

Should the Services Provided by Investment and Commercial Banks be Separated? If so, why?

Payal Chadha*

Swiss Management Center University Zug, Kuwait

Abstract

This paper examines whether the services provided by the investment and commercial banks should be separated or not. Commercial banks are defined as banks whose business is to deposit-taking and making loans. An investment bank's main business is securities underwriting, mergers and acquisitions advisory, asset management and securities trading. As of today, many commercial banks perform investment-banking services.

The paper concludes that while some countries like Switzerland don't prefer separating the services of investment and commercial banking as its beneficial for them, US and European countries like Greece need to separate their investment and commercial banking services by introducing more regulations to avoid further financial crisis like the Great Depression or Subprime crisis of 2007.

Keywords: Commercial banking services; Investment; Financial markets; Risky activity

Introduction

In 1933, Glass-Steagall was enacted after a Senate committee examination displayed the conflicts of interest in banks. The banks stuffed worthless stock that was underwritten into their depositor/investor accounts. This led massive stock price collapses and wiping out mass of investors [1,2]. The New Deal reform prohibited banks from engaging in the risky activity of underwriting and accomplished that exactly [2].

This Act separated the commercial and investment banking, but could not prevent the market "crash" of 1987, the savings and loan catastrophe of the late 1980s, the property loan problems of the banks, and the Asian debt crisis in the 1990s, or the internet bubble [2]. The root cause of the above events was too much lending, too much leverage, too much cloudiness and failure to notice [2].

Technology and the internet have transformed the financial markets and led to the creation of new products and services as of today [2]. Currently, banks have until 2019 to fully implement the reforms of separating the commercial and investment services via the Basel III international banking agreement [3]. Let us look into both banking establishments and discuss further, whether the separation of their services is beneficial or not.

History

The concept of banks came into existence in 1,800 BC in Babylon. The Greek and Roman banks lent loans, accepted deposits, and exchanged money¹. With the collapse of the Roman Empire, the banks vanished temporarily. However, banking began again in the 12th and 13th centuries in Florence and Genoa, present in Italy [4]. By the 16th century, a German family called the Fuggers became very important bankers [4].

Families like the Rockefellers, Rothschilds, and Morgans have gained control of the economy worldwide through the central banking system. They set up the Federal Reserve in the USA in 1913 and have manipulated the market to benefit themselves [5]. In 1694,

¹The Bible states that Jesus drove the money changers from the temple in Jerusalem (Lambert, 2012).

the Bank of England was the 1st central bank established² [4]. Mayer Amschel Rothschild spread his banking empire across Europe by the mid 1800³ [4]. In 1757, free of debt, fiat currency was printed in the interest of the public. In 1791, Congress created the 1st US bank, a private company with foreign ownership, to handle the financial needs of the Government. By 1816, 2nd bank of the US was chartered whose purpose was to serve as the main depository for Government Revenue. In 1833, President Jackson issued an executive order to stop depositing Government Funds into the Bank of US⁴. The period between 1837-1843 saw 343 of the 850 banks shut down as the largest banks consolidated wealth and power [5]. Modern banks started with the Bank Charter Act of 1844⁵. Towards the end of the 19th century and the beginning of the 20th century, many banks merged until in the late 20th century banking in Britain was conquered by the Barclays, Lloyds, Midland and National Westminster [4]. Between 1862-1863, Lincoln issued greenbacks⁶ to fund the war through the US Treasury [5].

In 1907, the New York Stock Exchange dropped because everyone tried to withdraw their money out of the banks across the nation⁷. In

²Model for most modern central banks today (Lambert, 2012).

³Banks were set up in Frankfurt, Vienna, London, Naples, and Paris (Thrive, n.d.).

⁴This period saw boom in the money supply till 1837 (Thrive, n.d.). The total money supply rose from \$150 million to \$267 million (Wiki, n.d.).

⁵The Act split the Bank of England into two departments - a banking department and an issuing department. From then on, the Bank of England could only issue notes if they were backed up by gold or government securities. The Bank Charter Act also forbade *new* banks to issue bank notes (Lambert, 2012).

⁶Lincoln's own currency (Thrive, n.d.).

⁷This panic led to the formation of the Federal Reserve whose purpose was to give more power to the private bankers with less transparency (Thrive, n.d.).

*Corresponding author: Chadha P, Swiss Management Center, University Zug, Kuwait, Tel: +96569078096; E-mail: payal.chad@gmail.com

Received May 10, 2016; Accepted July 30, 2016; Published August 05, 2016

Citation: Chadha P (2016) Should the Services Provided by Investment and Commercial Banks be Separated? If so, why? Int J Account Res S1: 006. doi: 10.4172/2472-114X.S1-006

Copyright: © 2016 Chadha P. This is an open-access article distributed under the terms of the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original author and source are credited.

1908, the associate from JP Morgan and the relative of Rockefeller, Nelson Aldrich, became the founders for the New National Monetary Commission. In 1910, bankers met in private on Jekyll Island to draft Federal Reserve Banking Legislation. In 1913, the Federal Reserve Act approved the present day central banking system⁸. The same year saw the establishment of income taxes, which covered the payment of debt due to the Central Bank and the Federal Reserve. In 1914, the Federal Reserve Bank Opened [5]. Between 1921 and 1929, the Federal Reserve improved the money supply to \$28 billion, almost a 62% increase over an eight-year period [6]. In 1929, the Federal Reserve pulled money out of circulation as loans were cleared⁹. This led to the most devastating stock market crash in history¹⁰ [6].

In 1963, Kennedy issued an Executive Order (11110) giving authority to the US Treasury to issue Silver Certificates, causing a threat to the Federal Reserve's Monopoly on Money. Johnson at the end of the year reversed Kennedy's banking rule and restored power to the Federal Reserve. In 1999, the Modernization Act permitted the banks to grow further [5].

The period 2000-2003 saw a financial boom via "Easy Credit" that lowered the Federal Fund Rate from 6.5% to 1% (The Federal Reserve, n.d.). In 2004, five of the biggest investment banks met with members of the Securities and Exchange Commission (SEC), to allow deliberate regulation of themselves, to determine how much money they could make up out of nothing to loan into circulation¹¹ [5]. From 2004-2006, the Federal Reserve made loans and adjustable rate mortgages expensive, which raised the Fed Fund Rates to 5.25%, thereby contracting the market [7]. The market contraction led to the financial crisis in 2007, which impacted people around the world. In 2008, J.P. Morgan Chase & Co. bought up both Washington Mutual and Bear Stearns [5].

Discussion of Facts and Issues

The role of regulators in a free market society is to create a supervisory environment within which financial markets can operate Rajan [8], thereby promoting efficient credit allocation, protecting consumers, and maintaining systemic stability [9]. Governments and regulators also need to protect the interests of individual investors who are not able individually to protect their interests [10-12]. Finding the right balance, and weighing the cost and benefits of regulation and supervision is important because regulators are faced with the possibility that inadequate regulation may result in failures, whilst overregulation may result in financial inefficiencies and lower innovation [13].

Lindo suggested in his Finance Watch Report 2013 that, "Separation would make banking groups simpler and more transparent; it would also facilitate market discipline and supervision and, ultimately, recovery and resolution" [14]. The goal is to keep banks that have access to federal deposit insurance away from products such as derivatives and other structured financial products [14].

⁸They were able to create money out of nothing (and loan it out at interest), make decisions without government consent, and control the amount of money in circulation (Thrive, n.d.).

⁹The Federal Reserve's actions sparked the banking crisis leading to the Great Depression (Thrive, n.d.).

¹⁰Billions of dollars were consolidated into the private banker's hands at the cost of everyone else (Thrive, n.d.).

¹¹Known as banks leverage ratio, or amount of assets to borrowing ratio. The SEC let the banks regulate themselves and take as much debt as they wanted for high-risk investment packages (Thrive, n.d.).

Harper and Benjamin [15] state that Volcker's proposition on separating the commercial and investment activities will prevent the financial crisis from occurring. The Volcker Rule as of 2014 prohibits the banking entities to engaging in short-term proprietary trading of securities, derivatives, commodity futures and options on these instruments for their own account; and owning, sponsoring, or having certain relationships with hedge funds or private equity funds [16].

On the contrary, in Switzerland, the Federal Council states, "such a radical change to the system would only create disadvantages. A state-mandated separated banking system would not result in greater financial stability. Instead, it would severely restrict the services provided by the big banks for their private and corporate clients. This would also significantly weaken Switzerland's globally-oriented national economy" [17]. During the Swiss real estate crisis in the early 1990s, it was the big banks that were able to use profit from international securities trading and commercial transactions – particularly in the derivatives business – to compensate for losses in the traditional banking industry; all this in contrast to the most severely affected regional and cantonal banks. The profits generated by the diversified business of the big banks not only created a buffer for the big banks themselves, but also contributed to the stabilization of the Swiss economy¹². Introducing a separated banking system would limit the number of these services offered and would cause the Swiss economy to depend more on foreign banks. Moreover, the combination of private banking and investment banking in Switzerland helps to create the capital market proficiency required for the Swiss financial center [17]. The universal banking model provides Switzerland's banks with the best conditions for binding synergies, which are enhanced when investment banking can work together with private banking and wealth management with fewer restrictions [17]. The private and corporate clients have placed increasing importance on broad access to capital market products. The universal banking model enables Switzerland's biggest banks to open up foreign markets and acquire new clients, creating added value and jobs in Switzerland [17].

Analysis of Facts and Issues

Many have blamed the financial and credit crisis of 2007-8 on the deregulation that had been expanded since the reversal of the Glass-Steagall Act. The repeal of the Glass-Steagall Act opened the way for deregulation and many blame the current crisis on it. The deregulation opened the way for many institutions to become one of the too-big-to-fails, and their demise caused a tremendous amount of assets to be wiped out. The repeal was initiated and lobbied because banking giants wanted to become yet bigger and more expansive. By the late 1990s and the dot-com bubble of 2000, the congress was somehow deluded into believing that the protection that comes from regulation is not needed in the financial sector. Allowing conflicts of interests, and the interests of the banks, insurance companies, investors, and depositors to merge was an obvious sign that all regulatory requirements were stepped on. The resulting concentration of wealth fueled the greed that overcame the professional and ethical standards. The repeal caused the current crisis not just by ultimately letting some institutions become too big to fail, but also by letting commercial banks engage in risky activities that would jeopardize the depositors' money through the investment banking activities, and this means taking risks on the behalf of depositors but without their consent [18].

Thus, globalization, deregulation and re-regulation, and innovation (including communications technology, computer science,

¹²See Prof. Dr. Martin Hellwig (2007): "Switzerland and Euroland: European Monetary Union, Monetary Stability and Financial Stability," p. 23

and information technology) have spurred changes in the way banks meet their customers' needs. Ravi (2008)¹³ assembled the reasons for the changes in banking activities:

1. Governments have implemented philosophies and policies based on an increase in competition in order to maximize efficiency. This has resulted in the creation of large new financial institutions that operate simultaneously in several financial sectors such as retail, wholesale, insurance, and asset management [19].

2. New technology creates an infrastructure, allowing a player to carry out a wide range of banking and financial services, again simultaneously [19].

3. Banks had to respond to the increased prosperity of their customers and to customers' desire to get the best deal possible. This has encouraged banks to extend their activities into other areas [19].

4. Banks had to develop products and extend their services to accommodate the fact that their customers are now far more mobile. Therefore demarcations are breaking down [19].

5. Banks have every motivation to move into new sectors of activity in order to try to deal with the problem that, if they only offer banking services, they are condemned forever to provide only a secondary level of utility to customers [19,20].

Conclusions

To conclude, separation enables specialization and the acquisition of institutional capabilities through learning by doing and otherwise. Appropriate separation can minimize moral hazard and hence, the need for external regulation and supervision. Separation facilitates regulation and supervision where it is still needed [21]. Structural separation is a key component of regaining the sovereignty of public interest over banks. Getting rid of too-big-to-fail, and implementing a structural separation of commercial banking and investment banking activities, are critical ways to reduce the possibility of taxpayers footing the bill when a potential bank failure threatens the whole economic system [22]. This separation must split those activities which cannot be interrupted, and which a bank failure would interrupt, from those which either could be interrupted or which a bank failure would not interrupt [22]. In short, it must separate deposits and payment services from financial market trading activities. This separation must be affected prior to crisis as the only way to reduce moral hazard and the implicit funding subsidy that trading arms of large universal banks today benefit from separation will offer investors a clear and meaningful choice between commercial banks and investment banks.

¹³Advances in Banking Technology and Management: Impacts of ICT and CRM by Vadlamani Ravi (Ed) IGI Global. (c) 2008

European banks are on life support-far from increasing funding costs for banks and therefore the rest of the economy, structural separation offers European banking a lifeline through a return to stability and confidence [22].

References

1. <http://lexicon.ft.com/Term?term=commercial-bank>
2. Lackritz M (2010) Separating investment banks will not make us safer. The Financial Times.
3. Out-Law (2011) Banks have until 2019 to separate retail and investment banking activities, says IC.
4. Lambert T (2012) A brief history of banks.
5. <http://www.thrivemovement.com/banking-history-timeline-follow-money>
6. <http://mises.org/rothbard/agd/chapter4.asp>
7. http://www.federalreserve.gov/monetarypolicy/openmarket_archive.htm
8. Rajan RG (2010) Fault lines: How hidden fractures still threaten the world economy. Princeton, Princeton University Press, New Jersey.
9. Fullenkamp C, Sharma S (2012) Good financial regulation: changing the process is crucial.
10. Walter I (2009) The new case for functional separation in wholesale financial services.
11. Wolf M (2009) Fixing global finance. How to curb financial crises in the 21st century. London, Yale University Press, UK.
12. West RC (1983) The evolution and devolution of bank regulation in the United States. Journal of Economic Issues 17: 361-367.
13. Lamfalussy A (1989) Globalization of financial markets: International supervisory and regulatory issues. Economic Review-Federal Reserve of Kansas 74: 3-8.
14. Crittenden MR (2013) Lawmakers move to rebuild wall between commercial and investment banking - bill would rebuild wall between commercial, investment banking.
15. Benjamin M, Harper C (2009) Volcker Urges Dividing Investment, Commercial Banks. Bloomberg.
16. <http://www.sifma.org/issues/regulatory-reform/volcker-rule/overview/>
17. Schaller E (2014) Switzerland-Separated Banks versus Universal Banks.
18. Azadinamin A (2012) Separation of investment and commercial banking. Swiss Management Center University.
19. Engler H, Essinger J (2002) The Future of Banking, Financial Times management.
20. Ohoukoh K (2011) Should the services provided by commercial and investment banks be Separated? SMC University.
21. Lau LJ (2014) Separation versus integration: on the efficiency and effectiveness of regulation of commercial Banks. Stanford University.
22. Lindo D (2013) The importance of being separated-making the public interest sovereign over banks. Finance Watch.

This article was originally published in a special issue, **Collection of Finance Research** handled by Editor. Payal Chadha, Swiss Management Center University Zug, Kuwait