



# Universal vs. Investment Banks

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# Content

- **General classification**
- Universal Banks
- Investment Banks
- Management of Banks
- Regulation
- Perspectives



# General classification

## (Definition)

**Bank** is a FI with a primary activity to act as a payment agent for customers and to borrow and lend money.

A bank acts as a *middleman* between

- suppliers of funds and
- users of funds.

### *English Common Law*

- ✓ Conducting CA for the customers
- ✓ Paying checks drawn on it
- ✓ Collecting checks for his customers



# General classification

## (Categories of banks)

### 1. Retail banks

- ✓ Commercial bank
- ✓ Community development banks
- ✓ Postal savings banks
- ✓ Private banks
- ✓ Offshore banks
- ✓ Savings banks

### 2. Investment banks

- ✓ Investment banks „underwrite“
- ✓ Merchant banks

### 3. Universal banks

### 4. Other banks



# General classification

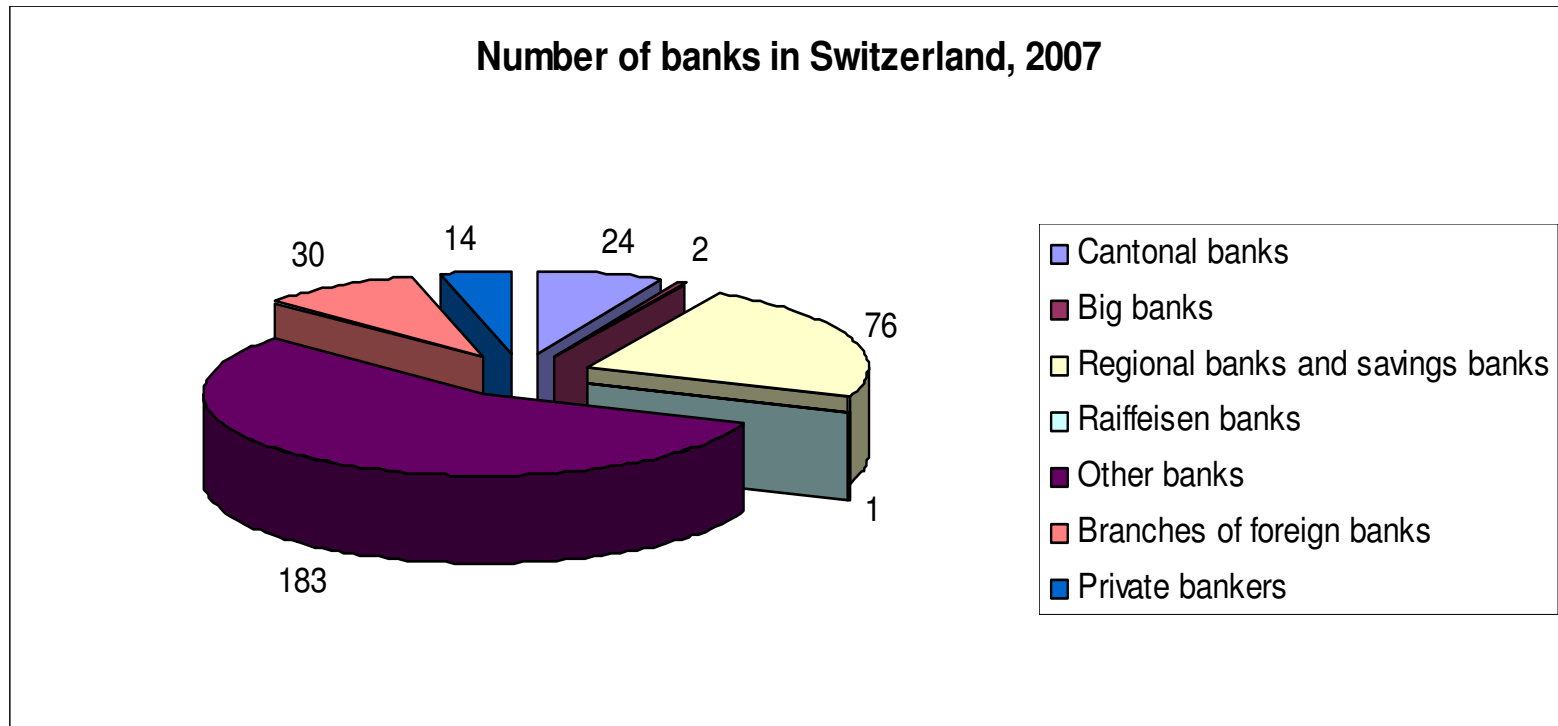
## (Economic functions of banks)

- ✓ Issue of money: cheques and CA s.t. Cheques or payment at the customers order
- ✓ Netting and settlement of payments
- ✓ Credit intermediation
- ✓ Credit quality improvement
- ✓ Maturity transformation



# General classification

(Banks in Switzerland)



SNB



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# Universal Banks

## (Definition)

### Universal banking:

✓ Loans

✓ Savings  
banking!

=> A combination of commercial and investment

✓ Investment services

### -View 1: *universal banks are good* 😊

- They are efficient institutions that overcome problems of asymmetric information
- Universal bank relations are characterized by a multitude of links which allow the bank to reuse costly information and to build up technical expertise

### -View 2: *universal banks are bad* ☹️

- Universal bank relations with affiliated companies give rise to conflicts of interest
- Universal bank relations allow the bank to loot the company at the expense of other investors, especially in an environment characterized by weak institutions and poor investor protection





# Universal Banks

## (Pros and Cons)

### The viewpoint of banks

- ✓ Economies of scale vs. Economies of scope
- ✓ one-stop supplier for various financial services
- ✓ innovation and substitution

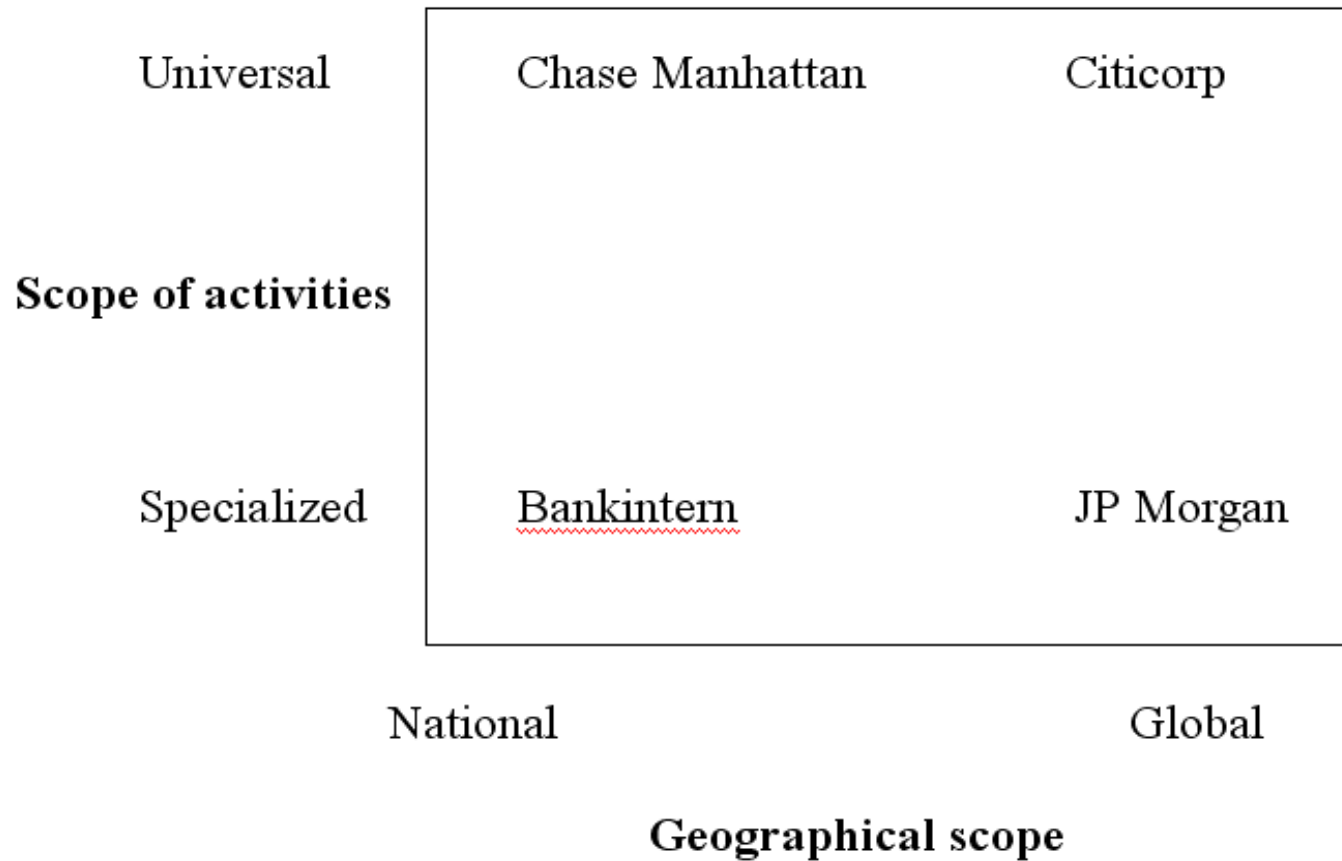
### The public policy viewpoint

- ✓ Financial stability
- ✓ concentration of power
- ✓ potential conflicts of interest
- ✓ economic growth



# Universal Banks

(The scope of bank activities)



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# Investment Banks

## Definition

An Investment Bank is a financial institution that deals with *raising capital, trading in securities and managing corporate mergers and acquisitions*. Investment banks profit from companies and governments by raising money through *issuing and selling securities* in the capital markets and insuring bonds (selling CDS), as well as providing *advice on transactions* such as mergers and acquisitions.

## Historical perspective

- Great Depression of the 1930's
  - Commercial banks, trust companies, insurance companies and private banks
- Banking Act 1933 (Glass-Steagall Act)
  - Prohibits commercial banks engaging in corporate securities offering
- Securities Act 1933
  - Full disclosure of information
- Securities Exchange Act 1934
  - The Securities and Exchange Commission (SEC) was established.

Investment banking business was protected from outside competition longer than for 60 years

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# Investment Banks

## Investment Banking Function

### 1. Investment banking activity

- ✓ advising
  - ✓ administration
  - ✓ underwriting
  - ✓ distribution
2. Asset management
  3. Capital markets
  4. Commodities
  5. Equities
  6. Fixed income
  7. Foreign exchange
  8. Insurance and pensions
  9. Mergers and acquisitions



# Investment Banks

## Investment Banking Function

### 1. Investment banking activity

- ✓ advising
  - assessment of funding needs
  - costs and benefits of various alternatives of raising funds
  - current market conditions and timing
  - suggest a funding mechanism and structure which suits best the client's needs
  - recommend a team of institutions that could assemble the recommended package
- ✓ administration
- ✓ underwriting
- ✓ distribution



# Investment Banks

## Investment Banking Function

### 1. Investment banking activity

- ✓ advising
  - ✓ administration
    - Details associated with a new issue
      - Recordkeeping
      - Title transfer
      - Tax and regulatory filing on behalf of the issuing firm
      - Remark: Fees constitute a small fraction but not trivial in absolute terms
    - Assistance in the completion of the legal documents for the SEC (including creation of a prospectus associated with any new issue)
      - Remark: Knowledge of both law and procedures is critical
  - ✓ underwriting
  - ✓ distribution
- 



# Investment Banks

## Investment Banking Function

### 1. Investment banking activity

- ✓ advising
- ✓ administration
- ✓ underwriting
  - Bring a new issue to the market on behalf of a client
  - Guarantee a fixed price to the security issuer in exchange to securities
    - Risk: too high or too low prices => proper valuation is a key
  - Delay price-fixing date to reduce a risk (up-to-date information)
  - Alternatives: best-efforts-basis public offering and private placements
    - Smaller risk => reduced service fees
- ✓ distribution





# Investment Banks

## Investment Banking Function

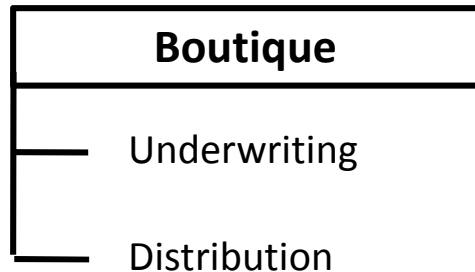
### 1. Investment banking activity

- ✓ advising
  - ✓ administration
  - ✓ underwriting
  - ✓ distribution
- 
- Essential part of the underwriting process (access to the large pools of funds)
  - Good distribution network => ability to reduce risks quickly
    - Underwriting syndicate (price stabilization function)
    - Selling group



# Investment Banks

## Investment Banking Structure



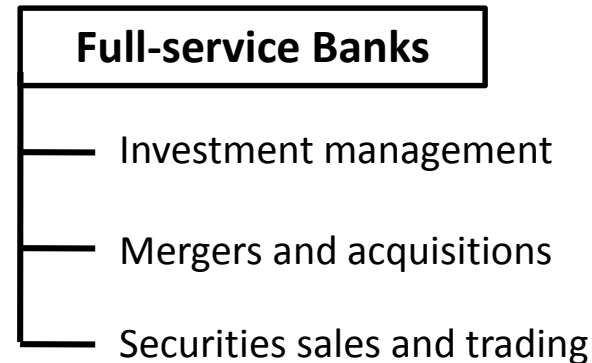
Magazine publisher  
Small computer firms  
Broadcasting firms  
etc.

### Pros:

- Exclusive knowledge
- Specialized distribution

### Cons:

- Reduce diversification
- Increase market risk



Natural advantage:  
knowledge and activity in underwriting  
business

### Pros:

- Separate lines of business
- Cost effective

### Cons:

- Conflict of interests
- Hostile takeover of a client



# Investment Banks

## Major Players



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# Management of Banks

## (Bank Risks)

Type of risk	Source of risk
Liquidity risk	Sudden withdrawals by depositors
Credit risk	Default by borrowers on their loans
Interest rate risk	Mismatch in maturity of assets and liabilities coupled with a change in interest rates
Trading (Market) risk	Trading losses in the bank accounts

Cecchetti, Ch. 12



# Management of Banks

## (Bank Risks)

### Responses:

#### LR:

- Cash reserves
- Manage assets
- Manage liabilities

#### CR:

- Diversify the spread risk
- Usage of statistical models
- Monitor

#### IR:

- Match of the maturity of both sides of the BS
- Derivatives

#### MR:

- Risk management tools
- Monitor



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# Regulation

## Objectives:

- ✓ Prudential
- ✓ Systemic risk reduction
- ✓ Misuse of bank -> avoid
- ✓ Banking confidentiality
- ✓ Credit allocation

## General principles

- ❖ market discipline
- ❖ supervisory review
- ❖ minimum requirements





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## Perspectives

- ✓ Will investment banks **survive**?
- ✓ **New generation** of investment banks?
- ✓ Investment banks – not only ones to **change**?



**Any questions?**

