Chapter 3

Types of banking

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Learning objectives

- To distinguish between traditional and modern banking
- To understand the differences between commercial and investment banking
- To describe the main features of mutuality
- To understand the differences between private and corporate banking
- To outline the main aspects of Islamic banking
This chapter outlines the main types of firms that undertake banking business and describes the main features of commercial and investment banking. The first part of the chapter describes the recent trend towards the development of financial service conglomerates and the widespread acceptance of the universal banking model. We then go on to outline the main types of banks engaged in commercial banking activity and also focus on the products and services offered to personal (including private banking) and corporate banking customers. Discussion on corporate banking services is split between services offered to small companies and corporate and investment banking products offered to mid-sized and large companies. Finally, we briefly highlight the main aspects of investment banking business and end by looking at some aspects of non-interest-based Islamic banking. A major theme throughout the chapter is the increasing blurring of distinctions between particular areas of banking and financial services provision, and the focus on customer relationships and meeting the increasingly complex and diverse needs of clients.

Banking business has experienced substantial change over the last 30 years or so as banks have transformed their operations from relatively narrow activities to full service financial firms. Traditionally, banks’ main business consisted of taking deposits and making loans and the majority of their income was derived from lending business. Net interest margins (the difference between interest revenues from lending minus the interest cost on deposits) was the main driver of bank profitability. In such an environment banks sought to maximise interest margins and control operating costs (staff and other costs) in order to boost profits. Banks strategically focused on lending and deposit gathering as their main objectives.

Up until the 1990s many banking markets were highly regulated and competition was restricted. In Britain banks were restricted from doing various securities and investment banking business up until 1986 when various reforms allowed commercial banks to acquire stockbroking firms. In continental Europe, branching restrictions were in place in Spain and Italy until 1992 and banks were also limited in terms of the types of business they could conduct. The implementation of the EU’s 1988 Second Banking Directive in 1992 established a formal definition of what constituted banking business throughout Europe and this introduced the so-called universal banking model. Under the universal banking model, banking business is broadly defined to include all aspects of financial service activity – including securities operations, insurance, pensions, leasing and so on. This meant that from 1992 onwards banks throughout the European Union could undertake a broad range of financial services activity.

A similar trend has also occurred in the United States. For example, there were nationwide branching restrictions in place until the passing of the Riegle-Neal Interstate Banking and Branching Efficiency Act in 1994 which allowed national banks to operate branches across state lines after 1 June 1997. Also the Gramm-
Leach-Bliley Act in November 1999 allowed commercial banks to undertake securities and insurance business thus establishing the possibility of universal banking activity for US banks. Similar legislation was also enacted in Japan in 1999.

The type of business banks can undertake, therefore, has expanded dramatically. As detailed in Chapter 2, in addition to deregulation various other factors have also had an impact on banking business globally. Capital restrictions that limited the free flow of funds across national boundaries gradually disappeared throughout the 1980s facilitating the growth of international operations. The role of state-owned banks in Europe and elsewhere has declined as a result of privatisation and various balance sheet restrictions (known as portfolio restrictions) have also been lowered or abolished allowing banks greater freedom in the financial management of their activities. These global trends have also been complemented by advances in technology that have revolutionised back-office processing and front-office delivery of financial services to customers. The general improvements in communication technology and the subsequent decline in costs allow dissemination of information throughout a widespread organisation, making it practical to operate in geographically diversified markets. Lower communication costs also increase the role of competitive forces, as physically distant financial service providers become increasingly relevant as competitors.

Technology has also continued to blur the lines of specialisation among financial intermediaries. The development of the internet and other computing technology, for example, has enabled insurance companies to offer banking services online (such as the online bank Egg owned by Prudential in Britain) and has also promoted asset securitisation particularly in the United States (where standardised packages of loans are moved off banks' balance sheets and sold to investors, resulting in intermediation of similar assets across different types of intermediaries). Advances in computing power also allow investment banks and other financial service firms to offer accounts with characteristics similar to bank accounts. Technological developments, therefore, have generally facilitated growth in the range of financial services available and heightened the competitive environment.

It can be seen that banking business has changed dramatically from an activity characterised by limited competition and a relatively restricted product offering to a much more competitive and diverse activity. These differences are highlighted in Table 3.1.

Table 3.1 shows that the nature of banking business has changed from being relatively restricted and uncompetitive to a much more dynamic activity. Banks are now regarded as full service financial firms – and many banks have even dropped the word ‘bank’ from their name in their promotional material, such as ‘Barclays’ in Britain and JP Morgan Chase in the United States. The transformation of banks into full service financial institutions has been motivated by the strategic objective of banks to be able to meet as broad a range of customer financial service demands as possible. The increase in products and services that can be sold to customers helps strengthen client relationships and (so long as customers value the services being provided) should boost returns to the bank over the longer term.

In an increasingly competitive environment banks have sought to diversify their earnings – complementing interest revenues from lending activity with fee and commission income from selling non-traditional banking products such as insurance. The greater emphasis on building client relationships means that banks have had to become much more demand-oriented, focusing on meeting the needs of a more diverse and financially sophisticated client base.
Banks have also had to pay much greater attention to the performance of their operations and in particular to rewarding their owners (shareholders). Traditionally, when banking markets were relatively restricted and uncompetitive there was less pressure on banks to generate high profits in order to boost their stock prices and keep shareholders happy. Typically, banks focused on strategies based on asset growth – in other words they sought to become larger as this was viewed as the main indicator of commercial success. Nowadays, bank strategy focuses on creating value for shareholders (the bank’s owners) and strategies based solely on asset growth are no longer deemed appropriate. The main reason for this shift in emphasis is because demands from shareholders have increased as has banks’ demand for capital. In banking, capital is a resource available to the bank that it uses to protect itself against potential losses and to finance acquisition or expansion. A commercial bank’s balance sheet comprises assets (e.g., loans, securities and fixed assets) and liabilities (mainly deposits) plus capital (e.g., shareholders’ equity plus retained profits and various other items). The regulators set minimum capital requirements (e.g., Basle ratios) so banks have sufficient resources to bear losses incurred from bad loans or from other activity. As such, banks need to generate sufficient performance for their equity to increase in value in order to attract new shareholders as well as keeping established shareholders. Senior managers therefore prioritise strategies that seek to increase the overall value of the bank (reflected in the share value of the bank and its overall market capitalisation). In modern banking, strategies that are expected to boosts banks stock prices are therefore prioritised.

### Table 3.1 Traditional versus modern banking

<table>
<thead>
<tr>
<th>Traditional banking</th>
<th>Modern banking</th>
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<tbody>
<tr>
<td><strong>Products and services:</strong> LIMITED</td>
<td><strong>Products and services:</strong> UNIVERSAL</td>
</tr>
<tr>
<td>• Loans</td>
<td>• Loans</td>
</tr>
<tr>
<td>• Deposits</td>
<td>• Deposits</td>
</tr>
<tr>
<td>• Insurance</td>
<td>• Insurance</td>
</tr>
<tr>
<td>• Securities/investment banking</td>
<td>• Securities/investment banking</td>
</tr>
<tr>
<td>• Pensions</td>
<td>• Pensions</td>
</tr>
<tr>
<td>• Other financial services</td>
<td>• Other financial services</td>
</tr>
<tr>
<td><strong>Income sources:</strong></td>
<td><strong>Income sources:</strong></td>
</tr>
<tr>
<td>• Net interest income</td>
<td>• Net interest income</td>
</tr>
<tr>
<td></td>
<td>• Fee and commission income</td>
</tr>
<tr>
<td><strong>Competitive environment:</strong></td>
<td><strong>Competitive environment:</strong></td>
</tr>
<tr>
<td>• Restricted</td>
<td>• High competition</td>
</tr>
<tr>
<td><strong>Strategic Focus:</strong></td>
<td><strong>Strategic focus:</strong></td>
</tr>
<tr>
<td>• Assets size and growth</td>
<td>• Returns to shareholders</td>
</tr>
<tr>
<td></td>
<td>• Creating shareholder value (generating Return-on-equity, ROE, greater than the cost of capital)</td>
</tr>
<tr>
<td><strong>Customer focus:</strong></td>
<td><strong>Customer focus:</strong></td>
</tr>
<tr>
<td>• Supply led</td>
<td>• Demand led</td>
</tr>
<tr>
<td></td>
<td>• Creating value for customers</td>
</tr>
</tbody>
</table>

Banks have also had to pay much greater attention to the performance of their operations and in particular to rewarding their owners (shareholders). Traditionally, when banking markets were relatively restricted and uncompetitive there was less pressure on banks to generate high profits in order to boost their stock prices and keep shareholders happy. Typically, banks focused on strategies based on asset growth – in other words they sought to become larger as this was viewed as the main indicator of commercial success. Nowadays, bank strategy focuses on creating value for shareholders (the bank’s owners) and strategies based solely on asset growth are no longer deemed appropriate. The main reason for this shift in emphasis is because demands from shareholders have increased as has banks’ demand for capital. In banking, capital is a resource available to the bank that it uses to protect itself against potential losses and to finance acquisition or expansion. A commercial bank’s balance sheet comprises assets (e.g., loans, securities and fixed assets) and liabilities (mainly deposits) plus capital (e.g., shareholders’ equity plus retained profits and various other items). The regulators set minimum capital requirements (e.g., Basle ratios) so banks have sufficient resources to bear losses incurred from bad loans or from other activity. As such, banks need to generate sufficient performance for their equity to increase in value in order to attract new shareholders as well as keeping established shareholders. Senior managers therefore prioritise strategies that seek to increase the overall value of the bank (reflected in the share value of the bank and its overall market capitalisation). In modern banking, strategies that are expected to boosts banks stock prices are therefore prioritised.
Universal banking and the bancassurance trend

A key feature of the deregulation trend is that it has allowed banks to compete in areas of the financial services industry that up until recently were prohibited. While the universal banking model has been an integral feature of European banking since the early 1990s, it has been a more recent development in the United States and Japan. One area that deserves particular attention regarding the adoption of the universal banking model has been the increased role of commercial banks in the insurance area (see Genetay and Molyneux, 1998). While it is relatively early to fully assess these developments in the United States and Japan (as the systems only allowed for banks to do insurance business from late 1999), the experiences of European banks provide a neat example of how the combination of banking and insurance business has developed. The combination of banking and insurance is known as ‘bancassurance’ or ‘allfinanz’.

Bancassurance is a French term used to define the distribution of insurance products through a bank’s distribution channels. Bancassurance – also known as allfinanz – describes a package of financial services that can fulfil both banking and insurance needs at the same time. A high street bank, for example, might sell both mortgages and life insurance policies to go with them (so that if the person taking out the mortgage dies then the life insurance will pay up to cover the outstanding mortgage).

Since the 1980s, the trend towards bancassurance has been steadily increasing. Some of the reasons put forward to explain such a trend are:

- Cross-selling opportunities for banks (scope economies).
- Non-interest income boosted at a time of decreasing interest margins.
- Risk diversification.
- Banks converting into full service financial firms (deregulation).

Until the 1980s, banks in many countries sold insurance guarantees that were a direct extension of their banking business. For example, credit insurance on consumer loans was common in France. Banks were also selling buildings insurance and home/contents insurance for property purchase funded by mortgages.

During the 1980s major developments occurred, particularly in France, where banks started offering capitalisation products (for example endowment products). However, despite the existence of an insurance component, it was a support factor to the savings objectives of these products. The 1990s brought greater customer orientation in the financial sector and banks in several EU countries attempted to exploit better the synergies between banking and insurance.

In 2004, bancassurers in Europe had an approximate 35 per cent share of the life insurance market. Nowadays, the term ‘bancassurance’ encompasses a variety of structure and business models. The development of each model has largely occurred on a country-by-country basis as the models are tailored to the individual market structures and traditions. In broad terms, bancassurance models can be divided between ‘distribution alliances’ and ‘conglomerates’.

As shown in Figure 3.1 the ‘conglomerate’ model goes beyond the traditional bancassurance model of ‘distribution alliances’ which involves simply cross-selling of insurance products to banking customers, as it involves retaining the customers.

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1 Comité Européen des Assurances (2003).
within the banking system and capturing the economic value added, that is a measure of the bank’s financial performance, rather than simply acting as a sales desk on behalf of the insurance company. The conglomerate model is where a bank has its own wholly owned subsidiary to sell insurance through its branches whereas the distribution channel is where the bank sells an insurance firm’s products for a fee.

In practice the use of ‘conglomerate’ and ‘distribution alliance’ models is influenced by the role of the banking sector in the particular country. In countries such as Italy, France, Spain and Britain, where banks are trusted and visited regularly, the ‘conglomerate’ model is likely to be preferred. In France, bancassurance represented 61 per cent of life and pensions market premium income at the end of 2002. In general, most of the major European markets have seen a rapid rise in the market share of bancassurance for sales of life assurance and pensions products in recent years. However, it is important to note that, because of the complexity of the bancassurance models and different implementation in EU countries, the figures may understate real sales levels. This holds true particularly for sales that are made through ‘Distribution Alliances’, which may lead to some understatement of the share of bancassurance, particularly in the United Kingdom.²

3.3 Retail or personal banking

Retail or personal banking relates to financial services provided to consumers and is usually small-scale in nature. Typically, all large banks offer a broad range of personal banking services including payments services (current account with cheque facilities, credit transfers, standing orders, direct debits and plastic cards), savings, loans, mortgages, insurance, pensions and other services (these services have been reviewed in Section 2.4).

A variety of different types of banks offer personal banking services. These include:

² Comité Européen des Assurances (2003).
Commercial banks are the major financial intermediary in any economy. They are the main providers of credit to the household and corporate sector and operate the payments mechanism. Commercial banks are typically joint stock companies and may be either publicly listed on the stock exchange or privately owned.

Commercial banks deal with both retail and corporate customers, have well-diversified deposit and lending books and generally offer a full range of financial services. The largest banks in most countries are commercial banks and they include household names such as Citibank, HSBC, Deutsche Bank and Barclays.

While commercial banking refers to institutions whose main business is deposit-taking and lending it should always be remembered that the largest commercial banks also engage in investment banking, insurance and other financial services areas. They are also the key operators in most countries’ retail banking markets.

Savings banks are similar in many respects to commercial banks although their main difference (typically) relates to their ownership features – savings banks have traditionally had mutual ownership, being owned by their ‘members’ or ‘shareholders’ who are the depositors or borrowers. The main types of savings banks in the United States are the so-called Savings and Loans Association (S&Ls or thrifts), which traditionally were mainly financed by household deposits and lent retail mortgages. Their business is more diversified nowadays as they offer a wider range of small firm corporate loans, credit cards and other facilities. Originally the US S&Ls were mainly mutual in ownership but now many have become listed. They represent the second largest deposit-taking group of financial institutions in the United States: there were 1,332 S&Ls in March 2005 with assets of $1.7 trillion. Savings banks are also important in various other countries. In Germany, for instance, they account for more than 50 per cent of the retail banking market and are the major players in household finance.

The German savings banks are public institutions owned by Federal or local governments who underwrite potential losses. Savings banks are also important in Spain – and these also have quasi public ownership. Note that in Britain LloydsTSB was created by the merger of Lloyds Bank and Trustee Savings Bank (TSB), and the latter converted from a type of mutual status to a publicly listed bank before merg-

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3 Various state guarantees that enabled the German central savings banks, the Landesbanken, to obtain low cost (AAA rated) purchased funds, are being withdrawn after EU recommendations about unfair competitive practice, and this will also affect the financing cost of the whole sector.
ing with Lloyds. As such, savings banks nowadays do not play a significant role in the UK banking market.

It should be noted that savings banks (in Europe and elsewhere) adhere to the principal of mutuality and pursue objectives relating to the social and economic development of the region or locality in which they operate. Unlike commercial banks they may pursue strategic objectives other than maximising shareholder wealth or profits. Typically their business focuses on retail customers and small businesses, but as some have become very large (especially in Germany and Spain) they closely resemble commercial banks in their service and product offering.

### 3.3.3 Co-operative banks

Another type of institution similar in many respect to savings banks are the **co-operative banks**. These originally had mutual ownership and typically offered retail and small business banking services. A recent trend has been for large numbers of small co-operative banks to group (or consolidate) to form a much larger institution – examples of which include Rabobank in the Netherlands and Credit Agricole in France – both of these are now listed and have publicly traded stock. In Britain the Cooperative Bank also is publicly listed.

### 3.3.4 Building societies

Another type of financial institution offering personal banking services prevalent in the United Kingdom and various other countries (such as Australia and South Africa) are known as **building societies**. These are very similar to savings and co-operative banks as they have mutual ownership and focus primarily on retail deposit-taking and mortgage lending.

As noted by the UK Building Society Association:

> A building society is a mutual institution. This means that most people, who have a savings account, or a mortgage, are members and have certain rights to vote and receive information, as well as to attend and speak at meetings. Each member has one vote, regardless of how much money they have invested or borrowed or how many accounts they may have. Each building society has a board of directors who direct the affairs of the society and who are responsible for setting its strategy. Building societies are different from banks, which are companies (normally listed on the stock market) and are therefore owned by, and run for, their shareholders. Societies have no external shareholders requiring dividends, and are not companies. This normally enables them to run on lower costs and offer cheaper mortgages and better rates of interest on savings than their competitors.


Chapter 12 provides more detail on the UK building society sector and shows that the number of these fell substantially during the 1990s as the largest converted from mutual to publicly listed companies and therefore became banks.
3.3.5 Credit unions

Credit unions are another type of mutual deposit institution that is growing in importance in some countries (especially in the United States and Ireland). These are non-profit institutions that are owned by their members. Member deposits are used to offer loans to the members. Many staff are part-time and they are usually regulated differently from banks. In the United States there were 9,058 as of March 2005 with 82 million members with deposits exceeding $520 billion and loans of over $355 billion.4

3.3.6 Finance houses

Finance companies provide finance to individuals (and also companies) by making consumer, commercial and other types of loans. They differ from banks because they typically do not take deposits and raise funds by issuing money market (such as commercial paper) and capital market instruments (stocks and bonds). In the United Kingdom these are sometimes referred to as hire purchase firms, although their main types of business are retail lending and (in Britain and continental Europe) leasing activity. All major retail firms and motor companies have their own finance house subsidiaries – for example General Motors’ finance house used to fund car purchase is known as GMAC Financial Services. A distinction is usually made between sales finance institutions (loans made by a retailer or car firm to fund purchases); personal credit institutions (that make loans to ‘non-prime’ or high-risk customers who usually cannot obtain bank credit) and business credit finance houses that use factoring (purchasing accounts receivables) and leasing to finance business activity.

The largest finance houses in Britain are subsidiaries of the major banks and they are significant operators in the unsecured consumer loan business. For instance, finance houses provided £68.4 billion of new finance to the consumer sector in 2004 and this represented nearly 30% of all unsecured lending in the United Kingdom. Around £18 billion of finance was related to car purchase and finance houses ‘financed at least 50 per cent of all new car registrations in the United Kingdom in 2004’.5

3.4 Private banking

So far we have discussed personal banking business outlining the various services on offer and the main types of financial institutions undertaking such activity. Another area of banking closely related to personal banking that has grown substantially over the last decade or so is known as private banking.

4 Also see Ferguson and McKillop (1997) for a comprehensive analysis of the credit union industry.
5 See the consumer finance section of the UK’s Finance and Leasing Association website at http://www.fla.org.uk for more details.
Private banking concerns the high-quality provision of a range of financial and related services to wealthy clients, principally individuals and their families. Typically, the services on offer combine retail banking products such as payment and account facilities plus a wide range of up-market investment-related services. Market segmentation and the offering of high quality service provision forms the essence of private banking and key components include:

- tailoring services to individual client requirements;
- anticipation of client needs;
- long-term relationship orientation;
- personal contact;
- discretion.

The market for private banking services has been targeted by many large banks because of the growing wealth of individuals and the relative profitability of private banking business. The CapGemini Merrill Lynch Wealth Report (2005) highlights various features of the market for high net worth individuals (HNWIs):

- 8.3 million people globally each hold at least US$1 million in financial assets;
- HNWIs’ wealth totalled US$30.8 trillion, an 8.2 per cent gain over 2003;
- Wealth generation was driven by fast-paced Gross Domestic Product (GDP) performance and moderate market capitalisation growth;
- HNWIs’ wealth and population growth in North America outpaced those in Europe for the first time since 2001;
- Singapore, South Africa, Hong Kong, and Australia witnessed the highest growth in HNWI numbers; and
- HNWIs’ financial wealth is expected to reach US$42.2 trillion by 2009, growing at an annual rate of 6.5 per cent.

An important feature of the private banking market relates to client segmentation. The bottom end of the market is referred to as the ‘mass affluent’ segment – typically individuals who have up to $100,000 of investable assets. The top end of the market are often referred to as ‘ultra HNWIs’ with over $50 million in investable assets and in-between lie HNWIs ($500,000 to $5 million) and very high HNWIs ($5 million to $50 million). The level of service and the range of products on offer increases with the wealth of the respective client.

Table 3.2 shows a listing of major private banks taken from a Euromoney (2005) ranking. It can be seen that major Swiss banks such as UBS and Credit Suisse are represented – this is not surprising as Switzerland is the global capital of offshore private banking business (where HNWIs have their investments managed by banks outside their home country). In addition, other large commercial banks have substantial private banking operations including HSBC, Deutsche Bank and Barclays.

The table also shows that the top US investment banks such as JPMorgan, Goldman Sachs and Merrill Lynch also rank highly in private banking as do some lesser-known Swiss banks (such as Pictet & Cie and Lombard Odier Darier Hentsch).

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Corporate banking relates to banking services provided to companies although typically the term refers to services provided to relatively large firms. For example, Barclays refers to its activities with firms as ‘business banking’ and distinguishes between three size categories – firms with turnover up to £1 million, £1 million to £10 million and greater than £10 million. Services offered to the latter, namely the largest firms, are referred to as corporate banking services. Note that this distinction is not clear-cut and some banks do not explicitly distinguish between ‘business banking’ and ‘corporate banking’ although one should be aware that the term ‘corporate banking’ is used mainly to refer to services provided to relatively large firms whereas business banking may relate to a wide range of activity ranging from financial services provided to small start-up firms as well as larger companies.

Banking services provided to small and medium-sized firms are in many respects similar to personal banking services and the range of financial products and services on offer increases and grows in complexity the larger the company. Below we highlight the main banking services used by different sizes of firms.

### 3.5 Corporate banking

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Banking services provided to small and medium-sized firms are in many respects similar to personal banking services and the range of financial products and services on offer increases and grows in complexity the larger the company. Below we highlight the main banking services used by different sizes of firms.

### 3.5.1 Banking services used by small firms

There are four main types of banking service on offer to small firms:

1. Payment services;
2. Debt finance;
3. Equity finance;
4. Special financing.

#### 3.5.1.1 Payment services

As noted earlier, banks play a pivotal role in the payments system. They provide clearing services to businesses and individuals making sure that current account transactions are processed smoothly; issue credit and debit cards that enable

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**Table 3.2 Best global private banks**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Bank</th>
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<tbody>
<tr>
<td>1</td>
<td>UBS</td>
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<tr>
<td>2</td>
<td>Citigroup Private Bank</td>
</tr>
<tr>
<td>3</td>
<td>Credit Suisse Private Banking</td>
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<tr>
<td>4</td>
<td>HSBC Private Bank</td>
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<tr>
<td>5</td>
<td>JPMorgan Private Bank</td>
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<tr>
<td>6</td>
<td>Goldman Sachs</td>
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<td>7</td>
<td>Pictet &amp; Cie</td>
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<tr>
<td>8</td>
<td>Deutsche Bank, Private Wealth Management</td>
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<tr>
<td>9</td>
<td>Merrill Lynch</td>
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<tr>
<td>10</td>
<td>ABN Amro Private Banking</td>
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<tr>
<td>11</td>
<td>Coutts &amp; Co</td>
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<tr>
<td>12</td>
<td>BNP Paribas Private Bank</td>
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<tr>
<td>13</td>
<td>MeesPierson</td>
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<tr>
<td>14</td>
<td>Rothschild</td>
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<tr>
<td>15</td>
<td>Morgan Stanley</td>
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<tr>
<td>16</td>
<td>Société Générale Private Banking</td>
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<td>17</td>
<td>ING Private Banking</td>
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<tr>
<td>18</td>
<td>Lombard Odier Darier Hentsch</td>
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<tr>
<td>19</td>
<td>Barclays</td>
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<td>20</td>
<td>Union Bancaire Privée</td>
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<td>21</td>
<td>Julius Baer</td>
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<td>22</td>
<td>Nordea</td>
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<tr>
<td>23</td>
<td>Royal Bank of Canada</td>
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<td>24</td>
<td>Carnegie</td>
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<td>24</td>
<td>LCF Edmond de Rothschild</td>
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</table>

customers to make payments and offer instant access to cash through their automated teller machines (ATMs) and branch networks. In many respects the payments services on offer to small firms are similar to retail customers’. The former are provided with business current accounts that give firms access to current accounts that provide a broad range of payment services. In the United Kingdom these include:

- Cash and cheque deposit facilities;
- Cheque writing facilities;
- Access to the CCCL (Cheque and Credit Clearing Company Limited) that deals with paper-based payments and processes the majority of cheques and paper-based credits;
- Access to BACS Limited (Banks Automated Clearing System), an automated clearing house responsible for clearing of electronic payments between bank accounts; processing direct debits, direct credits and standing orders;
- Access to CHAPS Clearing Company (Clearing House Automated Payments System) that provides electronic same day transfer of high-value payments. (Small firms, however, rarely use CHAPS as transaction costs are prohibitively expensive. In 1998 the average value of a CHAPS transaction was £2.3 million, compared to £552 for BACS and £636 for CCCL).

These are core payment services for which there are no substitutes. The supply of payment services to small firms is dominated by the main UK banks and these also control the wholesale networks for many transaction services.

One of the critical features of the payments system relates to small firm access to cash and the ability to make payments in cash and cheque form. Like retail customers, small firms use their business current accounts via the branch network to make cash and cheque payments into their current accounts. They also use the ATM network to obtain cash. In terms of the types of payments made by small firms in the United Kingdom, cheques and automated transactions such as direct debits and standing orders predominate. Cash and plastic card payments only account for around 5 per cent of the volume of business payments made in Britain.

### 3.5.1.2 Debt finance for small firms

The access to external finance is a critical success ingredient in the development of any business and to this extent small firms are no different from their larger counterparts. Traditional bank loan and overdraft finance are the main sources of external finance for small firms, although one should bear in mind that many small firms rely on internal funding to finance their operations. With regards to lending to small firms, features can obviously vary from country to country – in the United Kingdom, for instance the majority of bank lending is at variable rates of interest (as opposed to fixed rate lending) and in the case of term lending, typically has a maturity of more than five years.

The other main sources of external finance include:

- **Asset-based finance** – this includes both hire purchase and leasing. These two types of financial services are generally grouped together but they are two distinct types of product. Hire purchase agreements result in the purchaser of the goods building up ownership over a pre-determined period. On final payment the goods belong to the individual or firm making the payments. Leasing products are similar, but the legal ownership of the good remains with the lessor. For
example, a lease is an agreement where the owner (lessor) conveys to the user (lessee) the right to use equipment (e.g. vehicles) in return for a number of specified payments over an agreed period of time. Unlike a bank loan, a lease is an asset-based financing product with the equipment leased usually the only collateral for the transaction. Typically a firm will be offered a leasing agreement that covers not only the equipment costs but also the delivery, installation, servicing and insurance.

- **Factoring and invoice discounting** – factoring is the purchase by the factor and sale by the company of its book debts on a continuing basis, usually for immediate cash. The factor then manages the sales ledger and the collection of accounts under terms agreed by the seller. The factor may assume the credit risk for accounts (the likelihood that sales invoices will not be paid) within agreed limits (this is known as non-recourse factoring), or this risk may remain with the seller (factoring with recourse). (It is best to think of a factoring firm as a company’s debt collector. The factor takes on responsibility for recovering payments on sales made.) Invoice discounting is similar to factoring but here the sales accounting functions are retained by the seller.

- **Shareholders and partners** – these are individuals who provide their own personal finance to the firm and this confers ownership rights.

- **Trade credit** – credit given to firms by trading partners allowing the former to delay payment.

- **Venture capital** – long-term external equity provided by venture capital firms. The venture capitalist is an equity partner who places greater emphasis on the final capital gain (dependent on the market value of the company). According to the British Venture Capital Association (BVCA) (http://www.bvca.co.uk/) investments typically last for three to seven years. In addition to finance, the venture capital firm (or individual) will provide expertise, experience and contacts to help develop the business.

- **Other sources** – this category includes a broad variety of alternative finance sources that ranges from credit card borrowing, loans from private individuals conferring no ownership (e.g., a loan from a member of a family); various government grants for small business, and so on.

### 3.5.1.3 Equity finance for small firms

Most small firms rely on bank- and asset-based financing for their external financing and few access either public or private equity finance. Private equity finance can be distinguished according to two main types: formal and informal. Formal equity finance is available from various sources including banks, special investment schemes, and private equity and venture capital firms. The informal market refers to private financing by so-called ‘business angels’ – wealthy individuals who invest in small unquoted companies. According to the Bank of England the term private equity is increasingly being used in the United Kingdom instead of venture capital, where the latter typically refers to higher-risk start-up capital investments. It is estimated that under 5 per cent of small firm external finance is from some form of venture capital funding.

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All the main UK banks offer a range of equity products to small firms although there are differences in their willingness to undertake direct equity investments. For instance, HSBC has operated a network of HSBC Enterprise Funds mainly aimed at making investments in the £5,000 to £250,000 range. In addition, the same bank operates HSBC Ventures specialising in equity investments of between £250,000 and £1 million. All the other main banks offer some form of private equity investment services although these tend to be geared to larger firms or those in certain sectors – such as high-tech start-ups. It is interesting to note that the British Bankers Association (BBA)\(^8\) provides a section of its website dedicated to offering information on small firm financing. It also provides links to those wishing to know about equity investments to the British Venture Capital Association (BVCA)\(^9\) and the National Business Angel Network. The Business Angel Network is supported by Barclays, HSBC, Lloyds TSB and the Royal Bank of Scotland/NatWest along with the London Stock Exchange and the Corporation of London.

In addition to bank equity finance and that provided by business angels, Britain has the largest formal venture capital market in the world outside the United States. According to the European Venture Capital Association (EVCA)\(^10\) UK venture capital firms invested some €19 billion in 2004 – over half of all European venture capital funding.

However, one should not forget that there are a number of public equity markets that provide funding for small firms with strong growth potential. In the United Kingdom the main public equity market is the Official List of the London Stock Exchange. Smaller firms are categorised in the FTSE Small Cap (market capitalisation of £65 million to £400 million) or FTSE Fledgling (market capitalisation of less than £65 million) indices. There is also a small market index that combines the FTSE Fledgling, Small Cap and TechMark\(^11\) indices.

While access to the Official List is (in most cases) limited to medium-sized firms, fast-growth firms seeking a UK stock market listing are most likely to access the Alternative Investment Market (AIM). This is the second tier of the stock market and it has less onerous admission and trading requirements than the Official List.

Other sources of public equity finance in the UK include OFEX, an off-market trading facility provided by JP Jenkins Limited that has lower requirements than the AIM and provides seed capital to firms that may be contemplating an AIM or Official Listing in the future.

### 3.5.1.4 Special financing

In addition to all the above mentioned means of finance available to small firms, many countries have a range of government initiatives that seek to promote entrepreneurship and the development of the small firm sector. Britain is no exception, and there are a plethora of various initiatives aimed at promoting the development of the small firm sector.

Such recent schemes in the UK include initiatives geared to:

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\(^8\) See [http://www.bba.org.uk](http://www.bba.org.uk).

\(^9\) See [http://www.bvca.co.uk](http://www.bvca.co.uk).

\(^10\) See [http://www.evca.com](http://www.evca.com).

\(^11\) TechMark was launched in November 1999 as the London Stock Exchange's index for innovative technology companies.
Financing small businesses in economically deprived areas;
Financing technology-based small firms; and
Financing ethnic minority firms.

In addition to these the government also offers a wide range of fiscal advantages aimed at stimulating small firm growth, and especially start-ups.

3.5.2 Banking services for mid-market and large (multinational) corporate clients

The mid-market and multinational corporate sector is served by a variety of financial service firms including mainly commercial banks, investment banks and asset finance firms. These firms offer a broad range of services at varying levels of sophistication. The core banking products and services typically focus on the following range of needs:

1) Cash management and transaction services.
2) Credit and other debt financing facilities – loans, overdrafts, syndicated loans, commercial paper, bonds and other facilities.
3) Commitments and guarantees.
4) Foreign exchange and interest rate-related transactions.
5) Securities underwriting and fund management services.

At the bottom end of the middle-market sector companies generally require the services provided to the small firm sector but as they become larger they increasingly require a broader array of more sophisticated products.

3.5.2.1 Cash management and transaction services

An important area where larger company banking services differ from small firms is in the provision of cash management and transaction services. Cash management services have grown mainly as a result of: (a) corporate recognition that excess cash balances result in a significant opportunity cost due to lost or foregone interest, and (b) firms needing to know their cash or working capital position on a real-time basis. These services include:

- Controlled disbursement accounts. These current (or chequing) accounts are debited early each day so that firms get an up-to-date insight into their net cash positions.
- Account reconciliation services. A current account feature that provides a record of the firm’s cheques that have been paid by the bank.
- Wholesale lockbox facilities whereby a centralised collection service for corporate payments is used to reduce the delay in cheque payment and receipt (i.e., clearing).
- Funds concentration. Redirects funds from accounts in a large number of different banks or branches to a few centralised accounts at one bank.
- Electronic funds transfer. Includes overnight wholesale payments via a variety of different mechanisms depending on the country in which the bank is based. In Britain, overnight wholesale payments are made through CHAPS and automated payment of payrolls or dividends by automated clearing houses (such as BACS). In the United States overnight wholesale payments are made through Clearing House Interbank Payments System (CHIPS) and Fedwire, and automated payroll
payments through various automated clearing houses. International banks also conduct automated transmission of payments messages by the Society for Worldwide Interbank Financial Telecommunication (SWIFT), an international electronic message service owned and operated by US and European banks that instructs banks to make various wholesale payments.

- **Cheque deposit services.** Encoding, endorsing, microfilming and handling cheques for customers.
- **Electronic sending of letters of credit.** Allows corporate clients to access bank computers to initiate letters of credit.
- **Treasury management software.** Allows efficient management of multiple currency portfolios for trading and investment services.
- **Computerised pension fund services.**
- **Online corporate advisory and risk management services.**
- **Electronic data interchange (EDI).** An advanced application of electronic messaging that allows businesses to transfer and transact invoices, purchase orders, shipping notices and so on automatically, using banks as clearinghouses.

### 3.5.2.2 Credit and other debt financing

Large companies often have to decide whether they are going to raise funds in the domestic or foreign currency. For instance, they may raise finance in a foreign currency in order to offset a net receivable position in that foreign currency. For example, consider a UK company that has net receivables in Euro (€). If it requires short-term finance it can borrow Euro and convert them into pounds for which it needs funds. The net receivables in Euro will then be used to pay off the loan. In this particular example, foreign currency financing reduces the company's exposure to exchange rate fluctuations. This strategy, of course, is attractive if the interest rate of the foreign currency loan is low. The main point to emphasise is that both short- and longer-term borrowings, whether they relate to standard loan facilities or the issue of short- or longer-term debt instruments, can be denominated in either local or foreign currency.

#### Short-term financing

All companies have to raise short-term finance (for under one year) periodically and in most cases this is usually provided by banks. Typically, small firms will arrange extended overdraft facilities or negotiate term loans to meet short-term financing needs. In contrast larger firms can negotiate credit lines with a number of banks so they are not dependent on one sole supplier of funds. Bank credit, of one form or another, may be denominated in the domestic currency of the firm or in a foreign currency. Large firms can also raise short-term funds in the capital markets by issuing various types of short-term paper. The arrangement of bank credit lines, overdraft facilities and the issue of short-term funding instruments are the responsibilities of the Treasury function.

#### Commercial paper

Large firms have access to various markets for short-term finance through the issuance of tradable instruments. One method that has been increasingly used by large firms to raise short-term finance has been through the issue of commercial paper (CP). Dealers issue this paper without the backing of an underwriting syndicate, so a selling price is not guaranteed to the issuers. Maturities can be tailored to
the investor’s preferences. Dealers make a secondary market in commercial paper by offering to buy the paper before maturity. The US commercial paper market is the largest in the world and is the main way (outside bank credit) that large US firms raise short-term finance. Commercial paper issues denominated in currency outside the country of issue (such as a Yen or Eurocommercial paper issue made in London) are known as Eurocommercial paper. (Note that this is not to be confused with the new European currency – a Euro CP issue can be denominated in any currency as long as the issue of the paper is made outside of the country or area of issue of the currency.) Commercial paper issues are often preferred to bank credit especially when large firms have better credit ratings than banks and this means that the former can borrow on cheaper terms. As only a handful of international banks have the highest credit rating (for example, AAA given by Standard & Poor’s credit rating agency) this means that many large firms – such as General Motors and Coca-Cola – are perceived as being more creditworthy than the banks with which they do business. As such these firms can issue short-term financial instruments at finer terms than their relationship banks.

**Euronotes**

Euronotes are another type of instrument that large firms can issue to raise short-term funds. They are unsecured debt securities with interest rates based on interbank rates (mainly LIBOR – the London Inter Bank Offered Rate is the rate banks charge for lending wholesale funds to one another). These instruments typically have one-, three- or six-month maturities although they are often rolled-over as a form of medium-term financing. In the case of Euronotes, commercial banks usually underwrite the issue of these instruments guaranteeing an issue price. Banks and other companies purchase these as part of their investment portfolios.

**Repurchase agreements (repos)**

In addition to the aforementioned types of short-term financing there are numerous other types of financing techniques that companies can use to raise short-term finance. Recently, many large firms have developed their repo (repurchase agreement) activities. A repo deal involves pledging collateral (usually government bonds or some low-risk instrument) in return for short-term wholesale funds. At a set date, the funds will be repaid and the collateral ‘released’. There are various types of repurchase agreements that involve varying agreements concerning the sale and buy-back of wholesale funds backed by various types of collateral agreements. A main attraction of this type of business is that it allows companies to raise short-term funds at wholesale rates by pledging longer-term financial assets. (It is a technique widely used by banks to facilitate liquidity in the money market.)

**Long-term financing**

Companies also have to raise long-term finance (for over one year) in order to finance long-term investments. Large companies have access to a broad array of credit facilities including overdraft and both secured and unsecured lending facilities. For large lending requirements companies can borrow via the syndicated lending market. In addition, the largest companies can also issue bonds \(^{12}\) – either domestic or Eurobonds.

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\(^{12}\) For a brief introduction to the bond market, see Appendix A1.
Syndicated lending

Syndicated loans are a special category of loans in which an arranger, or group of arrangers, forms a group of creditors on the basis of a mandate to finance the company (or government) borrower. The main corporate borrowers in the syndicated loan market tend to be the largest multinational firms. Large firms typically chose this type of loan primarily because the required loan size is too great to be obtained from one bank (see also Section 4.6.1.3).

Eurobonds

Eurobonds are defined as securities that are issued, and largely sold, outside the domestic market of the currency in which they are denominated. Eurobonds are similar in many respects to domestic corporate bonds consisting of largely fixed-rate, floating-rate and equity-related debt (convertibles) with maturities usually around 10–15 years. Unlike domestic corporate bonds (that are denominated in the home currency and issued in the home market), the Eurobond market is subject to lower regulation and is instead effectively self-regulated by the Association of International Bond Dealers. The ‘Euro’ prefix in the term Eurobond simply indicates that the bonds are sold outside the countries in whose currencies they are denominated.

Eurobonds are issued by multinational firms, large domestic companies, sovereign governments, state firms and other international institutions.

3.5.2.3 Commitments and guarantees

Commitments relate to services where a bank commits to provide funds to a company at a later date for which it receives a fee. Such services include unused overdraft facilities and the provision of credit lines. Banks also provide facilities that enable companies to raise funds by issuing marketable short-term instruments such as commercial paper, Euronotes and (for longer maturities) medium-term notes. In the United States many large companies issue commercial paper to raise short-term funds and these facilities are almost always backed-up by a line of credit from a bank. In other words, the bank has a commitment to provide credit in case the issuance of commercial paper is not successful.

Guarantees relate to where a bank has underwritten the obligations of a third party and currently stands behind the risk of the transaction. Default by a counterparty on whose behalf a guarantee has been written may cause an immediate loss to the bank. Examples include such things as a standby letter of credit. This is an obligation on behalf of the bank to provide credit if needed under certain legally pre-arranged circumstances. Commercial letters of credit are widely used in financing international trade. This is a letter of credit guaranteeing payment by a bank in favour of an exporter against presentation of shipping and other trade documents. In other words it is a guarantee from the importers’ bank ensuring that payment for the goods can be made.

3.5.2.4 Foreign exchange and interest rate services offered to large firms

Banks can offer their corporate clients a variety of tools to manage their foreign exchange and interest rate risk. These instruments, broadly referred to as derivatives (also see Chapter 9), involve transactions such as:
- **Forward foreign exchange transactions** – which are contracts to pay and receive specified amounts of one currency for another at a future date at a pre-determined exchange rate. Default by one party before maturity exposes the other to an exchange risk.
- **Currency futures** – these are contracts traded on exchanges for the delivery of a standardised amount of foreign currency at some future date. The price for the contract is agreed on the purchase or selling date. As with forward contracts, gains or losses are incurred as a result of subsequent currency fluctuations.
- **Currency options** – these allow the holder of the contract to exchange (or equally to choose not to exchange) a specific amount of one currency for another at a predetermined rate during some period in the future. For a company buying an option the risk lies in the ability of the counterparty not to default on the agreement (credit risk). For the bank writing the option the risk lies in its exposure to movements in the exchange rate between the two currencies (a market risk).
- **Interest rate options** – these are similar to currency options. The buyer has the right (but not the obligation) to lock into a pre-determined interest rate during some period in the future. The writer of the option (typically a bank) is exposed to interest rate movements, the buyer to counterparty default.
- **Interest rate caps and collars** – a bank (or other lender) guarantees the maximum rate (cap) or maximum and minimum rate (collar) on variable rate loans.
- **Interest rate and currency swaps** – in a currency swap two parties contract to exchange cash flows (of equal net present value) of specific assets or liabilities that are expressed in different currencies. In the so-called ‘plain vanilla’ interest rate swap two parties contract to exchange interest service payments (and sometimes principal service payments) on the same amount of indebtedness of the same maturity and with the same payment dates. One party provides fixed interest rate payments in return for variable rate payments from the other, and vice versa.

Note that many companies engage in risk management with the use of such financial instruments provided via their banks. Companies can also go direct to the market to hedge various interest rate and exchange rate positions. Companies engaged in substantial international trade have greater need to hedge their foreign currency positions and therefore make wider use of currency-related options, futures and forward transactions.

### 3.5.2.5 Securities underwriting and fund management services

As companies become larger they increasingly seek funding direct from the capital market and as such they require banks to arrange and underwrite equity and bond issues. **Securities underwriting** had traditionally been the preserve of investment banks (or so-called merchant banks in the United Kingdom) but during the 1990s universal banking became the ‘norm’ and now nearly all large commercial banks have an investment banking operation that underwrites issues.

In the case of securities underwriting, the underwriter undertakes to take up the whole or a pre-agreed part of a capital market issue (equity or bonds) at a pre-determined price. The main risk is that the underwriter will be unable to place the paper at the issue price.

Banks also can provide their corporate clients with **asset management** services, not only to manage a company’s own investments but also to manage the pension funds of the firm’s employees. The main investment banks are leaders in
institutional fund management – this refers to the management of pension, insurance, corporate and other large-scale investments.

A major attraction for banks to provide services like commitments, guarantees, foreign exchange and interest rate-related transactions, securities underwriting and fund management services are that they are all fee-based and off-balance sheet (see Chapter 9). All the services listed above earn banks commissions and fees. In addition, they do not relate to any asset (e.g., a loan or investment) that has to be booked on the bank’s balance sheet – hence the term ‘off-balance sheet’.

As the above suggests, the range of products and services offered has grown rapidly over the last twenty years or so, as indicated in Figure 3.2. This increase in products can partially be explained by the growing overlap of commercial and investment banking services on offer to medium-sized and larger companies.

**Figure 3.2 Large corporate banking product set**

![Chart showing product set]

*Source: Authors’ estimates.*

### 3.6 Investment banking

The previous sections provide an overview of the main banking services offered to companies – some of which are similar to those provided to retail customers but on a larger scale. However, we have also briefly discussed a range of services – such as securities underwriting (including the issue of commercial paper, Eurobonds and other securities) that may be less familiar. These activities have traditionally been undertaken by investment banks (or the investment bank subsidiaries of commercial banks) and relate generally to large-scale or wholesale financing activities. Investment banks mainly deal with companies and other large institutions and they typically do not deal with retail customers – apart from the provision of upmarket private banking services as noted earlier.

While we have already briefly outlined various investment banking products and services available to the corporate sector it is best at this stage to explain the main features of investment banking activity to show how it differs from commercial banking.
The main role of investment banks is to help companies and governments raise funds in the capital market either through the issue of stock (otherwise referred to as equity or shares) or debt (bonds). Their main business relates to issuing new debt and equity that they arrange on behalf of clients as well as providing corporate advisory services on mergers and acquisitions (M&As) and other types of corporate restructuring. Typically, their activities cover the following areas:

- financial advisory (M&A advice);
- underwriting of securities issues (guaranteeing a price that the new equity or bond issue will sell for);
- trading and investing in securities on behalf of the bank or for clients. This activity can include trading and investments in a wide range of financial instruments including bonds, equities and derivatives products;
- Asset management – managing wholesale investments (such as pension funds for corporate clients) as well as providing investment advisory services to wealthy individuals (private banking) and institutions;
- Other securities services – brokerage, financing services and securities lending.

Note that sometimes financial advisory and underwriting is referred to as investment banking to distinguish this from trading and other securities-related business. It is also important to remember that investment banks do not hold retail deposits and their liabilities are mainly securities and short-term wholesale financing. Table 3.3 lists the top global investment banks based on fee earnings for 2004. US investment banks predominate although one should be aware that traditionally the main US investment banks (who tended to dominate global investment banking) were the so-called ‘bulge bracket’ firms including – Goldman Sachs, Merrill Lynch, Morgan Stanley. Because legislation (Glass-Steagall Act of 1933) prohibited commercial banks from doing investment banking business the market was dominated by the specialist investment banks. However, since 1999 and the abandonment of Glass-Steagall, US commercial banks have acquired investment banks (Citigroup now includes the investment bank Salomon Brothers and the brokerage firm Smith Barney; and the commercial bank Chase is now linked up to JP Morgan). This means that banks such as Citigroup and JP Morgan Chase offer both commercial and investment banking services. As explained earlier, intermediaries that undertake a wide range of financial services business (such as commercial and investment banking, insurance, pensions, and so on) are referred to as universal banks. Universal

Table 3.3 Bloomberg 20 top investment banks by fees (2004)

<table>
<thead>
<tr>
<th>Company</th>
<th>Total fees ($ billion)</th>
<th>Company</th>
<th>Total fees ($ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citigroup (US)</td>
<td>3.70</td>
<td>ABN Amro Bank (Netherlands)</td>
<td>0.90</td>
</tr>
<tr>
<td>Goldman Sachs (US)</td>
<td>3.60</td>
<td>Nomura Securities (Japan)</td>
<td>0.70</td>
</tr>
<tr>
<td>Morgan Stanley (US)</td>
<td>3.30</td>
<td>RBC Capital Markets (Canada)</td>
<td>0.70</td>
</tr>
<tr>
<td>JP Morgan Chase (US)</td>
<td>3.00</td>
<td>HSBC (UK)</td>
<td>0.70</td>
</tr>
<tr>
<td>Merrill Lynch (US)</td>
<td>2.70</td>
<td>Rothschild (UK)</td>
<td>0.60</td>
</tr>
<tr>
<td>UBS (Switzerland)</td>
<td>2.40</td>
<td>Daiwa Securities (Japan)</td>
<td>0.60</td>
</tr>
<tr>
<td>Credit Suisse (Switzerland)</td>
<td>2.10</td>
<td>Lazard (UK/US)</td>
<td>0.50</td>
</tr>
<tr>
<td>Deutsche Bank (Germany)</td>
<td>1.80</td>
<td>Wachovia (US)</td>
<td>0.50</td>
</tr>
<tr>
<td>Lehman Brothers (US)</td>
<td>1.60</td>
<td>Bear Stearns (US)</td>
<td>0.40</td>
</tr>
<tr>
<td>Bank of America (US)</td>
<td>1.00</td>
<td>BNP Paribas (France)</td>
<td>0.40</td>
</tr>
</tbody>
</table>

banking is common practice in Europe and one can also see from Table 3.3 that a variety of European commercial banks do substantial investment banking business. The main difference between commercial banking and investment banking is that the former refers to deposit and lending business while the latter relates to securities underwriting and other security-related business. Banks such as HSBC or Deutsche Bank are referred to as commercial banks because their main business is deposit- and lending-related – although they both have substantial investment banking operations. Goldman Sachs and Morgan Stanley are known as investment banks because securities-related activity constitutes the bulk of their banking operations even though they also take wholesale deposits and lend.

In terms of services offered to large companies, commercial banks typically provide cash management, payments and credit facilities whereas investment banks arrange other types of financing through the issue of equity and debt to finance company expansion. They also offer an extensive array of other securities-related services including risk management products (such as interest rate and foreign exchange derivatives) and also advice on company M&A activity as well as other company restructuring. In recent years, however, these distinctions have become blurred as large commercial banks have either acquired or expanded their investment banking services to meet the increasing demands of corporate clients. Also the growth in global stock market activity has encouraged many commercial banks to develop asset management and private banking operations to deal with the growing demand for securities-related services from both institutional investors and wealthy private clients.

### 3.7 Universal versus specialist banking

As commercial banks increasingly undertake investment banking (as well as insurance and other financial activity) this has led to a debate as to the benefits of universal compared to specialist banking. The major activity of many financial institutions is the provision of financial intermediation services, i.e., the channeling of funds between lenders and borrowers, and the creation of new financial assets and liabilities in the process. However, it should be recognised that financial institutions may provide a wide range of other services including:

- trading in financial assets on behalf of their customers, i.e., acting as brokers or agents for clients;
- trading in financial assets for their own accounts, i.e., acting as proprietary dealers;
- helping to create financial assets for their customers and then selling these assets to others in the market, for example underwriting and issuing new shares;
- providing investment advice to personal customers or business advice to firms on mergers and takeovers;
- fund management, for example managing the whole or part of a pension fund; and
- insurance services.

In fact, the largest financial institutions nowadays offer a plethora of products and services incorporating all the finance types undertaken by different sorts of financial institutions. This is a reflection of the universal banking trend where large financial firms benefit (or at least attempt to benefit) from scale, scope and other
economies associated with the production and distribution of a wide range of products and services. In other words, large banks have transformed themselves into full service financial firms offering a complete spectrum of personal and corporate banking services. The aim is to cross-sell many different products and services to customers through the product lifecycle.

For the personal banking customer, the typical product lifecycle is:

- Juniors (under 18 years of age) – offer basic deposit and payment services.
- Young adults (around 18 to say 25 years of age) – offer payment and limited credit facilities including student loans, travel insurance, property insurance, credit and debit card facilities.
- Adult/Young families (no children) – extend unsecured credit facilities, offer mortgages for house purchases, cross-sell house and related insurance, car insurance, encourage savings by offering savings and investment products to cover possible future costs associated with having a family;
- Young families with children – offer a wider range of mortgage options and credit facilities, sell protection products such as life insurance, critical illness insurance (e.g., ‘what would happen if one of you became ill or died – how would your children be supported?, etc.). Cross-sell savings and investment products (e.g. ‘how will you fund your child’s education? etc).
- Middle-aged families (children left home) – sell pensions, savings and investment products (e.g., ‘what will you live off when you retire?’), and so on

It can be seen that the financial requirements of personal banking customers span an extensive array of banking-, securities-, pensions- and insurance-related areas. The aim of banks is to cross-sell such an array of products and services to meet customer needs and also to generate more fee and commission income. A similar example for the product cycle of companies would show a reliance on commercial banking credit and payment facilities while the firm is small and as it grows a broader array of corporate and investment banking services would be demanded.

Given these aspects of the financial services industry it is hardly surprising that there has been a trend towards the creation of large financial services conglomerates and the acceptance of universal banking practice in many countries.

3.8 Islamic banking

So far this chapter has focused entirely on Western-based or conventional interest-based banking business. However, it would remiss of us not to mention the relatively recent development of Islamic banking business that is occurring in various parts of the world and is based on non-interest principles. Islamic Shariah law prohibits the payment of riba or interest but does encourage entrepreneurial activity. As such, banks that wish to offer Islamic banking services have to develop products and services that do not charge or pay interest. Their solution is to offer various profit-sharing-related products whereby depositors share in the risk of the bank’s lending. Depositors earn a return (instead of interest) and borrowers repay loans based on the profits generated from the project on which the loan is lent.
An example of a commonly used profit-sharing arrangement in Islamic banking is known as *Musharakah*, which is an arrangement where a bank and a borrower establish a joint commercial enterprise and all contribute capital as well as labour and management as a general rule. The profit of the enterprise is shared among the partners in agreed proportions while the loss will have to be shared in strict proportion of capital contributions. The basic rules governing the *Musharakah* contract include:

- The profit of the enterprise can be distributed in any proportion by mutual consent. However, it is not permissible to fix a lump sum profit for anyone.
- In case of loss, it has to be shared strictly in proportion to the capital contributions.
- As a general rule all partners contribute both capital and management. However, it is possible for any partner to be exempted from contributing labour/management. In that case, the share of profit of the sleeping partner has to be a strict proportion of his capital contribution.
- The liability of all the partners is unlimited.

There are a wide variety of Islamic banking products and services based on various profit sharing and other forms of arrangements that enable financial intermediation without the use of interest. Globally there are around 100 Islamic banks and financial institutions working in the private sector, excluding those in the three countries, namely, Pakistan, Iran and Sudan, which have declared their intention to convert their entire banking sector to Islamic banking. The geographical distribution of these Islamic banks is given in Table 3.4, which shows that the largest number of Islamic banks is in the Gulf Cooperation Council (GCC) countries followed by other Middle Eastern countries.

In addition to the development of Islamic banking practices in parts of the world where the Islamic faith is an integral feature of the socio-economic make-up of the population, there has also been a growing interest from Western banks in developing such services for their customers. HSBC, for instance, was the first to offer an Islamic mortgage to its UK customers and Lloyds TSB has followed suit by introducing a similar product in March 2005, details of which are summarised in Box 3.1.

### Table 3.4  Islamic banks by regions (2002)

<table>
<thead>
<tr>
<th>Region</th>
<th>Number of institutions</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>South and South East Asia</td>
<td>18</td>
<td>18.56</td>
</tr>
<tr>
<td>GCC</td>
<td>42</td>
<td>43.30</td>
</tr>
<tr>
<td>Other Middle Eastern countries</td>
<td>14</td>
<td>14.43</td>
</tr>
<tr>
<td>Africa</td>
<td>9</td>
<td>9.28</td>
</tr>
<tr>
<td>Rest of the world</td>
<td>14</td>
<td>14.43</td>
</tr>
<tr>
<td>Total</td>
<td>97</td>
<td>100</td>
</tr>
</tbody>
</table>

*Note: GCC = Gulf Co-operation Council countries (Saudi Arabia, Bahrain, Kuwait, Oman, Qatar, and the United Arab Emirates)*

This chapter outlines the main types of banking business undertaken globally. The main focus has been on commercial and investment banking activities although the last part of the chapter briefly highlighted some features of non-interest Islamic banking practices. A major feature of banking business has been the blurring distinction between different types of banking business and the emergence of full financial service conglomerates that offer an extensive array of retail, corporate and investment banking products. Many banks also offer insurance, pensions and other non-banking financial services. Even traditional Western banks nowadays offer various Islamic banking products and services to meet the needs of their customers.

This change in the features of banking business simply reflects the desire of banks to meet the ever increasing and divergent needs of their customers – both personal and corporate. It also reflects the trend to diversify earnings supplementing traditional commercial banking interest income with fee- and commission-based

### Box 3.1 Lloyds TSB’s Islamic mortgage product

On 21 March 2005 Lloyds TSB launched its debut Shariah-compliant Islamic home finance scheme at five branches in London, Luton and Birmingham, all cities with large Muslim populations.

Lloyds TSB, one of the top three banking groups in the UK, instead of developing its own standalone Islamic mortgage product, is utilising and co-branding a product off-the-shelf, the Alburaq Home Financing Scheme which is based on the pioneering diminishing Musharakah contract (a declining equity participation scheme between buyer and lender), which was pioneered last year by ABC International Bank and Bristol & West, a subsidiary of the Bank of Ireland Group in London. The Lloyds TSB scheme will be initially test-marketed by selected branches of the High Street bank. The added value which Lloyds TSB brings, stresses a spokesman, is our bespoke service elements. We only offer Islamic home finance from a single provider. According to Sheikh Nizam Yaquby, ‘the diminishing Musharaka offers the most viable solution for housing finance. This particular contract has been successfully implemented by mortgage providers in the US, the UK and Pakistan.’

Under this mode, the financial institution and client jointly purchase the house. The ownership of the house is split between the bank and the customer; and it is agreed that the customer will purchase the share of the bank in the house gradually, thus increasing his own share until all the share of the bank is purchased by him thus making him the sole owner of the asset after a specified period. But during the financing period, the bank’s share is leased to the customer who pays rent for using the bank’s share in the asset. The Alburaq home financing scheme, which typically has a tenor of up to 25 years, offers two payment options to the customer. In the first option, the rent is fixed for an initial period of six months, and is then reviewed every six months. In the second option, the rent is fixed for two years, and is then reviewed every six months.


### 3.9 Conclusions

This chapter outlines the main types of banking business undertaken globally. The main focus has been on commercial and investment banking activities although the last part of the chapter briefly highlighted some features of non-interest Islamic banking practices. A major feature of banking business has been the blurring distinction between different types of banking business and the emergence of full financial service conglomerates that offer an extensive array of retail, corporate and investment banking products. Many banks also offer insurance, pensions and other non-banking financial services. Even traditional Western banks nowadays offer various Islamic banking products and services to meet the needs of their customers.

This change in the features of banking business simply reflects the desire of banks to meet the ever increasing and divergent needs of their customers – both personal and corporate. It also reflects the trend to diversify earnings supplementing traditional commercial banking interest income with fee- and commission-based
revenues from other sources. The ultimate aim is to offer clients a spectrum of products and services that strengthen customer relationships and provide services that clients value.

Key terms

Universal banking  Invoice discounting
Traditional banking  Venture capital
Modern banking  Private equity finance
Bancassurance  Commercial paper
Retail or personal banking  Euronotes
Commercial banks  Repos
Savings banks  Syndicated loans
Co-operative banks  Eurobonds
Building societies  Commitments and guarantees
Credit unions  Risk management
Finance houses  Securities underwriting
Private banking  Asset management
Corporate banking  Investment banking
Leasing  Specialist banking
Hire purchase  Islamic banking
Factoring

Key reading


Revision questions and problems

1. In what ways does traditional banking differ from modern banking?
2. What is bancassurance?
3. Explain the main characteristics of the different types of banks that offer personal (retail) banking services.
4. What are the primary features of private banking?
5. What are the main features of corporate banking?
6. What are venture capitalists? To what extent are they similar to private equity finance?
7. What are the typical services offered by banks to the large (multinational) corporate sector? Distinguish between short- and long-term financing.
8. What services do investment banks typically offer to customers?
9. What are the benefits of universal banking compared to specialist banking?
10. What distinguishes Islamic banking from Western banking?