GLOBAL BANKING: ORIGINS AND EVOLUTION

Emmanuel N. Roussakis
Professor of Finance and Director of Certificate Programs for
Bankers of Florida International University

RESUMO: Este artigo revê as origens e a evolução das transações bancárias no mundo e indica a emergência de novas tendências para o ano 2000.

ABSTRACT: *This article reviews the origins and evolution of global banking and addresses the emerging patterns for the year 2000 and beyond.*

PALAVRAS-CHAVE: transações bancárias, tendências, perspectivas, história.

KEY WORDS: *global banking, trends, prospects, history.*

The purpose of this study is to review key phases in the institutional development of banking and identify emerging trends for the year 2000 and beyond. This study does not claim to be a through and systematic analysis of banking history through the ages; rather, it represents a rough summary of developments that provide a useful historical perspective for the present day activities of commercial banks. As these activities are currently in transition due to the undergoing consolidation of the financial system, this study also addresses the emerging patterns for the banking industry in the years ahead.

The weakening of church restrictions on economic activity during the Renaissance and the growth of maritime ties of coastal Italian cities with the Levant set the stage for the rise of Italian merchant banking houses.

ORIGINS AND EVOLUTION

The dawn of merchant banking

Although money lending and money changing are very old activities (there are records of loans by Babylonian temples as early as 2000 b. C.), the early beginnings of investment and commercial banking may be traced to twelfth century Italy. The weakening of church restrictions on economic activity during the Renaissance and the growth of maritime ties of coastal Italian cities with the Levant set the stage for the rise of Italian merchant banking houses. As these coastal cities grew to be an important conduit for trade with the European interior, some of the larger merchant banks extended their activities to other European countries and came to dominate international finance from the twelfth through the fifteenth centuries. These family-owned and managed firms are generally viewed as the predecessors of modern commercial banks. In addition to accepting deposits and financing foreign trade, these houses made a market in foreign exchange, extended short and medium-term loans to entrepreneurs, rulers, noblemen, and the clergy, and invested in industrial and commercial ventures.

Two of the largest banking houses in the early fourteenth century were those of the Bardi and the Peruzzi. Located in Florence, the leading banking center of this period, these banks handled extensive financial interests in key European centers. A more prominent bank, however was that of the Medici. Established in Florence, in 1397, the Medici bank grew both within and outside Italy; by the mid-fifteenth century it had branches in Rome, Venice, Milan, Pisa, Avignon, Bruges, London and Geneva. Each branch was separately capitalized, with the central partnership in Florence retaining the majority ownership stake and the local manager retaining the minority stake. However, based on performance, managers were compensated with a larger share in branch profits than was guarantied by their equity investment. Before any distribution of profits, it was a customary practice for managers to make due provisions for bad debts. Books were closed once a year and managers had to take them to Florence for a thorough audit.[1]

Branches worked closely with each other in the conducting of the banking business; for example, they extended to each other credit facilities, provided for the transfer of funds and settled claims arising from bills of exchange and other loans. Credit policy was formulated and enforced by guidelines laid down at the headquarters in Florence. Loans were of short or medium-term maturity and were made to merchants and manufacturers as well as to various members of the clergy and European nobility. Clergy and nobility were generally perceived as high risks and credit was allowed only on a collateralized basis, e.g., the pledge of jewels and other personal assets, land and revenues from mines, customs or tax receipts.[2] Credit

1. DE ROOVER, Raymond. *The rise and decline of Medici Bank, 1397-1494.* Cambridge, MA, Havard University Press, 1963, p. 100.

2. Idem, ibidem, p. 88 and 204.

© 1997, RAE - Revista de Administração de Empresas / EAESP / FGV, São Paulo, Brasil.

limits were set for loans to other banks in Italy and for selected officials of the Church (e.g., cardinals and the Pope).

In addition to branches, the bank maintained a network of agents and correspondents in the leading business centers of Europe and the Levant. Operations were sizable and often quite profitable. In the first year of its operation, the bank earned a 10 per cent return on investment, which was by no means excessive considering that the current interest rate paid by banks on time deposits was between 7 and 8 per cent.[3] However, as the bank expanded its geographic reach and scope of services, profitability was affected accordingly. The Rome branch, through its access to Papal deposits, was the principal supplier of liquidity for the Medici bank and produced more than 50 per cent of the bank's total profits during the early part of the fifteenth century.[4] Two other profitable branches were those of Venice and Geneva; throughout the second quarter of the fifteenth century they averaged a rate of return on equity of 60 per cent and 30 per cent, respectively.[5]

In seeking to employ its funds profitably the bank at times took high risks which ultimately undermined its soundness and viability. Indeed, in the course of business, the Medici bank had assumed extensive sovereign risk exposure through loans to such sovereigns as the Pope and Edward IV of England. When these loans went unpaid and had to be written-off, assets were no longer sufficient to meet depositors' claims. The Medici bank fell into insolvency much like its larger predecessors, the Bardi and the Peruzzi. Though bad loans made a major contribution to the collapse of the Medici bank in 1494, other causes included inadequate management and problems in coordinating foreign branches.

German merchant banking houses

As the winds of economic prosperity moved further north in Europe, German merchant banks grew in importance and dominated banking and finance throughout the sixteenth century. The initial momentum in the rise of German banking houses come from the southern part of the country — specifically from the cities into a position of prominence — and placed them in the midst of a commercial and financial network that extended to the great European centers of production and consumption. It was not, however, until the discovery of the trading routes to the Indies and the opening of the markets of southern Asia that German banks rose to a position of eminence in international finance. The discovery by the Portuguese of the trading routes to the Indies and the opening of the markets of southern Asia brought a shift in European trading patterns from the Mediterranean to the Atlantic seaboard. This shift changed the fate of the Low countries and contributed to the development and growth of Antwerp into a sophisticated international money market. German banks continued to dominate international banking by moving the center of their activities to this city.

The initial momentum in the rise of German banking houses come from the southern part of the country — specifically from the cities into a position of prominence — and placed them in the midst of a commercial and financial network that extended to the great European centers of production and consumption.

The most notable of the German merchant banks were the Fugger, the Welser and the Hochstetter and performed the same essential functions that had previously belonged to the Italian banks. Except that, with capital now more abundant than in the previous century, those banks played a more important role as financial intermediaries.[6] The assets of the Fugger bank, the most

3. Idem, ibidem, p. 41.

4. Idem, ibidem, p. 47, 106 and 202.

5. idem, ibidem, p. 249 and 283.

6. Jean-François Bergier, 'From the fifteenth century in Italy to the sixteenth century in Germany: a new banking concept?', in *The sawn of modern banking* (New Haven, Conn, Yale University Press, 1979).

prominent of the German merchant banks, were made up of holdings of land, mines and commodities and its loan portfolio included credits to trade and industry and such influential clients as the Tudors of England and the Hapsburgs. These assets were funded through equity capital, deposits and borrowings from the Antwerp money market. Loans to the Hapsburgs, for example, were funded in large part through the Antwerp money market and were made at a gross spread of about 4 percent per annum. The Fugger bank financed the credit needs of the Hapsburgs for a century and a half. Although the bank earned substantial profits from its imperial connection, ultimately it had to enter into a workout arrangement reducing interest rates and extending loan maturities. In 1650 the bank had to write off the Hapsburg debt, wiping out most of the profits it had realized with this client in the course of the previous century.

The discovery by the Portuguese of the trading routes to the Indies and the opening of the markets of southern Asia brought a shift in European trading patterns from the Mediterranean to the Atlantic seaboard.

The Dutch contribution

Economic history reveals that the center of commerce never stayed long in one place, as well as the growth of commercial banking activity. Thus, during the seventeenth century, Amsterdam, which had experienced the benefits of the great maritime commerce of its traders as early as the fourteenth century, emerged as the major money center in Europe. As a consequence, Dutch banks dominated trade and finance.

During Amsterdam's economic dominance, two distinct types of banking activity began to emerge: acceptance credits and loans to foreign governments. In the conducting of international commerce, Dutch merchants relied extensively upon commission merchants, agents who resided in commercial centers and sought out customers without owning the commodities in which they traded. In the course of the eighteenth century it became a practice among these merchants to ask established houses to endorse their trade bills and enhance their acceptance by exporters or bankers at home and abroad.[7] In essence, these houses were asked to assess credit risk and offer their guaranty. Bills guarantied in this way came to be known as "acceptances" and the houses that guarantied them as "acceptance houses". The development of this practice played an important role in the growth of trade financing in nineteenth century England.

The wealth of Amsterdam also contributed to the development of another financial activity which is that of lending to foreign governments. Indeed, in the course of the seventeenth and eighteenth centuries, the Dutch loaned substantial sums to finance the needs of foreign kings and governments. Initially, these loans were taken almost entirely by the lenders for their own accounts; gradually, however, other merchants and wealthy individuals were recruited to share in the financing of theses loans. In the second half of the eighteenth century, this process of syndication was further refined and developed into a specialized financial activity of international dimensions. A case on record is that of the leading Amsterdam firm of Hope and Company which floated ten loans for the Kingdom of Sweden (1767-1787) and eighteen loans for Russia (1788-1793). The loan contractors of the late eighteenth century also assumed the responsibility of retailing the bonds to investors not only on the Amsterdam stock exchange but also throughout Europe.[8] This pioneering technique of syndicating risk and distributing securities flourished in nineteenth century England and evolved into the modern-day securities underwriting.

Dutch influence of British finance went beyond the afore-described financial

7. CHAPMAN, Stanley. *The rise of merchant banking.* London, George Allen & Unwin, 1984, p. 1.

8. Idem, ibidem, p.3

specialisms. From the end of the seventeenth century on, Dutch money became an important source of financing for successive British administrations. Indeed, the largest part of the foreign-held debt of the British government was owed to Dutch investors. Personal and family ties between the two capitals also played an important role in the Dutch influence of British finance.

In the course of the eighteenth century, several Dutch merchants had members of their families relocated to London to facilitate and expand the scope of their operations. This simultaneous operation of a family business in two or more cities was known as "international house". While this form of business structure dated from the Middle Ages, it received important impetus during this period as a result of the sustained growth in trade. The Dutch employed this type of organization very successfully, although the ethnic trading groups were the ones that held to it more tenaciously. Geographically dispersed because of religious persecution, these groups — e.g., French Huguenots and Jews from Holland, France and Germany — used this form of organization routinely for the conducting of their business internationally. In the course of the eighteenth century, many of these houses established themselves in London, attracted by the strong growth of the British textile trade. The fusion of their capital and trading skills with the financial techniques that the British had adopted from the Dutch produced some of the families that later dominated British finance — families like the Rothschild, the Baring, the Warburg and the Schroder.

The rise of British banking houses

With the growth of large-scale industry and capitalistic enterprise, Great Britain started challenging Holland's dominance over international trade and finance. The gap between the two narrowed steadily and, at some point during the second half of the eighteenth century, London emerged as the undisputed center of European finance. Amsterdam's fate was sealed in 1795 when French troops occupied this city and most of its financial activity moved to London. London thus emerged as the leading center of the world and maintained this position until World War I. Paris, which had vied with London for this role throughout the nineteenth century, remained a dominant financial center in Europe.

By the end of the nineteenth century and up to World War I, British dominance of international finance was shared with French and German banks which, too, were actively involved in imperial and colonial financing.

The end of the American War of Independence and the Napoleonic Wars ushered in a period of political stability and created an economic environment conducive to the growth of international trade and investment. The strength of the sterling and of the British economy offered merchant banking houses in London the opportunity to engage in two distinct types of activity — trade financing and investment banking. An expanding commerce with European, North American and oriental markets required an increasing amount of short term financing. Specializing in the financing of particular branches of trade, merchant banks advanced the credits for manufacturers to send their goods to agents abroad. For sales in North America, for example, they customarily advanced up to two-thirds of the invoice to known clients, for periods of 3 to 4 months, while for sales in oriental markets advances were made for periods up to 12 months. A leading firm in trade financing was that of Baring Brothers which specialized in transatlantic finance. The activities of Baring Brothers and other notable firms in trade financing were instrumental in the development and growth of a major market in acceptances in London.

Unlike foreign trade, which required short term financing, the growing needs of private and public borrowers for industrial and infrastructural development made unprecedent demands for long-term financing. These demands expressed through the issuance of term debt and equity securities, became an established practice in countries that enjoyed significant savings and balance of payments surpluses — countries like Britain and France. By subscribing to securities issued in the London and Paris financial markets, the British and French public financed a wide variety of industrial and infrastructural projects, such as railways, canals, factories and mines. While local investors accounted for most of the subscriptions to the securities issued, in time foreign investors represented an important segment of the market. Their purchase of sterling-denominated foreign issues contributed to the development of significant entrepôt activity in London, in the nineteenth century.

Along with the private issues of domestic and foreign concerns, an increased amount of foreign government debt was floated in London. France, Russia, Austria, Portugal, Spain and Greece were among the first countries to raise funds in London. Other countries, to issue bonds in London included Costa Rica, Bolivia, Guatemala, Honduras, Uruguay, Paraguay, Liberia, Peru, Spain, Egypt and Turkey. Leading merchant bankers — such as Rothchild, Hambros, and Barings — arranged and underwrote these issues. London's financial euphoria during the nineteenth century had its period of speculation, bond defaults, bank failures, and financial crises.

Just as the 1960s and 1970s belonged to the U.S. banks, and the 1980s to the Japanese banks, the 1990s may be the decade of East Asian banks and European banks.

Opportunities within the British Empire and elsewhere led to the establishment, from the mid-century on, of dozen of British overseas. South Africa, Egypt, Turkey, The United States and specially the Far East attracted the establishment of a significant number of British banks, which were instrumental in financing trade transactions with Great Britain. By the end of the nineteenth century and up to World War I, British dominance of international finance was shared with French and German banks which, too, were actively involved in imperial and colonial financing.

Internationalization of U.S. Banks

The United States entered World War I as a debtor nation, and emerged from it as a creditor. The growing needs of the Allies and neutral nations generated the necessary momentum for the growth of exports. At the same time, this war stimulated the influx of flight capital from Europe and thus contributed to the rise of New York as an international financial center.

In the postwar period, the United States experienced greater demand for its manufactured products, increased its investments abroad and generally witnessed its transformation into an industrial and financial power. In fact, by 1929, it was the world's outstanding manufacturing country, expanding its international operations and presence overseas.

The banks' move to abroad was a repetition of what the Europeans had done a generation or two earlier. However, there was an important difference. U.S. banks were following their customers into industrialized countries as well as into developing countries so that a more truly international network of banking relationships and competition was begining to develop.

The international expansion of U.S. banks is exemplified in the following data. In 1960,[9] U.S. banks had a physical presence overseas consisting of 139 branches and subsidiaries. By 1970, 80 U.S. banks operated abroad through 540 branches and subsidiaries. And by 1982, almost every large and medium-sized bank in this country engaged in international banking; 162 banks had 900

9. These measures were the Interest Equalization Tax (IET), of 1963, the Foreign Direct Investment Program (FDIP), of 1964, and the Voluntary Foreign Credit Restraint (VFCR) Program, of 1965.

branches and 758 subsidiaries operating abroad. Their combined assets amounted close to $471 billion; about half of this amount was held in major European centers, with London accounting for the largest share. U.S. banks were in active competition not only among themselves but also with the major international commercial banks, and with merchant/investment banks in loan syndications and in Eurobond underwriting.

The energy crisis, brought about by the quadrupling of oil prices in late 1973, created a great need for the global financial intermediation of the surplus oil revenues of OPEC (Organization of Petroleum Exporting Countries). U.S. banks were in the forefront of this intermediation recycling petrodollars from oil-exporting to oil importing nations. Their international eminence contributed to attracting a large share of petrodollars in the form of deposits which were then loaned out to various borrowers, including less developed countries (LDCs). Bank lending to these countries grew rapidly until the early 1980s. Pursuit of a tight monetary policy in the United States, in order to curb inflationary pressures led the country into a deep recession which reduced the demand for imports and adversely affected the world commodity process. Similar conditions in other industrialized countries accentuated these trends and contributed to the collapse of the export markets of debtor nations with drastic consequences on their ability to service their debts to major banks around the world. In the summer of 1982, when Mexico announced to the world its inability to meet scheduled payments, it set off the international debt crisis. This announcement produced a chain reaction and, within a year, 30 countries — including Poland and many Latin American countries — followed suit. With the onset of the debt crisis, new lending to LDCs dried up and many U.S. banks took large losses.

International expansion of Japanese banks

As American banks were retreating from international lending, Japanese banks were filling the gap left by U.S. banks. Following the lead of their corporate clients and business affiliates within the "keiretsu"structures,[10] Japanese banks began to expand their international operations and presence overseas in the late 1970s. Flush with the proceeds of Japan's trading surpluses, they set out to penetrate the foreign network of 1939 branches and subsidiaries with assets of $189 billion; by 1989, this network had grown to 300 and $1.4 trillion respectively. Lending at low profit margins enabled japanese banks to capture a sizable market share worldwide which reached 40 per cent of the total international lending by 1989.

From the Florentine merchant bankers of the Renaissance to the contemporary period, banking has become an increasingly global business.

The early 1990s saw the international entrenchment of Japanese banks because of adversity at home. The deregulation of the financial market, combined with higher interest rates, raised the cost of funds and pressured banks to increase earnings. This pressure prompted Japanese banks to abandon their low-cost lending practices abroad in favor of loans that generated higher returns, boosted profits and added to bank capital.

The new focus on profit was moreover consistent with the need of Japanese banks to inprove, by 1993, their capital adequacy ratios in accordance with the Basle agreement.[11] The Basle capital requirements, though fair and consistent in their application to different countries, were significantly higher than the ones Japanese banks had to comply with before, at home. Under the circumstances during 1988 and 1989, Japanese banks had undertaken significant capital raising activities through the issuance of new equity and convertible bonds and realization of gain from the sale of their shareholdings in other Japanese companies.

10. "Keiretsu"(or business affiliations) are the dominant organizational structure in Japan and represents clusters of independent companies bound together by such considerations as reciprocal ownership of a small block of shares (5%); interlocking directorships; long term business relationships; and corporate projects. The Japanese do not allow holding company structures for fear of recreating the "zaibatsu", the family-controlled holding companies that dominated the pre-World II Japanese economy.

11. The Basle agreement was signed on July 11, 198, in Basle, Switzerland, by the United States, Canada, Japan and Western European countries all of which are formally known as the Group of Ten (G-10) countries of the Bank for International Settlements. The Basle Accord introduced uniform capital requirements for all signatory nations. It distinguishes bank capital into tier 1 (or core) — capital made up of equity and disclosed reserves — and tier 2 (or supplementary) — capital made up of undisclosed reserves, revaluation reserves, general provisions, hybrid (debt/equity) capital instruments and subordinated debt.

But some of the improvements in the capitalization of Japanese banks remained undone due to the ensuing sharp stock market decline of the 1990-92 period. This decline made it difficult for banks not only to raise additional equity stakes in commercial firms to bolster their capital positions; the depressed value of their shareholdings affected bank capital in another way, too. Japanese banks were allowed to count, as part of their capital base (tier 2 capital), 45 per cent of the unrealized capital gains from their stock portfolios. With the stock process drastically reduced, the contribution of these shareholdings to bank capital suffered accordingly.

As international markets become more integrated, competition in international banking will intensify still further.

The worldwide recession and the collapse of Japan's speculative economy put further pressure on Japanese banks in the form of substantial losses from international and domestic operations. In the United States most of their losses were on real estate in the depressed Northeast and California markets. In the domestic level, too, the drastic drop in real estate prices magnified the size of problem loans which, by some estimates, exceeded $1 trillion in 1995. These developments prompted an international downsizing of the operations of Japanese banks.

Trends for the 1990s

Just as the 1960s and 1970s belonged to the U.S. banks, and the 1980s to the Japanese banks, the 1990s may be the decade of East Asian banks and European banks. The 1980s have been a period of fast growth for the so-called East Asian "tigers": Hong Kong, Taiwan, Singapore, and South Korea. Development and growth of high tech manufacturing enabled the technological transformation of their economies within a decade — a process that took Japan fifty years to attain. As exports of high tech products rapidly expanded, the Asian "tigers"realized significant trade surpluses which were funneled to the Eurocurrency market, the standard source of funds for major corporations. A large part of these funds went to finance corporate restructurings in the United States and Europe where the age of consolidation seems at hand.

European banks are strong contenders for global dominance. Their strengths include solid capital bases, strong balance sheets and control of the home market. The Second Banking Directive of 1989, which came into efect on January 1st, 1993, permits banks to operate throughout the European Community (EC) with a single banking license issued by the bank's EC home-country. Economic integration and the move towards a monetary union by the turn of the century are creating important incentives for the consolidation of the financial sector. Banks are trusted as the catalysts to this consolidation. The model for banking under the EC regime is the universal banking system of Germany — fully integrated financial conglomerates that provide their customers with commercial and investment banking, leasing, and insurance services. With many European countries having no effective regulatory barriers to a comprehensive coverage of financial services, the European banking system is rapidly becoming universal.

EMERGING PATTERNS

From the Florentine merchant bankers of the Renaissance to the contemporary period, banking has become an increasingly global business. Two major forces were responsible for the globalization of banking. The first was technology. Recent improvements in technology and communications have decreased drastically the cost of recording, transmitting and processing financial information. This cost reduction makes it cheaper to extend and maintain realtime control over overseas operations. The second major force was the liberalization of financial markets. Recent decades have experienced the institutionalization of savings. Throughout the world, individual investors gave way to institutional investors who provide professional, prudent management and best execution for their customers. The growing importance of institutional investors has had an enormous impact on financial markets worldwide. The need of the new democratic nations of Eastern Europe and the Republics of the former Soviet Union to build market economies created an enormous demand for international capital. Moreover, competing for this capital there was an array of countries in need of developing modern, eficient economies. In the world markets countries with a restrictive financial environment found themselves in a situation of competitive disadvantage before countries with lesser regulation. As capital gravitated to wards countries with the freest markets it increased the pressure on other countries to deregulate. This pressure provided the impetus for the liberalization of financial markets and the consequent growth of international banking.

While the nationalities of the leading international banks have changed from time to time, the overall trend of international banking has been the same: rapid expansion of the types and the volume of services offered and of the number of banks providing those services, (which range from the traditional businesses of deposit taking, lending, and transfering of funds, to the new sources of financial profits: financing the worldwide thrust toward privatization of state-owned entreprises, and trading currencies, securities and derivative products). Advances in the theory of finance, combined with technology, have made it possible the development of a wide range of new derivative financial instruments, such as options, swaps and futures, as well as the trading of these derivatives. These advances have made it possible for banks to better manage the complex risks inherent in their business. More importantly, they have enabled banks to offer their corporate clients financial advice and risk management services, and allow them to better control and manage their international exposures.

As international markets become more integrated, competition in international banking will intensify still further. Recent changes in U.S. regulations have triggered a wave of "megamergers" that is producing banks with the size and strength necessary to face the fearsome competitive world of international banking. Moreover, long overdue regulatory revision toward financial consolidation should enable U.S. banks to offer, through bank-holding-company structures, a full range of banking, securities and insurance services. Their main competitors are EC's universal banks, many of which provide these services throughout member countries from a single legal entity. Japan's keiretsu banks operate like universal banks, providing all of the financial services needed by the companies affiliated to them. As the key players from each group will seek to become global banking powerhouses, competition will intensify still further. Experts anticipate that, of the 40 or 50 banks currently aspiring to such a role in the year 2000, only a dozen or so will succeed. Global status will demand covering customers in major product and geographic markets around the world. This implies market segmentation to identify the needs of specifc groups of customers and provide products and services tailored to the needs of these groups, anywhere in the world. Global banks must also be able to intermediate a sizable portion of the growing international flow of capital while remaining flexible enough to shift resources as needed to fast-growing areas and profitable businesses. ❑

Global banks must also be able to intermediate a sizable portion of the growing international flow of capital while remaining flexible enough to shift resources as needed to fast-growing areas and profitable businesses.

* **Emmanuel N. Roussakis** is the author of the book *Commercial Banking in an era of deregulation*, published by Praeger of Greenwood Press (3rd. edition, 1997).