Commercial and Investment Banking: Analysis of Separation or Unification

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ABSTRACT

This paper discusses the arguments for and counter-arguments against the separation of the services of investment and commercial banks. It firstly, looks at banking in general and the intermediary role of banks in promoting economic development through the allocations resources, and analyses the key features of main branches of banking including commercial, investment and universal banking. The paper also deduces the fundamental differences between commercial and investment banking in terms of services provided, regulation, sources of revenue and modes of operations. The Banking Act of 1933 referred to as Glass – Steagall Act was promulgated in the United States of America to promote the separation of commercial and investment banks, (Tabarrok, 1998; Jackson, 1987; Filipiak, 2009; Mayer, 2009). This Act was said to be occasioned by the financial crisis of the 1930s where the U.S stock fell by 90% from its 1929 peak. (Tabarrok, 1998). The proponents of this Act cited conflict of interest amongst other things to support the need for the separation. One counter argument put forward by Casserley, Härle and Macdonald (n.d) is that sophisticated global economy requires one-stop large banks where customers can be offered vast range of products and services. It is concluded that though universal banking is highly beneficial, there is the need for strict regulation, constant and effective supervision in order to avoid conflict of interest, monopoly and possible failure of the banking system.

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1. Introduction

Varied opinions on the separation of commercial and investments banking activities or otherwise have been espoused by various writers. Sheng (2009) plainly supports separation when he asserts that “You cannot mix the culture of investment banking (where risk taking is key) and commercial banking (where prudence is vital) under one roof.” (p. 326). Others have also defended the combination of these arms of banking (Jackson, 1987). These arguments have also been stretched beyond individual opinions to state levels preference where legislations have been enacted either for or against the separation of these two branches of banking.

The banking systems in the western world have witnessed diverse opinions and practices. United States of America has led and witnessed the longest and richest history of debate regarding separation of investment and commercial banking with the promulgation of laws to effect the separation. German banks on the other hand, have been universal banks for ages. In the United Kingdom, universal banking became popular in the 1980s. (Casserley, Harle & Macdonald (n.d). This paper looks at these two branches to banking and discusses the argument for and against their separation.

2. Banking

2.1. Banking Defined

According to Tebogo (2012), “Banking represents a series of contractual and non-contractual associations between deposits, investors, borrowers, and banks” (p. 3). The act of banking dates back in:

1,800 in Babylon where money lenders advanced loans to people (Grossman, 2010). Since then, the activities of banks have undergone significant changes in terms of structure, innovation, technological advancement, competition and performance (Fohlin, 2000; Bolt & Tieman, 2004; Borio & Filosa, 1994).

Today, banks continue to play a major intermediary role in the world’s financial system. The role of banks in the socio-economic development of any nation cannot be over-emphasized (James, Lindgren, & Teihova, 2002). The three main categories of banking discussed in this paper are commercial, investment and universal banking.
2.2. Commercial Banking

Commercial banks accept deposits from individual and institutional customers and use those funds to extend credit to other customers (Iannotta, 2010). Reed, Rose & Woodland (1976) refer to commercial banks as the heart of financial system. According to Tebogo (2012), the services of commercial banks include processing electronic payments, accepting bank deposits, lending money, providing letters of credits, providing performance bonds, cash management and treasury, merchant banking and private equity financing.

The main resource of revenue for commercial banks is interest from borrowers. It is however, important to note that dwindling margins caused by intense competition in today’s banking industry have compelled most commercial banks to explore other sources of non-interest income such as fee income. Stiroh (2002) underscores how the U.S banking industry is progressively increasing its dependence on non-traditional business activities that generate noninterest income such as fee income and trading revenues. His view is that this diversion toward non-interest income has contributed to higher levels of revenues of banks in recent years. He also indicates that the shift towards non-interest sources of revenues has the potential of lowering the volatility of commercial banks’ revenues as well as reducing the risk.

Another key feature of commercial banks’ regulation is the capital adequate ratio imposed by regulators, a requirement prescribed in Basel III (Anenberg, Horn & Hawken, 2010; Basel Committee, 2009). The capital adequacy ratio determines the ability of a bank to meet on time its liabilities and other risks such as credit and operational risks. As expressed by Sundararajan,

Enock, Jose, Hilbers, Krueger, Moretti, & Slack (2000), “capital adequacy and availability ultimately determine the robustness of financial institutions to shocks in their balance sheets” (p. 15). The primary objective of the capital adequacy requirement is to ensure that commercial banks are well cushioned to prevent bankruptcy (Tebogo, 2012).

2.3. Investment Banking

Subramanyam (2005) defines investment banking to include private placement, public offering, stock trading, marketing making, underwriting, broking, asset management, project advisory, business and financial advisory and mergers and acquisitions. Iannotta (2010) puts the main functions of investment banks in three categories - core or traditional services
(advisory and underwriting services), trading and brokerage, and asset management. Investment banks either assist surplus units to invest their surplus funds or deficit units to raise the needed funds for their business activities. Investment banks do not have an inventory of cash deposits to lend as commercial banks do. In essence, an investment bank amongst others things acts as an intermediary, and matches sellers of stocks and bonds with buyers of stocks and bonds.

The revenues of investment banks are fee – based normally made up of a fixed retainer fee and success fee (a percentage of transaction value). The success fee rate depends on the size of the transaction. Smaller transactions normally attract high percentages and vice versa.

2.4. Universal Banking

Universal banking refers to a combination of investment banking, commercial banking, development banking, insurance and many other financial activities. It is normally referred to as one – shop banking where a bank offers financial products including credit cards, mutual funds, mortgage loans, auto loans, insurance, in addition to all commercial and merchant banking products. Universal banks are usually very large banks characterized by a large network of branches across a country and beyond. The objective of universal banking is to allow such banks to offer a much wider variety of financial options to their customers.
3. Arguments for Separation

Several arguments have been put forward in favor of the separation of commercial and investment banking. The famous Act enacted in USA to promote the separation of these two branches of banking is the Banking Act of 1933 referred to as Glass – Steagall Act, (Tabarrok, 1998; Jackson, 1987; Filipiak, 2009; Mayer, 2009; Casserley, Harle, Macdonald, n.d).

The Glass-Steagall Act was occasioned by the financial crisis of the 1930s where the U.S stock fell by 90% from its 1929 peak. This Act was enacted to separate commercial banking from investment banking (Tabarrok, 1998). The proponents of this law led by Carter Glass, member of the US Senate Banking Committee blamed the crisis in the 1930s partly on the opportunity given to banks to engage in securities business resulting in overproduction of securities. Secondly, the holding of the volatile securities on the balance sheet was said to have culminated in loss of confidence in the banking system.

Proponents of the Glass-Steagall Act also cited increase in safety and reduction in bank and customer conflicts of interest (Tabarrok, 1998; Jackson, 1987). Their argument for the separation was that banks engagement in securities trading created overproduction of securities that led to the financial crisis in the 1930s. The proponents argued that the holding of volatile securities in the banks’ books had resulted in weak balance sheets and contributed to loss of confidence in the banking system at the time. They also identified that the selling of securities to the banks’ customers had resulted in serious conflict of interest. (Casserley, Härle and Macdonald, n.d; Wilmarth, 2009).

Paul Volcker, a former Chairman of US Federal Reserve under Presidents Jimmy Carter and Ronald Reagan as well as the former Head of President Barack Obama’s Economic Recovery Board advocated for the separation of commercial and investment banking. Volcker asserted this to prevent another occurrence of the banking crisis the U.S was experiencing at the time (Benjamin and Harper, 2009). Paul Volcker argued that the separation would enable commercial banks to be highly regulated whilst providing customers with depository options and access to credit whereas investment banks have the liberty to take more risk and practice trading in a relatively low regulated context. (Benjamin & Harper, 2009).
Another argument advanced for the separation is related to the magnitude of risk that universal banks possess (Jackson, 1987). Supporters of this assertion have looked at the effect the combination is having on non-loan assets such as bonds on a bank’s balance sheet. Proponents argue that having only commercial bank assets on a bank’s balance sheet is less risky as compared to inclusion of non-loan assets. Casserley, Härle and Macdonald (n.d) believe that it is very problematic when non-loan assets are low-rated and forms considerable portion of the total bank assets.

In terms of size and influence, a great deal of assertion has been made about the universal banks becoming too big, strong, powerful and instrumental (Jackson, 1987). Ferdinand Pecora described the 126 directorships held by J.P Morgan in 89 of the largest US companies in 1933 as “incomparably the greatest reach of power in private hands in our entire history” (Simon & Schuster, 1990, p.367 as stated in Casserley, Härle and Macdonald, n.d). Johnson and Kwaks (2010) emphasize this assertion by describing Wall Street banks as “a group that gains political power because of its economic power, and then uses that political power for its own benefit….”(p. 10).

The issue of undue risk taking by universal banks has also been put forward in favor of the separation (Damjanovic, Damjanovic & Nolan, 2012). It is argued that universal banks are beneficiaries of implicit government guarantee and are insured. As a result, they are believed to resort to undue risk taking with the view that they would be supported in terms of crisis. This is what is referred to as the moral hazard argument.

4. Arguments against Separation

Proponents of unified banking have debunked some arguments outlined by those in favor of separation and also outlined certain benefits likely to be derived from unification. One argument advanced by Casserley, Härle and Macdonald (n.d) in support of unification is that sophisticated global economy requires large banks which are able to provide vast range of products and services to their customers. According to this argument, universal banks are in a better position to promote economic growth and cheaply provide investment banking services than specialized companies. The proponents of this assertion also believe that activities of banks that provide both commercial and investment banking services are not likely to result in conflict of interest between the bank and the borrower. The reason is that since such banks
normally own shares in firms they finance, they take longer interest in these firms. Consequently, the interests of both the lender and the borrower tend to converge.

In addition, two antidotes have been prescribed to avoid conflict of interest put forward by proponents of separation (Jackson, 1987). These are promulgation of specific legislation to check conflict of interest as well as the formation of distinct subsidiaries to separately undertake lending and credit functions.

Counter arguments have also been advanced with regards to the propensity of universal banks to create more risk. As outlined in Jackson (1987), the investment activities depository organizations offer are low-risk in nature. Thus, offering such activities would not to lead higher risk. It is asserted that through diversification, overall organizational risk will be reduced.

Some authors have prescribed better supervision instead of drastic structural measures leading to complete separation of investment and commercial banks (Casserley, Härle and Macdonald, n.d). The argument is that once rigorous regulations are put in place and effectively implemented those anticipated flaws of the combination can be curtailed.

In addition to the above, various merits of the combination of the two banking branches have been put forward. These benefits include investors’ trust, resource utilization, profitable diversification, easy marketing and one-stop shop.

The investors’ trust argument has been put forward because universal banks are shareholders of many other companies. Consequently, it is not difficult for these companies in which these banks holds stake in to attract investors to invest in these businesses. It is argued that potential investors have full confidence in the universal banks and their ability to ensure that the activities the companies they invest in are well monitored.

Banks that provide both commercial and investment banking services are said to provide an avenue for resource utilization. Such banks are said to use their client's resources as per the client's ability to take a risk. As a result, their clients are advised to invest based on their risk taking capacity. Consequently, clients with high risk taking capacities are advised to make investments in high risk financial securities such as stocks whilst clients with a low risk taking capacity are advised to make safe investments such as balanced funds and fixed income
investments. According to Damjanovic, Damjanovic & Nolan (2012), “economies of scale and scope exist that can be exploited with universal banking such that their products and services are cheaper and better tailored to clients’ needs, thus benefiting the wider economy” (p. 2)

The combination of commercial and investment banking provides an opportunity for customers to have access to numerous financial products and services under one roof. This saves a lot of time and transaction costs and accelerates the speed of work. Closely related to this is easy marketing as combination allows such banks to sell and cross-sell all their financial products in their many branches. This will result in convenient banking and application of less marketing efforts.

5. Conclusion

Various arguments have been put forth in favor of separation of commercial and investment banking. Similarly, proponents of the combination of the two branches of banking are of the view that fears expressed by their opponents could be allayed through certain prescriptions. Besides, tangible benefits of the combination have also been outlined. It is evident that providing commercial and investment banking services under one roof provides enormous benefits to both the bank and its clients. However, there is the need for strict regulations as well as constant and effective supervision to avoid monopoly, conflict of interest and possible failure of the banking system.
6. References


