7. Suppose that Canterbury Bank has a net short position in U.S. dollars of $8 million, dollar-denominated liabilities of $115 million, U.S. dollar purchases of $268 million, and dollar sales of $173 million. What is the current value of the bank's dollar-denominated assets? Suppose the U.S. dollar's exchange value rises against the pound. Is Canterbury likely to gain or lose? Why?

Internet Exercises

1. Why are banks more prone to cross national borders today and even span continents to acquire other financial-service providers? Visit the Institute of International Bankers Web site at **www.iib.org**. Click on the Institute's Annual Global Survey covering the activities of more than 40 countries. Choose a country of interest to you and read the synopsis at the end of the survey. What are some key issues for your country?
2. You want some current news on international banks. Visit **www.newsnow.co.uk** and use the newsfeed to locate banking topics within business and finance news. Read an article from a country other than the United States. What were the major issues discussed in this article?
3. Suppose you want some detailed information about central banks outside the United States. Visit **www.bis.org/cbanks.htm**. What is the URL for the central bank of the European Union? Hong Kong? Thailand?
4. To get an idea of the internationalization of some of our large banks, visit Citigroup's Country Web site at **www.citigroup.com/citigroup/global/index.htm.** Describe its presence in Morocco, Saudi Arabia, and Finland.

REAL NUMBERS FOR REAL BANKS

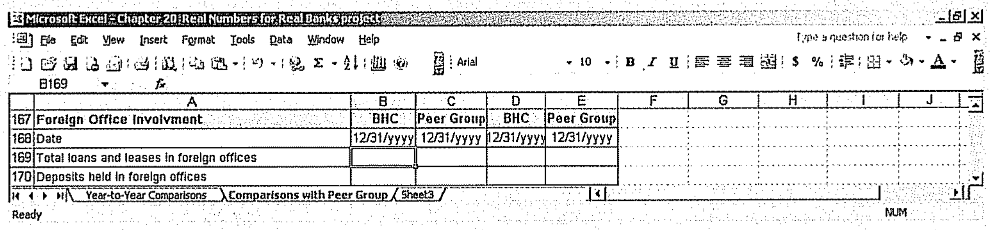
Assignment for Chapter 20

YOUR BANK'S USE OF FOREIGN OFFICES

Chapter 20 explores the services and issues involved with foreign banks operating in the United States and U.S. banks operating abroad. One way that U.S. banks can operate abroad is through foreign offices. This chapter describes the different types of offices, and they will be the focus of this assignment. First we will collect and examine the data to see how foreign offices affect our BHC's balance sheet. Then we will look at the number, types, and location of foreign offices associated with the BHC you have chosen.

Part One: Trend and Comparative Analysis of the Contribution of Foreign Offices to Your BHC's Report of Condition

A. **Data Collection:** In this assignment we return to the SDI at **www3.fdic.gov/sdi/main.asp** and collect data from the net loans and leases and total deposits reports. This entails using SDI to create a four-column report of your bank's information and the peer group information across years. You are to collect the two items listed below and enter this data into the spreadsheet for peer-group comparisons.



	A	B	C	D	E
167	Foreign Office Involvment	BHC	Peer Group	BHC	Peer Group
168	Date	12/31/yyyy	12/31/yyyy	12/31/yyyy	12/31/yyyy
169	Total loans and leases in foreign offices				
170	Deposits held in foreign offices				

B. Write one paragraph about the contributions of foreign offices to operations. Has your BHC focused more or less attention on foreign offices? Has your BHC moved into foreign markets using offices more or less than other very large banks (your peer group)?

Part Two: How Your BHC Used Foreign Offices to Expand Internationally

A. Go to the FDIC's Institution Directory at **http://www3.fdic.gov/idasp/**, and do a search for your bank holding company (BHC) using the BHC ID. This search will produce a list of bank and thrift subsidiaries. If you click on the active certificate links, additional information will appear and you will be able to pull up a current list of offices for that bank. At the bottom of the list of all offices associated with that bank you'll find information on location, codes identifying the type of office, and the date foreign offices were established. You will want to focus your attention on the number of foreign offices, their types, and their locations. Collect this information for each bank belonging to the bank holding company you have chosen.

B. Compose several paragraphs discussing your banking company's expansion internationally and evaluate their strategy to expand or not.

STANDARD &POOR'S

S&P Market Insight Challenge (www.mhhe.com/edumarketinsight)

S&P's Market Insight, Educational Version has a number of foreign bank and financial-service firms listed in its inventory of financial-service providers. Examples include Mitsubishi Financial Group, HSBC Holdings PLC, and Barclays PLC, among others represented in the Insight collection. Most of these foreign financial corporations have a solid presence in the United States, the European Community, Japan, and selected Asian markets. Which are significantly represented in all four of these areas of the globe? With what financial services? What advantages might this bring to those financial firms with the broadest global representation?

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DICTIONARY OF BANKING AND FINANCIAL-SERVICE TERMS

A

account party The customer who requests a standby letter of credit from a bank or other lender of funds.

add-on method A procedure for calculating a consumer's loan rate in which interest is assessed on the full principal of an installment loan.

adjustable-rate mortgages (ARMs) Loans against real property whose interest rate periodically adjusts to changes in market interest rates.

affiliated banks Banks whose stock has been acquired by a holding company.

agency offices International banking offices that provide credit and other nondeposit services.

agency problems An issue that often arises in acquisitions and mergers when management pursues these transactions for management's benefit rather than the benefit of the stockholders.

agency theory An explanation of the risk-taking behavior of individuals and institutions that focuses on the parties to a principal–agent contract in which any agent may seek to optimize his or her position at the expense of the principal(s) involved.

agricultural loans Credit extended to farm and ranch operations to assist in planting and harvesting crops and to care for and market livestock.

American depository receipt (ADR) A receipt issued by a U.S. bank that makes it easier for a foreign business borrower to sell its securities in the United States.

annual percentage rate (APR) Interest rate on a loan that the U.S. Truth and Lending Act requires to be quoted to a household consumer seeking a loan.

annuities An investment product sold by many financial firms today in which the customer invests his or her savings under the terms of a contract that promises a stream of income in the future (either fixed or variable in amount).

antidiscrimination laws Laws that prevent the grouping of loan customers into categories according to their age, sex, race, national origin, location of residence, religious affiliation, or receipt of public assistance and that prohibit the denial of a loan to anyone solely because of membership in one or more of these groups.

asset-based loans Loans secured by a business firm's assets, particularly accounts receivable and inventory.

asset conversion A strategy for meeting liquidity needs in which liquid reserves are stored in readily marketable assets that can be quickly converted into cash.

asset-liability management The process of decision making to control a financial institution's exposure to interest rate risk.

asset management A management strategy that regards the volume and mix of a financial firm's sources of funds as determined largely by the wishes of its customers and calls for management to concentrate on controlling assets, rather than on managing liabilities, in order to meet liquidity needs and other goals.

asset utilization The ratio of total operating revenues to total assets, measuring the average yield on assets.

assignments A form of loan sale in which ownership of a loan is transferred to the loan buyer who then has a direct claim against the borrower.

ATMs Automated teller machines through which a customer can access his or her deposit account, make loan payments, or obtain information and other services.

available funds gap The difference between current and projected credit and deposit flows that creates a need for raising additional reserves when the gap is negative or for profitably investing any excess reserves that may arise when the gap is positive.

B

balanced liquidity management The combined use of both asset management and liability management to cover liquidity needs.

bank The financial intermediary that offers the widest range of financial services—especially credit, savings, and payment services—and performs the widest range of financial functions of any business firm in the economy.

bank discount rate The method by which yields on Treasury bills and other money market securities are calculated using par value and a 360-day year to determine the appropriate discount rate or yield.

bankers' acceptance A bank's written promise to pay the holder of the acceptance a designated amount of money on a specific future date.

bankers' banks Regional service firms, often created as joint ventures by groups of banks and other financial firms, in order to facilitate the delivery of certain customer services, such as the rapid transfer and investment of customer funds and the execution of orders to buy or sell securities.

bank holding company A corporation chartered for the purpose of holding the stock (equity shares) of one or more banks.

Bank Holding Company Act U.S. law that brought bank holding company organizations under comprehensive federal regulation.

Bank Merger Act of 1960 A law passed by the U.S. Congress that requires each merging bank to notify its principal federal regulatory agency of a pending merger and requests federal approval before the merger can be completed.

Bank of Japan The central bank of Japan, chartered to control inflation and stabilize the Japanese economy.

Basel Agreement A negotiated agreement between bank regulatory authorities in the United States, Canada, Great Britain, Japan, and eight other nations in western Europe to set common capital requirements for banks under their jurisdiction.

Basel I The first official agreement between the United States, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and Luxembourg, formally approved in Basel, Switzerland, in 1988 and imposing common minimum capital requirements on banks headquartered in these countries.

Basel II The version of the Basel accord on bank capital requirements designed to succeed Basel I, permitting banks to employ their own internal risk-assessment methods and calculate their own minimum capital requirements as well as mandating periodic stress testing to estimate the impact of changing market conditions on each bank's financial position.

basic (lifeline) banking Low-cost deposits and other services that are designed to meet the needs of customers of limited means.

below-prime pricing Interest rates on loans set below the prevailing prime rate, usually based on the level of key money market interest rates (such as the current market rate on Federal funds or Eurodollar deposits).

beneficiary The party who will receive payment under a financial guarantee if certain events occur, such as default on a loan.

board of directors The committee elected by the stockholders to set policy and oversee the performance of a bank or other corporation.

Board of Governors The center of authority and decision making within the Federal Reserve System; the board must contain no more than seven persons, each selected by the president of the United States and confirmed by the U.S. Senate for a term not exceeding 14 years.

branch banking An arrangement in which a bank offers a full range of services from multiple locations, including a head office and one or more branch offices.

branch offices Full-service units operated by a business that is headquartered in another location.

business risk The probability that the economy will turn down into a recession, with reduced demand for loans, deposits, and other products and services.

C

call risk The danger that an investor in loans or securities will experience a lower-than-expected rate of return due to the issuer of the loans or securities calling in these instruments and retiring them early before they reach maturity.

CAMELS rating A system that assigns a numerical rating to a depository institution based on examiner judgment regarding its capital adequacy, asset condition, management quality, earnings record, liquidity position, and sensitivity to market risk.

capital Long-term funds contributed to a bank or other financial institution primarily by its owners, consisting mainly of stock, reserves, and retained earnings.

capital market instruments Investment securities that reach maturity over periods longer than one year.

capital risk The probability that a financial institution or one of its borrowing customers will fail, exhausting its capital.

cash This term is one of the six Cs of credit, which loan officers should review in any loan application, referring to the generation of income or cash flow by a borrowing customer.

cash flow Often measured by the net income plus noncash expenses (such as depreciation) of a business loan customer.

cash flow analysis An analytical approach to measuring the volume and composition of cash inflows and cash outflows experienced or expected by a borrowing customer.

cash flow risk The danger that cash flows may fluctuate widely due to economic conditions, service mix, and other factors; a merger may help to reduce this risk by combining organizations and service packages that have different cash flow patterns over time.

cash management services A service in which a financial firm agrees to handle cash collections and cash disbursements for a business firm and to invest any temporary cash surpluses in interest-bearing securities until those funds are needed.

certificate of deposit (CD) An interest-bearing receipt for the deposit of funds in a bank or thrift institution for a specified period of time.

charter of incorporation A license to open and operate a bank or other business, issued either by the commission of the state where the firm is to be located or by the Comptroller of the Currency (for federally chartered banks) inside the United States.

clearing balances Deposits held with the Federal Reserve banks by depository institutions to help clear checks for payment and collection and that allow the depository institutions using Federal Reserve services to earn interest credits on these balances in order to help offset the cost of Fed services.

collateral A borrower's possession of adequate net worth, quality assets, or other items of value that give added support to his or her ability to repay a loan.

commercial and industrial loans Credit granted to businesses to help cover purchases of inventory, plant, and equipment and to meet other operating expenses.

commercial paper Short-term, unsecured IOUs offered to investors in the money market by major corporations with the strongest credit ratings.

commercial paper market Market where short-term notes with maturities ranging from three or four days to nine months are traded, issued by well-known banking and nonbanking companies for the purpose of raising working capital.

common stock Type of capital measured by the par value of all common equity shares outstanding that pays a variable return to its owners after all expenses and other claims are met.

Community Reinvestment Act Federal law passed in 1977 requiring covered depository institutions to make "an affirmative effort" to serve all segments of their trade territory without discrimination.

compensating deposit balances Required deposits a customer must keep with a lender as a condition for getting a loan.

competitive effects The aspect of a merger or acquisition between two or more financial institutions that will have an impact on interfirm rivalry, either reducing or increasing competition in the markets served by the firms involved; this impact of a merger or acquisition is, under current federal law, the most important factor federal regulatory agencies must weigh in deciding to approve or deny any proposed acquisitions or mergers.

Competitive Equality in Banking Act Legislation that authorized recapitalization of the Federal Savings and Loan Insurance Corporation to deal more effectively with failing savings and loan associations, required depository institutions to provide more information to their customers on when credit is given for deposited funds, and placed a moratorium on the creation of nonbank banks and the offering of insurance, securities, and real estate services by banks operating inside the United States.

compliance risk Uncertainty as to whether a financial firm is engaging in behavior or taking actions not consistent with current laws, industry rules, or regulations.

Comptroller of the Currency (or Administrator of National Banks) The federal government agency, a part of the U.S. Treasury Department, that awards charters for new national banks in the United States and also supervises and regularly examines all existing national banks.

conditional pricing Establishing minimum-size account balances and charging a lower or even zero fee if the customer's deposit balance climbs *above* that required minimum but a higher fee if the average balance falls *below* the required minimum amount.

conglomerates Corporations that bring together a wide variety of different businesses and product lines under common ownership.

consolidating mergers Acquisitions of firms in the same industry as the acquiring firm.

construction loans Short-term loans designed to fund the building of new structures and then be paid off and replaced with a longer-term mortgage loan once the construction phase of the project has ended.

contingent liabilities Debt obligations that will not come due unless certain events occur, such as borrower default or the exercise of product warranties.

contingent obligation A financial instrument whose issuer pledges to pay if certain events (such as default on a loan) occur; for example, federal deposit insurance is a contingent obligation of the government, payable if a depository institution fails.

convergence The bringing together of firms from different industries to create conglomerate firms offering multiple services.

converging mergers Businesses reaching across industry boundaries to acquire a different type of firm.

convexity The rate of change in an asset's price or value varies with the level of interest rates or yields.

core capital Permanent capital, consisting mainly of common stock, surplus, retained earnings, and equity reserves.

core deposits A stable and predictable base of deposited funds, usually supplied by households and smaller businesses, that is not highly sensitive to movements in market interest rates but tends to remain loyal to the depository institution.

corporate bonds Debt securities issued by private corporations with original maturities longer than five years.

corporate governance The network of relationships between a corporation's board of directors and members of its management team that help to define who has control over what issues and who makes pivotal decisions within the organization.

corporate notes Debt securities issued by private corporations with original maturities of five years or less.

correspondent banking A system of formal and informal relationships among large and small depository institutions established to facilitate the exchange of certain services, such as the clearing of checks and the exchange of information.

cosigner A person obligated to support the repayment of a loan by a borrower who either has no credit record or has such a poor track record of repaying loans that he or she cannot get a loan without the support of the cosigner.

cost-plus deposit pricing Charging customers for the full cost or a significant portion of the total cost of any deposit services they use.

cost-plus loan pricing Figuring the rate of interest on a loan by adding together all interest and noninterest costs associated with making the loan plus margins for profit and risk.

cost savings (efficiency) A motivation for mergers that rests on the possibility that by combining two or more institutions together, overall operating expenses will be reduced, creating the possibility of a rise in net income for the combined (merged) institution.

credit availability risk The possibility that lenders may not have the funds to loan or be willing to accommodate every qualified borrower when credit is requested.

credit bureau A business firm that keeps data files on people who have borrowed money, indicating their previous record of loan repayments.

credit default swaps Financial agreements that permit a lender to protect itself against credit (default) risk by receiving compensation from a counterparty to help offset excessive loan losses or excessive fluctuations in loan revenue.

credit derivatives Financial contracts that are designed to protect a lending institution against loss due to defaults on its loans or security holdings.

credit enhancement A contract in which a financial institution promises to back up the credit of another firm.

credit life insurance An insurance policy that guarantees repayment of a loan if a borrower dies or is disabled before his or her loan is paid off.

credit option An agreement between a lending institution and an option writer that is designed to protect a lender against possible loss due to declines in the value of some of its assets or to prevent a significant rise in borrowing costs should the borrower's credit rating be lowered or other events occur that result in higher fund-raising costs.

credit risk The probability that the issuer of a loan or security will fail and default on any promised payments of interest or principal or both.

credit risk models Analytical tools, including computer programs, designed to assess the level of default risk associated with a loan customer seeking to borrow funds or the default-risk exposure of a whole portfolio of loans or other assets.

credit scoring The use of a discriminant equation to classify loan applicants according to the probability of their repaying their loans, based on customer characteristics, such as their credit rating or length of employment.

credit swap A financial contract designed to reduce the risk of default on loans by having two lending institutions exchange a portion of their expected loan payments with each other.

credit unions Nonprofit depository institutions that make loans to and accept deposits only from their members who must share a common bond (such as working for the same employer).

crime risk The danger of fraud, embezzlement, robbery, or other crimes that could result in loss for a financial institution.

currency exchange Trading one form of currency (such as dollars) for another (such as euros or pesos) in return for a fee; one of the first services offered when the banking industry began centuries ago.

currency futures contract Agreement between a buyer and a seller of foreign currencies that promises delivery of a stipulated currency at a specified price on a specific date in the future.

currency option Contract giving the option holder the right, but not the obligation, to deliver or take delivery of a specific currency at a set price on or before the contract's expiration date.

currency swaps Agreements between two or more parties who need to borrow foreign currency that help to protect each of them against changes in currency prices by agreeing to exchange payments denominated in different currencies.

customer privacy Protecting the personal information that customers supply to their financial-service providers so that customers are not damaged by the release of their private data to outside parties.

customer profitability analysis A method for evaluating a customer's loan request that takes into account all revenues and expenses associated with serving that particular customer and calculates an expected net return over all costs incurred from serving the customer.

customer relationship doctrine The management strategy whose first priority is making loans to all those customers who meet the lender's quality standards and from whom positive earnings are expected.

D

demand deposit Checking account services that permit depositors to write drafts in payment for goods and services that the depository institution involved must honor immediately upon presentation.

***de novo* bank** A newly chartered banking corporation.

Depository Institutions Deregulation and Monetary Control Act Law passed in the United States in 1980 requiring that federal interest rate ceilings on deposits sold to the public be phased out so that deposit interest rates could more closely reflect prevailing market conditions; it also authorized the offering of NOW accounts throughout the United States, which pay an explicit interest return to the customer and have third-party payment powers.

depository receipt (DR) A receipt issued by a domestic bank or other financial firm making it easier for a foreign firm to sell its securities to domestic investors.

dilution of earnings Spreading a fixed amount of earnings over additional shares of stock so that the earnings per share flowing to existing stockholders declines, as in the case when a merger results in excessive shares being issued to the stockholders of the acquired firm.

dilution of ownership The degree to which the proportionate share of ownership held by the current owners of a firm is reduced when additional equity shares are issued to new stockholders or to the shareholders of a firm that is being acquired.

disclosure rules Laws and regulations that mandate telling the consumer about financing costs and other essential terms of a loan or lease agreement, deposit contract, or other financial service.

discount brokerage services A service designed to assist customers with purchases and sales of securities at relatively low brokerage fees.

discounting commercial notes The process of making loans to local merchants who use IOUs received from their customers as collateral.

discount rate method The procedure used to assess interest on a loan in which interest is deducted up front at the beginning of the loan and the customer receives for his or her use the full principal of the loan less the interest assessed.

discount window Department within each Federal Reserve bank that lends legal reserves to eligible institutions for short periods of time.

dual banking system A system of banking regulation in which both federal and state authorities have significant regulatory powers and supervisory responsibilities over the activities of banks.

duration A present-value weighted measure of the maturity of an individual security or portfolio of securities in which the timing and amount of *all* cash flows expected from the security or portfolio of securities are considered.

duration gap The difference between the duration of an institution's assets and the duration of its liabilities.

duration gap management A strategy or technique used by the management of a financial institution to achieve a desired spread between the duration of its assets and the duration of its liabilities in order to control the institution's interest-rate risk exposure.

E

earnings risk The danger that earnings may fluctuate widely due to changes in economic conditions, demand for services, mix of services offered, or other factors; a merger between two or more organizations may dampen this form of risk by bringing together different revenue sources with different cash flow patterns over time.

economies of scale Cost savings achieved when a firm expands in size and becomes more efficient in using productive resources to produce goods and services.

economies of scope Employing the same management, staff, and facilities to offer multiple products or services, thereby helping to reduce the per-unit cost of production and delivery of goods or services.

Edge Acts Subsidiary companies of a banking organization that must devote the majority of their activities to transactions involving international trade and commerce; establishment of these subsidiaries must be approved by the Federal Reserve Board.

efficiency An indicator of how well management and staff have been able to keep the growth of revenues and income ahead of rising operating costs.

Equal Credit Opportunity Act Legislation passed by the U.S. Congress in 1974 that prohibits lenders from asking certain questions of a borrowing household customer, such as his or her age, race, or religion, and from denying a loan based solely upon a credit applicant's age, race, religion, ethnic origins, receipt of public assistance, or similar characteristics.

equipment leasing services The purchase of equipment on behalf of a customer in order to lease the equipment to that customer in return for a series of lease payments.

equity commitment notes Type of bank capital in the form of debt securities that is repayable only from the future sale of bank stock.

equity multiplier The ratio of total assets to total equity capital.

equity reserves Type of capital representing funds set aside for contingencies such as losses on assets, lawsuits, and other extraordinary events, as well as providing a reserve for dividends expected to be paid out to stockholders but not yet declared and a sinking fund to be used to retire stock or debt capital instruments in the future.

Eurobond market An institution that brings together sellers of bonds issued outside their home country and interested buyers in one or more other nations.

Eurocommercial paper (ECP) Short-term notes issued by multinational corporations and sold to investors in one or more countries that permit these corporations to borrow funds for a few days, weeks, or months.

Eurocurrency deposit Deposits denominated in a currency different from the currency of the home country where they are created.

events of default A section contained in most loan agreements listing what actions or omissions by a borrower would represent a violation of the terms of the agreement and what action the lender is legally authorized to take in response.

exchange ratio The number of shares of stock in the acquiring firm that stockholders of the acquired firm will receive for each share they hold.

exchange risk The probability of loss because of fluctuating currency prices in international markets.

expense preference An approach to the management of a firm in which managers draw upon the resources of the firm to provide them with personal benefits (such as lavish offices, country club memberships, etc.) not needed to produce and sell products, thereby raising the cost of production and reducing returns to the firm's owners; an agency cost problem in which the interests of the managers of a firm take precedence over the interests of its owners.

Export-Import Bank A lender of funds created by the U.S. government to aid with export-import financing and to make loans that support the development of overseas markets.

export trading companies (ETCs) Organizational devices to aid customers in selling their goods abroad, particularly the products of smaller businesses, by creating a subsidiary firm to help with foreign marketing and the financing of exports.

Export Trading Company Act Law passed by the U.S. Congress in 1982 that allowed U.S. banks to make direct investments in export trading companies to help their U.S. business customers sell goods and services abroad.

F

factoring Sale of the shorter-term assets of a business firm that are expected to roll over into cash in the near term, such as accounts receivable and inventory, in order to raise more working capital.

Fair Credit Billing Act Law enacted by the U.S. Congress in 1974 that permits consumers to dispute alleged billing errors committed by a merchant or credit card company and requires that consumers receive a prompt investigation of any billing disputes under penalty of forfeiture of at least a portion of the amount billed.

Fair Credit Reporting Act Law that authorizes U.S. consumers to review their credit records, as reflected in the files of a credit bureau, for accuracy and to demand the investigation and correction of any inaccuracies.

Fair Debt Collection Practices Act Law passed by the U.S. Congress limiting how far a creditor can go in pressing a loan customer to pay up.

FDIC Improvement Act A law passed by the U.S. Congress in 1991 to recapitalize the Federal Deposit Insurance Corporation and exercise closer regulation over troubled depository institutions.

federal agency securities Marketable notes and bonds sold by agencies owned by or started by the federal government, such as the Federal National Mortgage Association (FNMA) or the farm credit agencies.

Federal Deposit Insurance Corporation (FDIC) The U.S. government agency that guarantees the repayment of the public's deposits in U.S. banks and thrifts up to a maximum of $100,000 and assesses insurance premiums that must be paid by depositories offering federally insured deposits.

Federal funds market A domestic source of reserves in which a depository institution can borrow the excess reserves held by other institutions; also known as *same-day money* because these funds can be transferred instantaneously by wire from the lending institution to the borrowing institution.

Federal Open Market Committee (FOMC) Composed of the members of the Federal Reserve Board and the presidents of the Federal Reserve banks, the FOMC sets money and credit policies for the Federal Reserve System and oversees the conduct of open market operations, the Federal Reserve's chief policy tool.

Federal Reserve Bank A quasi-public U.S. institution created in 1913 by the Federal Reserve Act that provides financial services, such as check clearing, to depository institutions in the region served by each individual Federal Reserve Bank.

Federal Reserve System The federal agency that serves as a "lender of last resort" for depository institutions in need of temporary loans and is charged by the U.S. Congress to monitor and control the growth of money and credit and stabilize credit market conditions and the economy.

fiduciary relationship An agreement between a financial institution and its customer in which the institution becomes responsible for managing the customer's funds or other property.

finance companies Financial institutions that extend credit to businesses and individuals, either through direct loans or through purchasing accounts receivable from their customers, and raising loanable funds principally through borrowing in the money and capital markets.

financial advisory services A range of services that may include investment advice, the preparation of tax returns, and help with recordkeeping; business customers often receive aid in checking on the credit standing of prospective customers unknown to them and assistance in evaluating marketing opportunities abroad.

financial boutiques Financial-service companies that offer a limited set of services to selected customer groups.

financial futures Contracts calling for the delivery of specific types of securities at a set price on a specific future date.

financial guarantees Instruments used to enhance the credit standing of a borrower in order to help lower the borrower's credit costs by pledging to reimburse a lender if the borrower fails to pay.

financial holding companies (FHCs) Corporations that control one or more financial institutions and, perhaps, other businesses as well; under the terms of the Gramm-Leach-Bliley Act of 1999 banks, insurance companies, security dealers, and selected other financial firms may be acquired and brought under common ownership through a financial holding company organization.

financial institution loans Both long- and short-term credit extended to banks, insurance companies, and other financial institutions.

Financial Institutions Reform, Recovery, and Enforcement Act U.S. law passed in 1989 that authorized bank holding companies to acquire healthy savings and loan associations and restructured the FDIC, dividing its insurance fund into a Bank Insurance Fund (BIF) to cover U.S. commercial bank deposits and a Savings Associations' Insurance Fund (SAIF) to insure the deposits of U.S.-based savings and loan associations and other thrifts.

fixed-rate mortgages (FRMs) Loans against real property whose rate of interest does not change during the life of the loan.

Foreign Bank Supervision Enhancement Act U.S. law, passed in 1991, giving the Federal Reserve Board greater regulatory powers over foreign banks operating in the United States, including the power to close a foreign bank's U.S. facilities if found to be inadequately supervised or operated in an unsafe manner.

FOREX Foreign currencies and foreign-currency—denominated deposits offered by international banks to aid their customers who trade and travel abroad.

forward contracts Agreements that can be used when a customer anticipates a future need to acquire foreign currency or expects to receive foreign currency; a financial institution negotiates a contract with another party on behalf of its customer, fixing the price at which currency is exchanged and specifying a date on which the currency will be delivered.

full-service branch A branch office that offers all or most of the same services that the firm's head office also offers.

full-service interstate banking The establishment of banks or bank branches across state lines by individual banking organizations that offer a complete menu of banking services.

Funds-Flow Statement A financial statement that shows where funds have come from and how they have been used over a specific time period.

funds gap The difference between current and projected credit and deposit flows that creates a need for raising additional reserves or for profitably investing any excess reserves that may arise.

funds management Combining asset and liability management strategies in order to achieve a financial institution's goals and meet its liquidity needs more effectively.

G

Garn–St Germain Depository Institutions Act A U.S. deregulation law, passed in 1982, that permitted thrift institutions to become more like commercial banks in the services they could offer and allowed all federally regulated depository institutions to offer deposits competitive with money market mutual fund share accounts.

geographic diversification Spreading out credit accounts and deposits among customers located in different communities, regions, or countries in order to reduce the overall risk of loss to a bank or other financial institution.

Glass-Steagall Act Law passed by the U.S. Congress in 1933 that legally mandated the separation of commercial and investment banking, imposed interest rate ceilings on bank deposits, authorized the creation of the Federal Deposit Insurance Corporation, and granted federally chartered banks the power to branch throughout a state, provided that state grants similar powers to its own state-chartered banks.

Gramm-Leach-Bliley (Financial Services Modernization) Act A U.S. federal law approved in 1999 permitting common ownership of banks, securities firms, and insurers through financial holding companies or subsidiaries if well capitalized and well managed and granted regulatory approval.

H

hedge funds Private partnerships that sell shares to only a limited group of investors in order to invest in a wide variety of assets and derivative instruments in the hope of achieving exceptional returns regardless of the direction the market subsequently moves.

Herfindahl-Hirschman Index A summary measure of market concentration used by the U.S. Justice Department, in which the assets of each firm serving a given market are squared and the squared market shares of all firms are then summed to derive a single index number reflecting the degree of concentration of assets in the largest firms.

holding period yield (HPY) A rate of discount bringing the current price of a security into line with its stream of expected cash inflows and its expected sale price at the end of the investor's holding period.

home equity loans Credit extended to an individual or family on the basis of the spread or gap between the estimated market value of a home and the amount of mortgage loans outstanding against the property.

I

inflation risk The probability that the prices of goods and services (including the interest rate on borrowed funds and the cost of personnel and other productive resources) will rise or that the value of assets will be eroded due to rising prices, lowering the expected return on invested capital.

installment loans Credits that are repayable in two or more consecutive payments, usually on a monthly or quarterly basis.

in-store branches Branch offices located in a grocery store or other retail outlet.

insurance policies Contracts that guarantee payment if the customer dies, becomes disabled, or suffers loss of property or earning power.

interest-rate cap Ceiling interest rate imposed on a loan designed to protect the borrower from an unacceptable rise in the interest cost of that loan.

interest-rate collar A combination of an interest-rate cap and an interest-rate floor; puts brackets around the movement of a loan rate so that it cannot rise above the cap or fall below the floor.

interest-rate floor Minimum interest rate below which the interest cost of a loan normally cannot fall, thus protecting the lender from additional lost revenue if market interest rates move lower.

interest-rate option A contract that either (1) grants a holder of securities or loans the right to place (put) those instruments with another investor at a specified exercise price before the option expires or (2) allows an investor to take delivery of securities or other financial instruments (call) from another investor at a specified price on or before the option's expiration date.

interest rate risk The probability that rising or falling interest rates will adversely affect the margin of interest revenues over interest expenses or result in decreasing the value of net worth.

interest-rate swaps Agreements that enable two different borrowers of funds to aid each other by exchanging some of the most favorable features of their loans; usually the two participating institutions exchange interest rate payments in order to reduce their borrowing costs and better balance their inflows and outflows of funds.

interest sensitive An asset or liability item that can be repriced as market interest rates change.

interest-sensitive gap management Management techniques that usually require a computer analysis of the maturities and repricing opportunities associated with interest-bearing assets, deposits, and money market borrowings in order to determine when and by how much a financial institution is exposed to interest rate risk.

interim construction loan Secured short-term lending to support the construction of homes, apartments, office buildings, shopping centers, and other permanent structures.

internal capital growth rate The rate of growth of net earnings that remain inside a firm rather than being paid out to its stockholders; this growth rate depends on a firm's return on equity and its dividend policies.

International Banking Act Law passed by the U.S. Congress in 1978 that brought foreign banks operating in the United States under federal regulation for the first time; it required foreign banking offices taking deposits from the public to post reserve requirements and allowed them to apply for federal deposit insurance coverage.

international banking facility (IBF) Computerized account records that are kept separate from a U.S. bank's domestic accounts and that keep track primarily of international transactions.

International Lending and Supervision Act Law passed by the U.S. Congress in 1983 that requires U.S. banks to hold stipulated minimum amounts of capital and that sets standards for making, evaluating, and restructuring overseas loans.

Internet banking The offering of information and selected services through the World Wide Web by banks and other financial-service firms.

Internet service sites Computer files or pages set up on the World Wide Web to advertise services or offer selected service options to Web users.

investment banking A financial firm that underwrites new stock and bond issues and provides financial advice to corporate and governmental clients.

investment banking services A bank's offer to underwrite a corporate or institutional customer's securities in order to aid that customer in raising funds.

investment products Sales of mutual funds, annuities, and other nondeposit instruments offered through a bank's service delivery facilities, either with the aid of an affiliate or offered by an unrelated financial services company but sold through the bank's service outlets.

J

joint venture Cooperative service production and delivery between banks or between banks and nonbank firms in order to provide a wider array of customer services at a profit.

Justice Department Merger Guidelines Standards for evaluating the impact of a proposed merger on the concentration of assets or deposits in a given market area; the Justice Department uses these standards to help it decide whether to sue to block a proposed merger that might damage competition.

L

lagged reserve accounting (LRA) An accounting system begun by the Federal Reserve in 1984 for calculating each depository institution's legal reserve requirement, in which the reserve computation and reserve maintenance periods for transaction deposits are not exactly the same.

LBOs (leveraged buyouts) Contractual agreements in which a company or small group of individual investors purchases a business or buys a portion of a business firm's assets with heavy use of debt and relatively little equity capital and relies on increased earnings after the business is taken over to retire the debt.

legal reserves Assets that by law must be held behind deposits or other designated liabilities; in the United States, these assets consist of vault cash and deposits at the Federal Reserve banks.

legal risk Uncertainty in earnings or returns due to actions taken within the legal system, such as lawsuits or court judgments impacting a financial firm.

letter of credit A legal notice in which a financial institution guarantees the credit of one of its customers who is borrowing from another institution.

liability management Use of borrowed funds to meet liquidity needs, in which a financial institution attracts the volume of liquidity it needs by raising or lowering the rate of interest it is willing to pay on borrowed funds.

LIBOR The London Interbank Offered Rate on short-term Eurodollar deposits, which is used as a common basis for quoting loan rates to corporations and other large borrowers.

life and property casualty insurers Firms selling risk protection to their customers in an effort to offset financial losses related to death, ill health, negligence, storm damage, and other adverse events.

life insurance policies Contracts that promise cash payments to beneficiaries when the death of a policyholder occurs.

life insurance underwriters Companies that manage the risks associated with paying off life insurance claims and collecting premium payments from life insurance policyholders.

liquid asset Any asset that meets three conditions: (1) price stability, (2) ready marketability, and (3) reversibility.

liquidity Access to sufficient immediately spendable funds at reasonable cost exactly when those funds are needed.

liquidity gap The amount by which the sources and uses of liquidity do not match.

liquidity indicators Certain bellwether financial ratios (e.g., total loans outstanding divided by total assets) that are used to estimate liquidity needs and to monitor changes in liquidity position.

liquidity risk The probability that an individual or institution will be unable to raise cash precisely when cash is needed at reasonable cost and in the volume required.

loan commitment agreements Promises to provide credit to a customer in the future, provided certain conditions are met.

loan option A device to lock in the amount and cost of borrowing for a designated time period by allowing a customer to borrow at a guaranteed interest rate, regardless of any subsequent changes in market interest rates, until the option expires.

loan participation Agreement under which a lender will share a large loan with one or more other lenders in order to provide the borrower with sufficient funds and reduce risk exposure to any one lending institution.

loan review A process of periodic investigation of all outstanding loans to make sure each loan is paying out as planned, all necessary documentation is present, and loan officers are following the institution's loan policy.

loan sales A form of investment banking in which the lender trades on his or her superior ability to evaluate the creditworthiness of borrowers and sells some of the loans the lender has made to other investors who value the lender's expertise in assessing credit quality.

loans to individuals Credit extended to households to finance the purchase of automobiles and appliances, medical and personal expenses, and other household needs.

loan strip The sale of a portion of a large loan for a short period of time, usually for a period less than the loan's remaining time to maturity.

loan workouts Activity within a lending institution that focuses on delinquent loans and that tries to develop and implement strategies designed to recover as much as possible from troubled borrowers.

M

market-penetration deposit pricing Offering high interest rates (often well above current market levels) or charging low or zero customer fees in order to bring in as many new deposit customers as possible.

market-positioning benefits A motive for conducting a merger between two or more firms, in which the firms involved anticipate gaining access to important new markets not previously served or securing a stronger foothold in markets currently served.

market risk The potential for loss due to rising or falling interest rates; the danger that changing interest rates may force a financial institution to accept substantial losses on any assets that must be sold or acquired or on any funds that must be borrowed or repaid.

maturity gap The difference between the average maturity of a financial-service firm's assets and the average maturity of its liabilities.

McFadden-Pepper Act Legislation passed by the U.S. Congress in 1927 that allowed national banks to branch within the city where they are headquartered if the laws of the state involved do not forbid such branches.

member bank A commercial bank that has joined the Federal Reserve System and is subject to its rules and regulations; includes all national banks as well as state-chartered banks that elect to join the Federal Reserve System.

merchant banks Banks that often provide not only all the consumer and commercial services a regular bank provides but also offer credit, investment, and consulting services in an attempt to satisfy all the financial service needs of their clients; usually these banks invest a substantial share of their own equity capital in a customer's commercial project.

merger premium A bonus offered to the shareholders of a firm to be acquired, consisting of an amount of cash or stock in the acquiring institution that exceeds the current market value of the acquired firm's stock.

minority interest in consolidated subsidiaries Partial ownership interest that a financial firm holds in other business firms.

monetary policy A central bank's primary job, which involves making sure that the financial system functions smoothly and that the supply of money and credit from that system contributes to the nation's economic goals.

money market deposit accounts (MMDAs) Short-maturity deposits having a term of only a few days, weeks, or months and on which the offering depository institution can pay any competitive interest rate over designated short intervals of time; these deposits also have limited checking account powers.

money market instruments Investment securities that reach maturity within one year and are noted for their low credit risk and ready marketability.

money position manager Managerial position that is responsible for ensuring that the institution maintains an adequate level of legal reserves to meet its reserve requirements as set by law and also has access to sufficient quantities of reserves to accommodate customer demand and meet other cash needs.

mortgage-backed bond A debt instrument representing a claim against the interest and principal payments generated by a pool of mortgage loans.

mortgage banking companies Financial-service firms that acquire mortgage loans for eventual resale to longer-term lenders (e.g., insurance companies and pension funds).

multibank holding companies A type of holding company that holds stock in more than one bank.

municipal bonds Debt obligations issued by states, cities, counties, and other local governmental units.

mutual funds Investment companies that attract savings from the public and invest those funds in a pool of stocks, bonds, and other financial instruments, with each saver receiving a share of the earnings generated by the pool of financial instruments.

N

National Credit Union Administration A federal regulatory agency set up during the 1930s as a result of passage of the Federal Credit Union Act in the United States to charter and supervise federal credit unions.

negotiable CD A type of interest-bearing deposit that may be sold to other investors in the secondary market any number of times before it reaches maturity.

net interest margin The spread between interest income and interest expense divided by either total assets or total earning assets.

net liquidity position The difference between the volume of liquid funds available and the demand for liquid funds.

net profit margin The ratio of net income after taxes divided by total operating revenues.

networking The sharing of facilities for the movement of funds and financial information between financial-service providers.

nonbank banks Financial-service firms that either offer checking account services or grant commercial loans, but not both.

noninterest margin The spread between noninterest income and noninterest expenses divided by total assets or total earning assets.

note A written contract between a borrowing customer and a lender describing the responsibilities of both parties.

note issuance facility (NIF) A medium-term credit agreement between an international bank and its larger corporate and governmental credit customers, where the customer is authorized to periodically issue short-term notes, each of which usually comes due and is retired in 90 to 180 days, over a stipulated contract period (such as five years), with the bank pledging to buy any notes the customer cannot sell to other investors.

NOW accounts Savings deposits against which a customer can write negotiable drafts (checks) but that reserve the depository institution's right to insist on prior notice before the customer withdraws his or her funds.

O

Office of the Comptroller of the Currency See Comptroller of the Currency.

Office of Thrift Supervision A federal regulatory agency inside the U.S. Treasury Department that is authorized to charter and supervise thrift institutions, including savings and loan associations and savings banks.

open market operations (OMO) Purchases and sales of securities—in most cases, direct obligations of the government—that are designed to move reserves and interest rates toward levels desired by a central bank (such as the Federal Reserve System).

operational (transactional) risk Uncertainty surrounding a financial firm's earnings or rate of return due to failures in computer systems, management errors, employee misconduct, floods, hurricanes, and similar events.

opportunity cost Forgone income that is not earned because idle funds have not been invested in earning assets; also, the yield available on the next best alternative use of an individual's or institution's funds.

option ARM Home mortgage loan that allows the borrower to pay a reduced amount the first few years (such as paying interest only) and then requires larger payments (including principal) in the later years.

organizational forms The structure of operations, facilities, and personnel within a bank or other financial firm that enables it to produce and deliver financial services.

P

participation loans Purchases of loans by a third party, not part of the original loan contracts.

passbook savings deposits Accounts sold to household customers in small denominations along with a small booklet or computer statement showing the account's current balance, interest earnings, deposits, and withdrawals.

People's Bank of China The central bank of China, directing that nation's money and credit policies.

pledging Backing deposits owed to the federal government and local units of government by requiring the financial institutions holding those deposits to hold designated high-quality (low-risk) assets (usually government securities of various types) that could be sold to recover government funds if the depository institution fails.

point-of-sale (POS) terminals Computer equipment in stores to allow electronic payments for goods and services.

points An up-front fee often charged a borrower taking on a home mortgage, which is determined by multiplying the loan amount by the number of percentage points assessed the borrower.

portfolio diversification Spreading out credit accounts and deposits among a wide variety of customers, including many large and small businesses, different industries, and households in order to reduce the lender's risk of loss.

portfolio immunization An interest-rate hedging device that permits a financial institution to reduce loss in the value of its assets or in the value of its net worth due to changing interest rates by equating the average duration of its assets to the average duration of its liabilities.

portfolio shifting Selling selected securities, often at a loss, to offset taxable income from other sources and to restructure a financial firm's asset portfolio to one that is more appropriate for current market conditions.

predatory lending Granting loans to weaker borrowers and charging them excessive fees and interest rates, increasing the risk of their defaulting on those loans.

preferred stock Type of capital measured by the par value of any shares outstanding that promise to pay their owners a fixed rate of return or (in the case of variable-rate preferred) a rate determined by an agreed-upon formula.

prepayment risk A risk carried by many securitized assets in which some of these assets (usually loans) are paid off early and the investor receiving those prepayments may be forced to reinvest the prepaid funds at lower current market yields, resulting in a lower than expected overall return from investing in securitized assets.

price leadership A method for setting loan rates that looks to leading lending institutions to set the base loan rate.

primary capital The sum of total equity capital, the allowance for possible loan losses, mandatory convertible debentures, and minority interests in consolidated subsidiaries, minus intangible assets other than purchased loan-servicing rights.

prime rate An administered interest rate on loans quoted by leading banks and usually set by a vote of each bank's board of directors; the interest rate that the public usually thinks is the best (lowest) rate for loans and that a bank quotes to its biggest and best customers (principally large corporations).

product-line diversification Offering multiple financial services in order to reduce the risk associated with declining revenues and income from any one service offered.

profitability An important indicator of performance, it represents the rate of return a financial firm or other business has been able to generate from using the resources at its command in order to produce and sell services.

profit potential A motive for carrying out a merger, in which the shareholders of either the acquiring firm, the acquired firm, or both anticipate greater profits due to greater revenues or lower operating costs after the merger is completed.

project loans Credit designed to finance the construction of fixed assets associated with a particular investment project that is expected to generate a flow of revenue in future periods sufficient to repay the loan and turn a profit.

property-casualty insurance policies Contracts that pledge reimbursement of policyholders for personal injuries, property damage, and other losses incurred in return for policyholder premium payments.

public benefits Aspect of a merger or holding-company acquisition application in which merging or acquiring financial firms must show how the transaction will improve the quality, availability, or pricing of services offered to the public.

public need One of the criteria used by governmental agencies to determine whether a new bank, branch, or other financial service unit should be approved for a charter, which focuses on whether or not an adequate volume and variety of financial services are available conveniently in a given market area.

purchase-of-assets method A method for completing a merger in which the acquiring institution buys all or a portion of the assets of the acquired organization, using either cash or its own stock to pay for the purchase.

purchase-of-stock method A method for carrying out a merger in which the acquired firm usually ceases to exist because the acquiring firm assumes all of its assets and liabilities.

R

real estate brokerage services A service that assists customers in finding homes and other properties for sale or for rent.

real estate loans Credit secured by real property, including short-term credit to support building construction and land development, and longer-term credit to support the purchase of residential and commercial structures.

relationship pricing Basing fees charged a customer on the number of services and the intensity of use of those services that the customer purchases.

Report of Condition A depository institution's balance sheet, which lists the assets, liabilities, and equity capital (owners' funds) held by or invested in the depository institution at any single point in time; reports of condition must be filed periodically with regulatory agencies.

Report of Income A depository institution's income statement, which indicates how much revenue has been received and what expenses have been incurred over a specific period of time; reports of income must be filed periodically with regulatory agencies.

representative office The simplest organizational presence for an international bank in foreign markets, consisting of limited-service facilities that can market services supplied by the home office and identify new customers but usually cannot take deposits or make decisions on the granting of loans.

repurchase agreement (RP) A money market instrument that involves the temporary sale of high-quality assets (usually government securities) accompanied by an agreement to buy back those assets on a specific future date at a predetermined price or yield.

reputation risk Uncertainty associated with publicity that a financial firm may attract or changing public opinion regarding a firm's behavior and performance.

reserve computation period A period of time established by the Federal Reserve System for certain depository institutions over which the daily average amounts of various deposits are computed to determine each institution's legal reserve requirement.

reserve maintenance period According to federal law and regulation, a period of time spanning two weeks, during which a depository institution must hold the daily average amount of legal reserves it is required by law to hold behind its deposits and other reservable liabilities.

residential mortgage loans Credit to finance the purchase of homes or fund improvements on private residences.

restrictive covenants Parts of a loan agreement, specifying actions the borrower must take or must not take for a loan agreement to remain in force.

retail banks Consumer-oriented banks that sell the majority of their services to households and smaller businesses.

retail credit Smaller-denomination loans extended to individuals and families as well as to smaller businesses.

retirement plans Financial plans offered by various financial institutions that accumulate and manage the savings of customers until they reach retirement age.

revolving credit line A financing arrangement that allows a business customer to borrow up to a specified limit, repay all or a portion of the borrowing, and reborrow as necessary until the credit line matures.

Riegle-Neal Interstate Banking and Branching Efficiency Act Federal law passed in 1994 that permits bank holding companies to acquire banks nationwide and authorized interstate branching and mergers beginning June 1, 1997.

right of offset The legal authority of a lender that has extended a loan to one of its customers to seize any checking or savings deposits the customer may hold with the lender in order to recover the lender's funds.

ROA Return on total assets as measured by the ratio of net income after taxes to total assets.

ROE Return on equity capital invested in a corporation by its stockholders, measured by after-tax net income divided by total equity capital.

Rule of 78s A method for calculating rebates of interest payments to be returned to a customer if a loan is retired early.

S

safekeeping A financial institution's practice of holding precious metals, securities, and other valuables owned by its customers in secure vaults.

Sarbanes-Oxley Accounting Standards Act Federal law passed in the United States in 2002 designed to prohibit public companies from publishing false or misleading financial reports and creating an accounting standards board to oversee the practices of the accounting and auditing professions.

savings and loan associations Depository institutions that concentrate the majority of their assets in the home mortgage loan area and rely mainly on savings deposits as their principal source of funding.

savings deposits Interest-bearing funds left with a depository institution for a period of weeks, months, or years (with no minimum required maturity under U.S. regulations).

secondary capital The sum of all forms of temporary capital, including limited-life preferred stock, subordinated notes and debentures, and mandatory convertible debt instruments not eligible to be counted as primary capital.

Securities and Exchange Commission A federal oversight board created by the Securities and Exchange Act of 1934 that requires public companies to file financial reports and disclose relevant information about their financial condition to the public and to prevent the issuance of fraudulent or deceptive information in the offering of new securities to the public.

securitization Setting aside a group of income-earning assets and issuing securities against them in order to raise new funds.

securitized assets Loans placed in an income-generating pool against which securities are issued in order to raise new funds.

security brokerage Offering customers a channel through which to buy or sell stocks, bonds, and other securities at low transactions cost instead of having to go through a security broker or dealer.

security brokers and dealers Financial firms engaged in buying and selling stocks, bonds, and other securities on behalf of their customers and providing underwriting services for new issues of stocks and debt securities as well as financial advice regarding market conditions and other financial matters.

security underwriting A service provided by investment banks to corporate and governmental customers in which new securities issued by a customer are purchased by the investment bank and sold in the money and capital markets in the hope of earning a profitable spread.

self-liquidating loans Business loans, usually to support the purchase of inventories, in which the credit is gradually repaid by the borrowing customer as inventory is sold.

service differentiation Creating perceptions in the minds of customers that a particular financial firm's services are of better quality, are more conveniently available, or differ in some other significant way from similar services offered by competitors.

servicing rights Rights retained by a lender selling a loan in which the lender continues to collect interest payments from the borrower and monitors the borrower's compliance with loan terms on behalf of the purchaser of the loan.

shell branches Booking offices located offshore from the United States that record international transactions (such as taking deposits) and escape many regulatory restrictions that limit the activities of domestic offices.

simple interest method A method for calculating the interest rate on a loan that adjusts for the declining balance on a loan and uses a formula, principal times interest times time, to determine the amount of interest owed.

sources and uses of funds method Approach developed for estimating liquidity requirements that examines the expected sources of liquidity (for a bank, principally its deposits) and the expected uses of liquidity (principally its loans) and estimates the net difference between funds sources and uses over a given period of time in order to aid liquidity planning.

Sources and Uses of Funds Statement Financial reports on a business customer showing changes in assets and liabilities over a given period of time.

standby letter of credit (SLC) Popular type of financial guarantee in which the issuer of the letter guarantees the beneficiary of the letter that a loan he or she has made will be repaid.

state banking commissions Boards or commissions appointed by governors or legislators in each of the 50 states that are responsible for issuing new bank charters and supervising and examining state-chartered banks.

state insurance commissions Regulatory bodies created by state law in each of the 50 U.S. states that regulate life and property/casualty insurance companies selling their policies to the public in an effort to ensure adequate service at reasonable cost.

Statement of Cash Flows A financial report often constructed by credit analysts or by borrowing customers that shows a prospective borrower's sources of cash flowing in and flowing out and the actual or projected net cash flow available to repay a loan or other obligation.

stockholders The owners of a business who hold one or more shares of common and/or preferred stock issued by their corporation and elect its board of directors.

strategic risk Variations in earnings or rates of return due to longer-range business decisions or a financial firm's responses to changes in the business environment.

stripped security A debt security whose promised interest payments and promised repayments of principal are separated from each other; each of these promised payment streams becomes the basis for issuing new securities in the form of interest-only (IO) and principal-only (PO) discount obligations.

structure of funds method Method of estimating liquidity requirements that depends on a detailed analysis of deposit and loan customers and how the levels of their deposits and loans are likely to change over time.

subordinated debentures (or notes) Type of capital represented by debt instruments whose claim against the borrowing institution legally follows the claims of depositors but comes ahead of the stockholders.

subprime loans Credit granted to borrowers whose credit rating is considered to be weak or below average, often due to a prior record of delinquent payments, bankruptcy, or other adverse developments.

subsidiary A corporation operated by international banks that is used to sell bank and nonbank services overseas and is often set up or acquired because bank branch offices may be prohibited in some foreign markets or because of tax advantages or other factors.

super NOWs Savings accounts that usually promise a higher interest return than regular NOW accounts but often impose restrictions on the number of drafts (checks) or withdrawals the depositor is allowed to make.

supplemental capital Secondary forms of capital, such as debt securities and limited-life preferred stock, that usually have a definite maturity and are not, therefore, perpetual funding instruments.

surplus Type of capital representing the excess amount above each share of stock's par value paid in by stockholders when they purchased their shares.

sweep accounts Contracts executed between a depository institution and some of its deposit customers that allow the institution to transfer funds (usually overnight) out of the customers' checking accounts into their savings deposits or into other types of deposits that do not carry legal reserve requirements.

syndicated loan A loan or line of credit extended to a business firm by a group of lenders in order to reduce the credit risk exposure to any single lending institution.

synthetic CDOs Financial instruments based on pools of derivatives, usually issued to help guard against defaults on corporate bonds.

T

tax benefits Ways to save on a potential tax obligation by investing in tax-exempt earning assets, incurring tax-deductible expenses, or accruing income losses that help offset taxable income from loans or other income sources.

tax swapping A process in which lower-yielding securities may be sold at a loss that is deductible from ordinary taxable income, usually to be replaced by securities bearing more favorable returns.

term loans Credit extended for longer than one year and designed to fund longer-term business investments, such as the purchase of equipment or the construction of new physical facilities.

thrift deposits Accounts whose principal purpose is to provide an interest-bearing outlet for customer savings—that is, a place for the customer to store liquid purchasing power at interest until needed.

Tier 1 capital Core capital for a banking firm that includes common stock, undivided profits, selected preferred stock and intangible assets, and minority interest in subsidiary businesses.

Tier 2 capital Supplemental long-term funds for a bank, including allowance for loan and lease losses, subordinated debt capital, selected preferred stock, and equity notes.

time deposits Interest-bearing accounts with stated maturities, which may carry penalties in the form of lost interest earnings or reduction of principal if early withdrawal occurs.

transaction deposit A deposit service in which checks or drafts against the deposit may be used to pay for purchases of goods and services.

Treasury bill A direct obligation of the U.S. government that must mature within one year from date of issue.

Treasury bonds The longest-term U.S. Treasury debt securities, with original maturities beyond 10 years.

Treasury notes Coupon instruments issued by the U.S. government, with original maturities from more than 1 year to a maximum of 10 years, which promise investors a fixed rate of return.

trust services Management of property and other valuables owned by a customer under a contract (the trust agreement) in which the bank serves as trustee and the customer becomes the trustor during a specified period of time.

Truth-in-Lending Act Law passed by the U.S. Congress in 1968 that promotes the informed use of credit among consumers by requiring full disclosure of credit terms and costs.

Truth-in-Savings Act Law passed by the U.S. Congress in 1991 that requires depository institutions to fully disclose the prices and other terms offered on deposit services so that customers can more easily compare deposit plans offered by different service providers.

U

underwriting Buying new securities from the businesses that issued them and attempting to resell those securities at a profit to other investors.

underwriting property/casualty insurance risks Companies that attempt to profit from collecting policyholder premiums that exceed cash outflows to pay off policyholder claims for injuries and damages.

undivided profits Type of capital representing net earnings that have been retained in the business rather than being paid out as dividends to the stockholders.

Uniform Bank Performance Report (UBPR) A compilation of financial and operating information, periodically required to be submitted to federal banking agencies, which is designed to aid regulators and financial analysts in analyzing a U.S. bank's financial condition.

unit banks Banks that offer the full range of their services from one office, though a small number of services (such as taking deposits or cashing checks) may be offered from limited-service facilities, such as drive-up windows and ATMs.

USA Patriot Act Federal law passed in the United States in the fall of 2001 requiring selected financial institutions to verify the identity of customers opening new accounts and to report any suspicious activities (especially those possibly related to terrorism) to a division of the U.S. Treasury Department.

V

value at risk (VaR) models A statistical framework for measuring an asset portfolio's exposure to changes in market prices or market rates of interest over a given time period, subject to a given probability level.

virtual banks Banking firms chartered by federal or state authorities to offer financial services to the public exclusively online.

W

warranties A section within a loan agreement in which a borrower affirms to the lender that the information he or she supplies is true and correct.

wholesale banks Large metropolitan banks that offer financial services mainly to corporations and other large institutions.

wholesale lenders Lending institutions that devote the bulk of their credit portfolios to large-denomination loans extended to corporations and other relatively large business firms and institutions.

working capital The current assets of a business firm (consisting principally of cash, accounts receivable, inventory, and other assets normally expected to roll over into cash within a year); some authorities define working capital as equal to current assets minus current liabilities.

working capital loans Loans that provide businesses with short-term credit lasting from a few days to one year and that are often used to fund the purchase of inventories in order to put goods on shelves or to purchase raw materials.

Y

yield curve A graphic picture of how interest rates vary with different maturities of securities as viewed at a single point in time.

yield to maturity (YTM) The expected rate of return on a debt security held until its maturity date is reached, based on the security's purchase price, promised interest payments, and redemption value at maturity.

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Independent Community Bankers of America	www.ibaa.org
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Inner City Press	www.innercitypress.org
Innovative Interfaces, Inc.	www.iii.com
Institute of International Bankers	www.iib.org
Institute of Islamic Banking and Insurance	www.islamic-banking.com
Insurance Information Institute	www.iii.org
International Country Risk Guide	www.icrgonline.com
International Monetary Fund	www.imf.org
International Swaps and Derivatives Association, Inc.	www.isda.org
Internet Fraud	www.internetfraud.usdoj.gov
InternetNews.com	www.internetnews.com
InvestingInBonds.com	www.investinginbonds.com
Investment Company Institute	www.ici.org
iMoneyNet	www.imoneynet.com
The Investment FAQ	www.invest-faq.com
Investopedia	www.investopedia.com
InvestorGuide	www.investorguide.com
InvestorWords.com	www.investorwords.com
Japanese Bankers Association	www.zenginkyo.or.jp/en/
KeyBank	www.key.com
LACE Financial Corp.	www.lacefinancial.com
LaSalle Bank	www.lasallebank.com
Lehman Brothers	www.lehman.com
Lendertraining.com	www.quick-start.net
The Library of Economics and Liberty	www.econlib.org
Loan Pricing Corporation	www.loanpricing.com
MarketWatch, Inc.	www.marketwatch.com
Markit Group	www.markit.com
MerchantConnect	www.merchantconnect.com
Merrill Lynch & Co.	www.ml.com
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Morningstar, Inc.	www.morningstar.com
Mortgage 101	www.mortgage101.com
Mutual Fund Investor's Center	www.mfea.com
myFico	www.myfico.com
National Association for Bank Security	www.banksecurity.com
National Association of Credit Management	www.nacm.org
National Association of Insurance Commissioners	www.naic.org
National Bankers Association	www.nationalbankers.org
National Banking Network, Inc.	www.nbn-jobs.com
National Credit Union Administration	www.ncua.gov
National Venture Capital Association	www.nvca.org
New York State Banking Department	www.banking.state.ny.us
Nexus Generations	www.nexusgenerations.com
Nolo	www.nolo.com
The Office of Thrift Supervision	www.ots.treas.gov
Olson Research Associates, Inc.	www.olsonresearch.com
Onecle	www.contracts.onecle.com