

Sam analyzes theory and structure of international banking and what they mean for economics in the new century.

THEORY AND STRUCTURE OF INTERNATIONAL BANKING

As countries around the world strive to integrate their economies into the framework of globalization and financial liberalization, international banking appears as an important instrument to facilitate the flow of financial resources to places where they could be employed most efficiently. In this context, individuals and businesses continuously allocate their resources in foreign financial institutions. Therefore, in order to seek a true understanding of international banking, one needs to investigate the reasons behind why banks headquartered in particular countries set up branches and subsidiaries in other countries?

This paper seeks to answer the above question through two main sections: the first section covers the theory as well as the main aspects of international banking and its relation to international flow of money; the second section will reveal some of the more specific reasons behind the importance and attractiveness of Switzerland's banking system and services in the context of the topics discussed in the first section.

THEORY OF INTERNATIONAL BANKING

One of the main questions with regards to international banking is why banks headquartered in particular countries set up branches and subsidiaries in other countries. The internationalization of banks hints at some of the advantages that some banks have that helps them compete with host-country banks. Another question is whether the number of foreign branches headquartered in particular countries are systematic. In other words, whether banks headquartered in particular countries are underrepresented or overrepresented.

Economists have offered various answers to these questions. Metais offered the traditional answer to the first question: banks go abroad to serve their domestic customers who have gone abroad, which is also sometimes called "the gravitational pull effect" (Metais 1979). For instance, let's consider Citibank. Based on the above theory, one could argue that the reason that Citibank opens branches in Japan is to serve American business people who have moved to Japan, usually due to the globalization of American firms. This argument was based on the principle that the domestic banks in host countries are poorly-equipped to serve the local branches of source-country firms (Aliber 1984). However in the last three-four decades of the twentieth century, many foreign branches were established in industrial countries whose domestic banks had the resources to serve the branches of foreign banks well. For instance, Mizuho Corporate Bank of Japan is well equipped to serve American individuals and businesses, and hence there is no need for Citibank to open branches in Japan. Therefore, Aliber presents a modified version of gravitational pull effect: "banks follow their domestic customers abroad to reduce the likelihood that they might lose their business to host-country banks" (Aliber 1984). These foreign branches are likely to lend to the foreign affiliates of the same companies they lend to at home and to provide these affiliates with a variety of services. Indeed, Caves indicated that each bank had a differentiated package of products, which sometimes gave foreign banks advantage over domestic institutions (Caves 1977). For example the kinds of services that

Citibank offers are different than those of Mizuho Corporate Bank or Saitama-Resona Bank of Japan.

The above explanation is also significant because it leads to identification problem (Aliber 1984). This identification problem is created because the factors that explain why firms headquartered in one country set up foreign subsidiaries in other countries might also explain why banks headquartered in the same country also set up branches abroad. In other words, this view suggests that we must look at banks as entities that are to maximize their own profits by providing services to as many foreign or domestic customers as possible, rather than looking at them as financial institutions that only move abroad when their domestic clients move abroad. For instance, knowing that they provide unique services that German banks do not offer, Bank One may choose to open branches in Germany in order to take advantage of serving not only Americans in Germany, but also German clients who are interested in their services. Based on this view, expansion of banks abroad may occur quite independently of whether domestic firms are investing broad.

Aliber notes that casual observation suggests that the expansion of various foreign markets of banks headquartered in particular countries occurs in waves that parallels the foreign expansion of industrial firms headquartered in the same countries (Aliber 1984). For instance in the late 1960s and 1970s, U.S. banks expanded at a higher rate abroad at the same time that American firms were expanding abroad. In the 1970s and 1980s, in contrast, Japanese and European banks expanded in the United States.¹

One may also consider the view that relates pattern of expansion to interest rates. This view asserts that banks based in countries with relatively low spread between the interest rates they pay on deposits and the interest rates they receive on loans would be more likely to open foreign branches. But one also needs to keep in mind that the low spreads might be a location-specific advantage that reflects the “factor endowments” of a country rather than firm-specific advantage that certain group of firms own in a country (Aliber 1976).

Some economists such as Giddy have based their analysis of reasons behind banks’ expansion on the differences among the activities of foreign branches of domestic banks (Giddy 1981). These activities include off-shore banking, domestic banking, and multinational and wholesale banking. Indeed, Grubel claimed to present a first attempt to develop a general theory of multinational banking with capability to explain the activity-based expansion phenomenon explained above, with some simple price theory principles (Grubel 1977). He explained that these banks use management technologies and marketing techniques they have developed for domestic uses at very low costs abroad. For instance, the Bank of New York uses the management technologies and know-how in marketing which it has developed for use in the United States at low costs in Europe and Asia. Additionally, Grubel believes that the growth of multinational wholesale banking is due to the fact that the multinational banks operate on narrower spreads between borrowing and lending rates than their domestic counterparts (Aliber 1984).

In 1981, Gray and Gray applied microeconomic theories such as Dunning’s theory of production, which combines location-specific and owner-specific advantages to explain the growth of international banks (Gray and Gray 1981). For instance, based on theory, one might attempt to understand the expansion of Citibank around the world by taking into account specific advantages that various countries have provided for the bank. However Dunning’s theory does not seem to explain the rapid growth of European and Japanese investment in the United States

¹ A more detailed discussion on international banks’ patterns of expansion will follow in the next section.

in the late 1970s as economists have not been able to find any correlating growth of benefits in investment in America during that time specifically.

Finally and more recently, Dwenter and Hess analyzed banking theory based on asymmetric information between a bank and its customers, and concluded that banks' profits should differ between economic booms and busts, and between transactional and relationship banks (Dwenter and Hess 1998). For instance based on their conclusion, Citibank's profits should have decreased towards the end of 1990s when the bursting of technology bubble due to the growth of dotcomers ended the economic boom in the United States during that period. These authors also argued that one of the main reasons that explain expansion of banks abroad in certain countries is due to the protection that the legal systems of these countries offer to foreign financial institutions (La Porta 1997). For example Japan may have laws that protect foreign banks, encouraging them to open branches in that country.

The theory of international banking has built heavily on the theory of foreign direct investment. However, Aliber notes that "one of the major shortcomings of the latter is the extensive attention to conceptualization and the modest attention to testing" (Aliber 1984). Therefore the basis of theory of international banking has been handicapped in a similar way.

Following the discussion of and different approaches to the theory of international banking, it is important to briefly review some of the other aspects of multinational banking.

Patterns of Expansion in International Banking

Throughout the years, economists have been trying to find any possible patterns of expansion that multinational banks maybe following throughout the world. These efforts have produced literature that analyzes these expansions using different methods. It is therefore important to review these methods in order to understand this aspect of international banking.

One method that economists have used is to trace the historical development of international banks. A classical example for this example is Born's *International Banking in the 19th and 20th centuries*. Then there are global surveys of the pattern in the current structure of international banking, such as the United Nations' *Transnational Banks* and OECD's *The Internationalization of Banking* (Aliber 1984). In addition, some economists explain patterns of expansion by focusing on one country as a source country – like the expansion of U.S. banks in other countries – or on one as a host country – such as the growth of foreign banks in the United States (Aliber 1984).

One of the major problems in developing inferences about the patterns of international expansion of major banks arises because of the lack of adequate data. The reason is that national monetary authorities provide data on individual banks' deposits and loans of banks operating within their jurisdictions denominated in their own currencies and various foreign currencies, but few provide information on whether the deposits and loans are those of domestic or foreign banks (hUallachain 1994). The Bank of England is one of the few banks that present data on the sterling-denominated deposits and loans of non-British banks in Great Britain as well as their deposits and loans denominated in currencies other than sterling (Aliber 1984). These data allow analysis of the market share of non-British banks in the domestic market for sterling-denominated deposits and loans.

What makes the research on patterns of international banks' expansion limiting is the fact that most literature on the topic discusses the number of foreign branches and entities of banks headquartered in different countries, but with little attention to their share of a market for

deposits and loans denominated in foreign currencies. Focusing on these ratios would be more useful, because they can help determine whether banks in a particular country are more nearly international than banks headquartered in other countries. Nonetheless it is evident that foreign banks in the United States have expanded at a higher rate in the 1990s than any decade before that period.

In general, data about the changes in the position of U.S. and foreign banks in the loan market do not provide adequate basis for explaining the competitive position of U.S. banks in deposit markets denominated in various foreign currencies and of foreign banks in the market for U.S. dollar deposits. However, it is clear that headquartered in Canada, Western Europe and Japan have been increasing their share of the market for loans denominated in U.S. dollar (Aliber 1984).

It is sound to follow discussion of foreign banks' patterns of expansion with a review of the regulations and structure of international banking.

Regulations and Structure of International Banking

Regulations are counted as an important element in the study of international banking, because they may restrict the ability of domestic banks to establish foreign branches. In addition, where entry is permitted, regulations in certain countries may limit the activities of foreign banks relative to domestic banks (Aliber 1984). For example, France might impose restrictions on the size of transactions made by the branches of Citibank located in France.

Several themes are apparent in the studies on multinational regulations. One involves "the impact of restrictions on entry of foreign banks into national markets" (Aliber 1984). This theme examines the effect that restrictions of certain countries have on the operations of foreign banks in relation to those of domestic banks.

A second theme involves the impact of national regulations on the establishment of foreign banks in certain countries (Murray 1984). For instance domestic limitations on the branching of US banks lead American banks to expand in deposit and loan markets outside the United States. An example of these national legislations is McFadden Act, which included an implicit prohibition of interstate branching by commercial banks (Murray 1984). This results in Bank One to move some of its operations abroad in order to escape American regulations. Other policies that have similar effect are national reserve requirements, interest rate ceilings, and "examination procedures that [motivate] banks to open braches abroad" (Aliber 1984). Murray gives the example of an influx of foreign banks in Canada between 1982 and 1984 (Murray 1984). He continues by saying this influx was due to the fact that the Bank Act, which had previously prohibited banks from entering the Canadian market was revised.

While economists do not agree on the extent to which regulations are the reasons for the globalization of banks, most do agree on its effect nonetheless. Regulations, therefore, could be considered as another element that motivates banks to open foreign branches. It is important to review another important aspect of international banking that is related to its growth, which is the profitability of international banking.

Profitability of International Banking

It is important to briefly review the finding of recent researches and analyses of profitability in international banking in order to understand its significance on the patterns of expansion.

Williams (2003) and Focarrelli and Pozzolo (2001) studied the profitability of international banking in the OECD and also that of domestic and foreign banks in Australia, respectively. Both studies concluded that efficient banks expanded abroad aiming at gaining higher profits that are *negatively* correlated to their market share. Additionally, there have been studies on the merger of international banks and the effect of merger on their profitability. Using data from banks in Italy, Panetta, Focarelli and Salleo (2002) showed that mergers increase income from expanded services and product lines, but the increase is offset by higher costs.

Many studies have been done on the effect of international banking on profitability. While the methods employed in these studies differed, one common conclusion was reached by the majority of them with regards to profitability: In general, banks that have expanded their operations to foreign banks have seen subsequent increases in their overall profits (Chotigeat 2004).

Following the discussion on the main component of modern international banking, it is important to review some of the main aspects of Switzerland's banking system which has resulted in the popularity of Swiss bank accounts all across the world.

THE SWISS CASE

One of the main differences between the Swiss banks and those in other countries is ways in which these banks get access to financial resources of foreigners. While banks from most countries need to open international branches in other countries in order to attract foreign resources, the banks in Switzerland attract those resources without opening foreign branches. Therefore, one might wonder what the main reasons are that allow Swiss banks to have this comparative advantage.

The main reason for the popularity of Swiss bank accounts has to do with the legendary privacy such accounts provide (Swiss-Bank-Accounts.com). Swiss banks are under obligation to keep any information about investors or their accounts strictly confidential. This Bank secrecy is one of the strictest in the world and stems from an old financial tradition. Any banker who reveals information about an individual or company without his/her consent is subject to both civil and criminal legal penalties. The only cases where exceptions are made are those involving serious crimes, such as drug trafficking and smuggling.

Another important aspect of the Swiss privacy laws is that it is not lifted for tax evasion. The main reason for this fact is that as opposed to most other countries, failure to report income and assets is not a crime in Switzerland (Lewis 2001). Therefore, neither the Swiss government nor any other government can obtain information about bank accounts even for tax purposes. In order to get access to privacy-protected information, they first need to convince a Swiss judge that the account owner has committed a serious crime that is punishable by the Swiss Penal Code. Privacy codes also will not be lifted for private matters such as divorce and inheritance if one has kept his/her information strictly confidential. Therefore, plaintiffs can decide if they wish to prove that the account exists if they wish to pursue the case.

Another important advantage of Swiss bank accounts to foreigners is that Switzerland does not levy any taxes on Swiss accounts owned by non residents. There are only three exceptions to this rule: Swiss withholding tax: dividends and interests paid by Swiss companies are subject to a 35% withholding tax; US persons: US persons (i.e. US citizens, green card holder and US taxpayers) are faced with these choices: Either they renounce to invest in US securities from their Swiss bank account, or they have to report it to the IRS. EU residents: Starting in 2005, clients who live in the European Union will have to pay a withholding tax on the interest paid by certain investments, which could be between 15% and 35%. Although the tax for US persons might lead some Americans to avoid Swiss accounts, one can also follow a common strategy for US clients, which is to use their bank accounts in the US to invest in US equities and use their Swiss bank account to diversify into non-US investments. Swiss privacy laws and tax system are the two main reasons for the attractiveness of Swiss bank accounts. Therefore, the Swiss banks enjoy these advantages exclusively, because they are brought to them by the system of their government.

CONCLUSION

Liberalization of economies around the world has coincided with a growth of internationalization in banking and the financial sector. The aim of this research has been to investigate the main reasons behind why banks have been opening branches in countries other than their own. Careful study of the theory of international banking indicates a problem with investigation on such topic: in the majority of cases, economists employ different methods and consider different elements to explain reasons for international banking. This phenomenon makes it difficult to select one theory as the one reason explaining the growth of international banking. Another problem with studies on international banking is that the theory of international banking has built heavily on the theory of foreign direct investment, which has the shortcoming of paying extensive attention to conceptualization and modest attention to testing.

However, this study has been functional nonetheless in the sense that it provides us with a “basket” of the most important factors that have collectively led banks from various countries to expand their operations abroad. Therefore one recommendation made here for future research is that economists should not focus on finding *one* factor that could alone explain the growth in international banking; rather, they must focus their studies on composing *baskets* of most important elements that could collectively explain financial globalization. Results of the major studies done on international banking indicate that various elements could be simultaneously leading more banks toward internationalization. For instance Citibank is likely to consider *all* factors such as regulations in Japan, market for the bank’s unique services in that country, number of Americans in Japan, etc. before opening branches in Tokyo.

Despite differences amongst studies on international banking reviewed here, the vast majority of them indicate that as firms around the world move toward liberalization, banks and financial institutions alike see international banking as an ever-more effective way of gaining access to new capital and reap the benefits of global economy.

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