MODULE 4 – Commercial Banking

Introduction

Commercial banking is an offshoot of the overall banking system that evolved throughout the history of financial and economic endeavors. Commercial banking began with the Goldsmith Principle and contributed to the progress of the industrial revolution. In this module, we will focus on commercial banking and how financial services are offered, from correspondent banking all the way to full-fledged multinational banks offering financial services to worldwide clientele. Furthermore, in this module we will touch upon the role the IMF plays in the operation of international commercial banking. Finally, we will discuss different financing methods and how risk is managed by commercial bankers.

Objectives

Upon successful completion of this module, the student should be able to:

- Describe correspondent banks, representative offices, branch offices, agencies, subsidiaries, and consortium banks.
- List different types of financing projects.
- Identify risks posed to international commercial banking.
- Describe the process of syndicated lending and its objectives.
- Distinguish between internal and external processes that combined are considered operational risks.

The inevitability of globalization of financial and economic activity caused international banks to overhaul their operational orientation from the traditional banking activity of accepting deposits and loan packaging into broader financial services in line with the globalization trend. The recent shift in the operation of international commercial banks is helping multinational corporations to receive a wide variety of services from the banking systems with which they have an established financial relationship. With this in mind, the international commercial banks are fiercely competing in establishing a financial relationship with multinational corporations. This competition has been responsible for opening areas of the globe to international banks that were previously dominated by the domestic banking system.

Commercial banking moved away from the practice of simply collecting individuals’ assets and issuing certificates known as “IOUs,” and then charging the asset holders a percentage for safeguarding them. The Goldsmiths used the said assets to lend to the deficit sector of society for a fee. Later on, they were compelled to pay interest to the original asset holders. This process evolved to become what commercial banking is today, that fundamentally they offer the same types of services that were offered after the Industrial Revolution by collecting funds from the surplus sector of society and lending them to the deficit sector. In the Contemporaries, commercial banking evolved to become a major player in the financial markets by providing services to the commercial sector also. In modern times, with the advent of globalization, they provide a vast variety of financial services to households and the business sector. For further information, please see Footnote #1.

When domestic commercial banks make the decision to enter the international arena, there is an evolutionary process of organizational structure through which they must go in order to become full-fledged commercial banking concerns. An international bank’s organizational hierarchy in
the host country varies, since each host country provides challenges such as cultural, societal and economical issues that need to be rectified if the international banking operation is to be successful. In establishing organizational hierarchy, international banks have to take under consideration the laws of the host country, human resources (preferably hiring skilled banking workers from within the host country), whether the bank is planning its operation to be long or short term, the economic indicators of the host country, the balance of trade, political stability, creditworthiness, anticipated future capital formation and the level of GDP and national debt.

The following are brief descriptions of different stages of the said structure:

**Correspondent Banking**

Correspondent banking is the very first representation of an international bank in the home country for testing the possibility of further expansion in another host country. This process allows the international bank to establish economic, financial and trade relationships with the local domestic banks and get to know the intricacies of the host country’s banking system, as well as conduct a cost/benefit analysis, in order to ensure the environment of the host country is conducive for its possible future operation. For further information, please see Footnote #2.

**Representative Office**

This form of banking structure represents the preliminary stage of the evolutionary process that international banks have to go through in order to establish a foothold in the foreign market as full service international banks. Unlike correspondent banking that provides only limited exposure for the international bank, the representative office increases that exposure by actually being located in the host country, with limited functions. It also does not abide by the host country’s banking laws. A representative office undertakes one or more of the following activities. The Central Bank's Board of Directors Resolution No. 57/3/1996 dated 14/4/1996 regarding Representative Offices:

1. Representing the financial institution licensed to deal inside the country, including contacts on its behalf with concerned agencies as well as promoting its services in the local market.
2. Providing the head office of the licensed financial institution with data relating to economic developments in the country.
3. Providing customers of the licensed financial institution with information on the local market.
4. Providing data to local agency, which intends to develop its business at countries wherein the licensed institution conduct its business.
5. Providing customers with banking, financial and investment consultation services.

The representative offices should represent a bank or any other financial institution incorporated outside the country, holding a valid license obtained from competent authorities. Such bank or financial institution should also be subject to the direct supervision and examination of the said authorities at the country of origin and/or the head office as per laws of the country. For further information, please see Footnote #3.
The Representative Office cannot offer the services of the international bank (parent company) in the host country.
Branch Offices

As previously mentioned, the establishment of IB requires an evolutionary process. So far, we discussed limited exposure (correspondent banking) and more exposure, though still limited (representative office). The next step is the establishment of branch offices by the international banks in the host countries, which constitutes a physical presence and an indication of more commitment and that financial services will be provided. Branch offices legally abide by the conduct of the parent company in a foreign land. Branch offices may conduct their operation independently, as long as their functions are permitted by the laws of the host country. Branch offices can conduct traditional banking activity, such as accepting deposits and packaging loans.

Agency

This form of banking structure’s financial activity and exposure are greater than a Representative Office’s exposure but less than a Branch office’s exposure and financial activity.

Subsidiary

This form of banking structure further increases the financial activity and exposure of the international bank in the host country. It provides full financial services allowed by the laws and regulations of the host country. A subsidiary is separate legally from the parent bank, therefore it is considered a new organization, or can acquire a local bank to establish a foothold in the foreign land. Like every other banking institution, subsidiary banks have gone through an evolutionary process. Subsidiary banks are under U.S. banking laws and regulations when conducting banking activity in foreign countries. In the past, they were not allowed to function in the host countries by involving themselves in providing the banking services for which they were originally established. For further information, please see Footnote #4.

Consortium Banks

Similar to an international oligopoly (cartel), international banks can combine their resources and establish an entity known as a consortium bank. This form of banking structure reduces capital requirements and risks when involved in international lending activities. The major difficulties in running consortium banks were the disagreements among the parent institutions on how the banks should run their operation and who was going to make the final decision when it came to new ventures. A series of large consortium bank lending activities helped emerging market societies to go through economic austerity programs over the past three decades. For further information, please see Footnotes #5 and #6.

Services Provided by International Banks

The orientation of the international bank is dependent upon the economic condition of the host country and the global financial activity as a whole. For instance, if there is financial instability as a result of political upheaval, the international bank becomes more conservative in cross-border lending and universal banking activities. Further, the competition of other large multinational banks in the global financial market may limit the availability of credit, and this...
may trickle downward into the economic hierarchy of the society, such as small investors and enterprises. Finally, if political upheaval and economic instability persist, it would be very difficult for the sovereign regime to stop the contagion. Ultimately, the purpose of all financial transactions by international banks is to generate revenue for the banks. The profit of an international bank is determined from the difference between the cost of capital to the bank and the income that the bank earns from the said capital, known as the “spread.” A wider spread is an indication that the bank is being operated and managed efficiently. For further information, please see Footnote #7.

With globalization of financial markets, economic activities and international trade, international banks are heavily involved in facilitating global financial needs. They offer various forms of credit to economic entities, such as revolving credit. Also, the financial services can be in the form of a syndicated loan. For further information, please see Footnotes #8 and #9.

The collapse of the banking system and a decline in the financial market activities of many developing nations, OECD, and emerging markets caused the decline in worldwide syndicated loan activities. There is a long-standing understanding and belief that the economic austerity program imposed by large international banks through syndicated loans was mostly responsible for the volatility of economic variables. Therefore, borrowing nations were unable to satisfy their loan agreements, and they defaulted on the principal and, in some cases, even interest payments.

The agreed upon interest rate for both revolving credit and syndicated loans is determined by the London Interbank Offered Rate (LIBOR). For further information, please see Footnote #10.

Under the Basel Agreement’s capital adequacy requirement, international banks were forced to maintain a certain ratio of capital to loans that reduced syndicated lending activity and thus eliminated the risk involved with this type of lending. Club deals replaced syndicated loan activity during the decade of the 90’s, even though syndicated loan activity became popular again, since the limitations imposed by the capital adequacy requirement, coupled with the economic vitality of the emerging market, reduced the risk involved with this lending activity. For further information, please see Footnote #11.

Eventually, the original capital adequacy requirement was replaced by a new capital adequacy standard. For further information, please see Footnote #12.

**Project Finance**

Another type of financial activity/lending by the IB system is project finance. International banks are in favor of project finance lending services rather than syndicated lending, since financing a large-scale project reduces the economic risk, such as volatility of the economic variables, involved with syndicated lending, mostly in the emerging market. One must not forget that fluctuations in the economic activity, such as inflationary forces, of the host country for which project finance is obtained can pose a threat to the value of the cash flow expected by the international bank. For further information, please see Footnote #13.
Though it is devoid of the risk of syndicated lending, project finance can also pose a series of risks for international banks, such as:

- Market Risk
- Regulatory Risk
- Operational Risk

For further information, please see Footnotes #14, #15 and #16.

**Trade Finance**

With the globalization of international financial, economic and trading activities, international banks are compelled to offer a diverse menu of services to facilitate cross-border lending and international trade. For example, a letter of credit is provided to the bank guaranteeing the creditworthiness of the customer who wishes to conduct trading activity. A secondary form of creditworthiness is provided by a standby letter of credit for payment of the said trading activity. The other type of service that IB is providing to facilitate international trade is known as trade finance. For further information, please see Footnotes #17, #18 and #19.

**Credit Analysis in International Lending**

Because of the many forms of risk (as mentioned before) that pose problems for IB operation, international banks follow the thorough process of credit analysis of their borrower, especially cross-border lending. Like every other economic institution that conducts credit analyses, international banks are worried about the creditworthiness of the borrower. A series of tools are available to international banks to utilize in order to reduce the risk associated with cross-border lending in the international lending theater. To mention a few, whether the customer can provide collateral or not, the cash flow from the project (rate of return), the bylaws (agreement), and the credit history of the borrower. International banks also provide non-lending services to generate fees that enhance the cash flow of the organization; to name a couple, cash management, and asset management, which is known as global custody. For further information, please see Footnote #20.

Maintaining one’s assets, especially operating in the international market, requires economies of scale in the art of global custody. This includes international bankers needing to maintain liquidity sufficient enough for their operation.

Long term and short term financial stability is directly related to how the banking system manages its cash and liquidity, especially in the international financial arena, and the very survival of the entity rests on the cash management issue. International banks need to be able to forecast the future need for liquidity and how to handle it during a crisis.

**Conclusion**

In this module, you have learned how a commercial bank evolved from a simple correspondent bank to become a major international bank. You should have learned the different types of financing projects financed by the commercial banking system for economic development.
purposes. Furthermore, you should be able to identify and examine the many forms of risk, particularly operational risk, which is the common threat posed to international banks by internal and external forces.
FOOTNOTES

(1) Commercial Bank
http://www.wisegeek.com/what-is-a-commercial-bank.htm

(2) Correspondent Bank

(3) Strengthened Bank Representation in Donor Countries
http://www.financeocean.org/finance_glossarydefinition/221-representative-office

(4) Subsidiary
http://www.investopedia.com/terms/s/subsidiarybank.asp#axzz1s8BMAfvh

(5) Consortium Bank
http://www.investopedia.com/terms/c/consortium-bank.asp#axzz1s8BMAfvh

(6) Consortium Bank
http://www.investorwords.com/17075/consortium_bank.html

(7) Global Banking

(8) Revolving Credit

(9) Syndicated Loan

(10) LIBOR
http://en.wikipedia.org/wiki/LIBOR

(11) Club Deal
http://www.investopedia.com/terms/c/clubdeal.asp

(12) A new capital adequacy framework
http://www.bis.org/publ/bcbs50.htm
(13) Project Finance Definition
http://www.investopedia.com/terms/p/projectfinance.asp#axzz1s8BMAfvh

(14) Market Risk
http://www.investorwords.com/2987/market_risk.html

(15) Risk Management in Banking

(16) What is Operational Risk?

(17) Letter of Credit
http://www.investopedia.com/terms/l/letterofcredit.asp

(18) Understanding and Using Letters of Credit
http://www.crfonline.org/orc/cro/cro-9-1.html

(19) Trade Finance
http://www.investopedia.com/terms/t/tradefinance.asp

(20) Global Custody Definition