INVESTMENT BANKING: SHOULD IT BE SEPARATED FROM RETAIL BANKING?

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ABSTRACT:

Nowadays banks tend to diversify their business by engaging in investment banking and retail banking activities and become more towards universal banking. But there is high risk in doing investment banking activities because of the exposure to the capital market. As this paper continues, we will examine the advantages and disadvantages of the investment banking separation from retail banking and answer our title’s question in the conclusion. International financial market was shocked when Lehman Brothers, one of the biggest investment bank in the USA, collapsed in September 2008. Since then, people are starting to realize that there is something wrong happened in the current banking system. The discussion is led to the endless debate on should the investment banking be separated from retail banking.

Key words: investment banking, retail banking, financial crisis, banking system.

ABSTRAK:


Kata kunci: investasi perbankan, perbankan ritel, krisis keuangan, sistem perbankan.
INTRODUCTION

Banking industry is the main industry in the international financial market. They act as a financial intermediary between surplus and deficit units to have financial claims transaction which they transform risk, maturity and size to meet borrower and lender needs (Turner, 2010). In addition, their services are beneficial to their clients because they can reduce transaction cost, reduce asymmetric information and help provide system that make payment system easier, quickly and reliable (Buckle and Thompson, 2004). Nowadays, banking industry can be divided into two big groups based on their activities which are retail banking and investment banking.

Retail banking is a deposit taking institution that takes deposit usually from individuals and small business and they provide loans to the same groups (Kay, 2010). It is a high value and low cost business because the transactions are very high but not in a big amount of money. They make money from the difference between interest rate borrowing and interest rate of lending. In order to give service quality to the customer, they might provide services through mobile banking, phone banking or internet banking.

While on the other hand, investment banking is a non deposit taking institution that provides several services related to capital market activities to their corporate clients include: arranges bond issuance, underwrites initial public offering (IPO), assists mergers and acquisitions transactions and gives management consulting services (Ritter, 2003). In addition, they may engage in other capital market activities such as market making, brokerage and asset management. Besides trading stocks and bonds on their client behalf, investment banking may trade with their own account that usually called proprietary trading. They make money from service fees and profit of the proprietary trading.

As discovered by Sul (1998), it is common nowadays for banks to diversify their business by engaging in both activities and become more towards universal banking. But, as the illustration above, there is high risk in doing investment
banking activities because of the exposure to the capital market. As this paper continues, we will examine the advantages and disadvantages of the investment banking separation from retail banking and answer our title’s question in the conclusion.

As mentioned above, bank’s main function is to take deposits and make loans (Benston and Kaufman, 1996). People trust their banks to manage their deposit and get interest rate by the end of agreed time horizon. In addition they can withdraw their money anytime they want. Small businesses also depend on bank to give loan to run their business. They will look for a bank that can give the lowest interest rate with the longest time horizon possible.

Knowing the bank’s nature of business, we may then see the situation from the management perspectives. Banks borrow short term from their depositors while they lend long term to their borrowers (Benston and Kaufman, 1995). Therefore the managements are faced with liquidity risk for the duration mismatch and asset risk if their borrowers become bankrupt and cannot repay their loans. In addition, since bank is also a profit oriented institution, the managements are also expected by their shareholders to make profit.

Therefore, the managements tend to take higher risk in order to make higher profit without considering all possible consequences that can jeopardize the entire financial market system. They do this by engaging in complicated activities like investment banking. By diversifying their business the managements expect they can manage the risk better and also give additional revenue. The managements do not realize that they may not improve the total revenue but end up increase overall risk (Geyfman and Yeager, 2009).

However, according to Kroszner (1998), research held by Kroszner and Rajan (1994 and 1997) regarding banks behavior towards risk appetite before Great Depression era showed that bank takes risk wisely and does not want to abuse their credibility by engaging in more speculative business. Market forces them to find better structures and proportion for on which side of the business to
invest in. However, there was different external factor with the current financial market situation.

External factor that promote this risk taker behavior is the government intervention which include the existence of deposit insurance and central bank’s function as the lender of last resort. Deposit insurance means depositors’ money is guaranteed by the government. This make the obligation to repay the depositors’ money shifts from the managements to the government. In this safety net scheme, there is no punishment for insolvent bank and reward for bank that stays solvent (Kroszner, 1998). Keeley (1990) showed that the managements tend to take higher risk on their business because of the existence of deposit insurance.

Even if in the end the bank is going bankrupt, the government will not let this happened because banking industry is interconnected and one’s failure may lead to systemic failure. The bank has become too big to fail because when they fail, they may disrupt the entire financial system to function as usual as defined in Avgouleas (2010). Ordinary uninformed depositors may not have the ability to differentiate financial condition of an individual bank. When they see one bank collapsed, they might assume that the other banks will have the same problems and finally withdraw all of their savings. As a result, this will affect the other financially health bank that has strong fundamental because they are faced with unexpected bank run (Kroszner, 1998). This is the situation where the government will bail out the bank through central bank as the lender of last resort. In doing so, the government will use national reserves that comes from taxpayer’s money. In short, the taxpayers have to take the consequence of incapable bank’s management managing their financial position.

ADVANTAGE

Still having these incentives, there is advantage of investment banking separation from retail banking for public interest. Separating the main function from the speculative function eventually enhance public interest protection (Kay,
2010). The managements cannot engage in a high risk activity that may lead their bank to failure. By doing so, the government also reduced the possibilities of bailing out insolvent bank. If the investment bank is going bankrupt, the government will not be concerned to bailing out such bank because they do not taking deposit and will not affect the function of financial system.

In terms of financial market monitoring, having two different banking institutions will be easier to regulate. As Avgouleas (2010) suggested, government need to concern only about retail banking, where all people put their savings into. Investment banking sector could be less regulated and monitored because people that attracted to have deal with them is considerably already know their risk. It should be left to the market mechanism to achieve the most effective and efficient structure for investment banking system. It eventually leads to a decrease in cost of monitoring that will also benefit the public interest.

USA once has regulation that separate retail banking from investment banking. 1933 Glass-Steagall Act was in force until 1999 following Great Depression that gives protection to individual customers from unwanted capital market exposure. After the act was repealed there were many mergers between retail bank and investment bank. Study done by Wilmarth (2009) and Kay (2010) showed that banks are taking more profits by engaging speculative transaction in capital market compare to lending their money to small business. Whereas, when the act was still in force, each bank plays their own function in the financial market. This is evidence that separation requires less monitoring effort from the government.

When bank fails to play their main function as lender to small business, the economic stability will be disturbed (Kay, 2010). It will be difficult for business to get the capital they need. If business goes bankrupt they will fire the employees and the unemployment rate will be higher. Therefore, it is ideal for bank to be more focus on their main function rather than gamble speculatively in the capital market.
In addition, the separation will also give more transparency on the bank’s activities. For bank that engages in both retail and investment banking, there is also conflict of interest issue. The bank may have lent some money to a small business, when they want to issue shares publicly they may engage the same bank as their underwriter. This situation gives advantages for the bank because they already have thorough information about the company since the first loan contract. Schenone (2004) argues that the bank have the incentive to use their superior information to exploit issuers and increase asymmetric information to the public. As consequences, the rational investor expects to get lower price to compensate such asymmetric information.

By having the separation, there will not be any conflict of interest issue. The depositors will have different bank for their loan purposes and capital market activities purposes. The investment bank does not have superior information regarding their client previous activities. It eventually increases credibility of the investment bank itself because their client will have more trust that the investment bank will act for their best interest and will not have incentive to abuse their trust.

DISADVANTAGES

Having several businesses in the portfolio will eventually reduce the risk expose to the company (Geyfman and Yeager, 2009). This is the ultimate idea for combining retail bank and investment bank. If they engage in both businesses, when one business faces a downturn, they still have the other business to count on. It might be the case if everything goes as planned. Unfortunately, it is not the case in the current financial market situation.

Engaged in both businesses, banks have the incentive to decide in which part of the business they want to invest. They eventually more attracted to the business that might give them higher return and tend not to make their portfolio in a balanced proportion (Geyfman and Yeager, 2009). Therefore, they prefer engage in capital market rather than give loan to small business.
As a result, this situation needs more regulation to achieve most efficient and effective financial system. Government need to intervene and set the highest proportion for a bank to engage in capital market activities. More regulations also mean more cost needed to be spent to monitor that bank follow the regulation. More complex institution engages in sophisticated industry need more monitoring and supervision in order not to fall apart (Kay, 2010). In the end, the ultimate idea of combining retail bank and investment might be the downfall for itself.

Furthermore, by collecting money from several different channels, banks may take advantage of the economics of scope and scale. They may operate in a more cost efficient operation because they do not need to spend initial investigative cost for investment banking activity since they already have information through their borrowing relationship (Kroszner, 1998). They might also identify potential new business and bring them to capital market from the earlier stage among their borrowers. However, as stated by Sul (1998) research made by Saunders and Walter (1994) showed that banks engage in both retail and investment banking may also experience diseconomies of scale.

From the customer perspective, combining retail bank and investment bank means that they can have a one stop financial service. They not only make deposit and ask for loan, but also engage in capital market activity with the same bank. According to Geyfman and Yeager (2009), studied by Yasuda (2005) show that company prefers to be underwritten by bank that they already have relationship with. Having this situation, customer does not need to explain the company situation when they decide to have public offering because they already have relationship with the bank from the first loan contract. They also might seek advice regarding the best time to enter capital market and through which instruments, debt or equity. It eventually reduces the transaction cost of the customer in searching for independent investment bank.

As I mentioned earlier, this situation still have downfall. Having all the company information and background, investment bank has superior information
compare to any other party. As a result, investment bank may act for their best interest and not for the clients'. Since the bank is also the debtholder of the company, they have incentives to underwrite the company’s public offering and have them repay the loan without disclosing this information to public (Kroszner, 1998). Independent investment bank will not have the same incentive as bank that also has borrowing history in the past.

CONCLUSION

Banking system should be designed to have more benefit to the society. As the deposit taking institution, protection of public interest should be the basis of consideration. As mentioned above, the cost of combining retail banking and investment banking in one institution may outweigh the benefit of doing so. There will be more risk and potential regulation cost involved in the combining process.

On the other hand, separation of retail banking and investment banking will have more benefit towards entire financial system. Each bank plays their main function in the financial system. It also minimizes any management’s bad incentives to used safety net scheme provided by the government. In addition, the separation also reduces conflict of interest issue that will eventually increase credibility of the investment banking itself. Therefore, in conclusion, investment banking function should be separated from retail banking function.

REFERENCE


