

INVESTMENT BANKING AND COMMERCIAL BANKING

INVESTMENT BANKING AND PRIVATE BANKING IN CONNECTION WITH ACTIVITIES OF CERTAIN NON-BANKING ENTITIES • INVESTMENT AND COMMERCIAL BANKING, MODELS FOR THEIR SET-UP • SITUATION IN THE EU AND IN SLOVAKIA

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Certain business corporations in Slovakia, to whom a banking license has not been granted, offer services of investment banking and private banking. We therefore deem it necessary to define the relationship of both of the mentioned categories to the currently applicable Banking Act and other relevant laws. In this context, it is also desirable to clarify the relationship between investment banking and commercial banking.

Investment Banking

Investment banking (hereinafter the "IB") is an economics category, but a completely unequivocal definition of its nature is not simple even for any theory of economics. Investment banking is not a legal term and as such this concept is neither defined nor used in applicable laws or other statutory regulations. It was coined in response to the specific activity of investment conducted by banks notably in the securities markets. This was as a result of a prevailing focus on performance of investment activities and a specific group of investment banks were profiled within the banking systems of certain countries. Nevertheless, investment activities were also carried out by other specialised institutions, apart from banks, whereas the term of investment banking came to be generally used to refer to this type of service, regardless of the type of licensed entities providing them.

Several definitions of investment banking are in use in the theory of economics.

For example, Petr Musílek¹ quotes that according to R. Kuhn² the following four definitions of IB are possible, starting from the broadest to the narrowest one:

1. All the activities of major Wall Street firms - from international issuing operations to retail business, including real estate business and trading in insurance products.
2. All the activities in capital markets, i.e. issuing operations,

corporate finance, mergers & acquisitions, assets management, financing using venture capital, merchant banking and securities transactions for institutional investors. This concept of IB does not include e.g. retail securities transactions and trading in insurance products.

3. Selected capital market operations with emphasis on issuing operations, mergers & acquisitions and merchant banking.

4. The narrowest definition is historically rooted, where once in the past issuing operations and brokerage or dealer trading in secondary markets were deemed to constitute IB.

P. Musílek defines investment banking as transactions in securities, financial derivatives and other instruments of private financial markets. In his understanding, IB comprises: issuing operations, own and intermediary trading in investment instruments, custody, assets management and mergers & acquisitions. Investment banking primarily encompasses intermediary trade for the clients' account, with the main source of profits being brokerage commission, and/or a difference between the bid and asked prices (unlike commercial banking with prevailing trading for one's own account and at one's own risk and the main source of profits consisting of an interest margin between lending and deposit-taking business bearing interest).

Under the Slovak legislation currently in place, investment banking actually is a set of activities regulated under the term of investment services by Act No. 566/2001 Z.z. on Securities and Investment Services and the Amendment of Certain Laws, as amended (hereinafter the "Securities Act"). The conduct of such activities is preconditioned by a license for the provisi-

¹ Musílek, P.: Finanční trhy & investiční bankovníctví (Financial Markets & Investment Banking), Prague, ETC Publishing, s.r.o. 1999.

² Kuhn, R.: Investment Banking. New York, Harper and Row, 1990.



on of investment services from the Financial Market Authority, which authorises the establishment of a securities dealer or a branch of a foreign securities dealer within the territory of the SR (§ 54 of the Securities Act).

Pursuant to § 6 of the Securities Act, investment services (both principal and auxiliary ones) shall be provided to clients in handling investment instruments under the conditions set forth thereunder.

Investment instruments comprise: shares, bonds, equity certificates, the so-called substitutable securities with the attached right to acquire shares and bonds, or giving rise to the right to settlement in certain instruments of payment, securities issued beyond the Slovak territory, to which similar rights are attached as to the previously mentioned securities, money market instruments denominated in both the Slovak and foreign currencies, futures contracts also allowing for the financial settlement of obligations arising thereunder, and related to investment instruments, interest rates, instruments of payment in both the Slovak and foreign currencies or financial market indices, options for the purchase or sale of underlying investment instruments and instruments equivalent to them also allowing for the financial settlement (options relating to the Slovak and foreign currency funds, i.e. currency options, and interest rate options), interest rate, currency and equity swaps.

The principal investment services include:

- the acceptance of the client's order for the acquisition, selling, or another kind of handling of investment instruments and the subsequent transfer of the client's order with a view to its execution;
- the acceptance of the client's order for the acquisition or selling of an investment instrument and its execution for an account other than the service provider's account;
- the acceptance of the client's order for the acquisition or selling of an investment instrument and its execution for one's own account;
- the management of a portfolio formed of one or several investment instruments as mandated by the client under a contract on the securities portfolio management separated from the portfolios of other clients;
- arranging the sale of investment instruments for the issuer when they are issued (i.e. flotation);
- the acquisition of investment instruments from their issuer when they are issued with a view to their selling, including an obligation to buy from the issuer not placed investment instruments (i.e. underwriting).

Auxiliary investment services include:

- custody or management of one or several investment instruments;
- making loans or advances to the client with a view

to the execution of the client's order to acquire or sell an investment instrument, providing that the lender is a party to this deal and the conditions as per the Banking Act have been met;

- giving advice on business strategy and consulting and services concerning the company amalgamation, merger, changeover or division or the purchase of an enterprise;
- taking care of the issuance of securities for issuers and services associated with the underwriting, placement, the payment of earned income and redemption of investment instruments;
- advisory services relating to investment in investment instruments;
- receiving payments from the client and trading in foreign exchange assets in accordance with the Foreign Exchange Act in the scope needed for the provision of major investment services;
- conducting similar activities as in the case of principal investment instruments provided securities and derivatives are involved that are not investment instruments.

From the above mentioned one can infer that investment services are not those activities that may only be performed on the basis of a banking license, i.e. money deposit taking (associated with the provision of interest or other considerations constituting a tax expense) and making loans and advances (based on repayable monies obtained from other persons). On the other hand, the Act No. 483/2001 Z.z. on Banks and the Amendment of Certain Laws, as amended (hereinafter the "Banking Act") allows banks and branches of foreign banks (hereinafter the "bank") to carry out certain investment activities subject to an authorisation to be obtained from the Financial Market Authority pursuant to the Securities Act in the capacity of securities dealers, provided that subsequently those activities are also stated in the banking license. However, even in the Banking Act the concept of "investment banking" is not employed, but the term "investment operations" is used instead.

The comparison between the content of investment banking and the currently applicable legislation clearly indicates that IB does not comprise those (typically) banking activities that may only be performed on the basis of a banking license. Activities expressed by this term are in fact activities governed by the Securities Act under the name of investment services and that may be performed solely on the basis of an authorisation granted by the Financial Market Authority. Although the expression of "investment banking" has already established itself, its use in advertising offers of entities that are not banks cannot be considered as appropriate or right for the following reasons:



- concerned is the provision of investment services, and not banking services or operations;
- the word "banking" invokes an idea that the advertised activities are offered by an entity with a banking license granted to it, which in reality is not the case;
- investment banking falls within the line of business of separate specialised banks, and when it comes to universal or commercial banks, this type of business (activities) there is separated, in terms of organisation, accounting and information flows, from typically banking operations.

The publication of offers of investment banking services by entities to whom a banking license has not been granted is therefore misleading, especially if such advertisements do not contain a closer specification of activities on the offer or at least a word of caution that in fact they are activities as per the Securities Act and not activities (operations) as per the Banking Act.

Private banking

Private banking (hereinafter the "PB") also is an economics and banking category used in connection with the conduct of banking activities with a historical background to it. That is to say that it is not a legal category, since the concept of "private banking" has not been defined in the Slovak system of law or used in laws or other statutory provisions.

Private banking stands for the provision of banking services notably to the most lucrative group of clients, i.e. individuals or families whose net equity has reached a certain required value.³ It is more about lending and less about deposit-taking in comparison to commercial banking, also encompassing the management of investments or investment funds of the said group of clients. It may be performed by a separate bank or a designated subdivision within a bank. In PB, banking operations account for a significant part of services provided to the given clientele compared to the volume of investment operations rendered (unlike investment banking).

By virtue of our applicable legislation, private banking first and foremost represents the conduct of those activities that in the SR may only be performed on the basis of a banking license granted under the Banking Act (making loans and taking of deposits). The notion of PB denotes to a decisive extent banking activities, whilst also encompassing certain investment services,

i.e. activities that may only be carried out based on an authorisation granted pursuant to the Securities Act (see the text hereinbefore).

Offering private banking services in advertisement campaigns of entities that are not banks may therefore be considered as inappropriate, even as verging on admissibility, namely on the following grounds:

- private banking in the first place signifies the provision of typical banking services, i.e. the performance of operations requiring a banking license, even though, to a lesser degree, it concurrently also includes the provision of investment services; from which it can be further inferred that:

- such package of services may always be provided only by an entity to whom a banking license has been granted, i.e. a bank;

- in global terms, self-contained banks targeted at the most moneyed kind of clientele are engaged in private banking, and, as for a major part of other banks, the conduct of private banking business is covered by specialised organisational subdivisions and employees.

The publication of any offers to provide the service of private banking by entities not holding a banking license is therefore a possible deception, since such entities are not authorised to perform activities requiring a banking license.

In conclusion to this section we can briefly note that the use of labels "investment banking" and particularly "private banking" in offered services produced as part of any advertising by entities missing a banking license not only has a misleading effect, but is even a deception (§ 2(2) of Act No. 147/2001 Z.z. on Advertisement and the Amendment of Certain Laws and § 45 of the Commercial Code). Should one of such entities actually conduct private banking, unauthorised business would be involved at the end of the day.

Non-banking (licensed) entities should offer investment services instead of investment banking and they should not employ the notion of private banking in their services offered at all.

Institutional Arrangement of Investment Banking and Commercial Banking

When it comes to the institutional set-up of intermediaries of investment business executing operations in the markets for securities and financial derivatives and intermediaries of a typical banking business, a distinction between several models for arrangement of investment banking and commercial banking can be made. These models, which result from economic, historical, legislative and regulatory as well as political factors, are as follows: a model of universal banking,

³ For example, according to Michael Atz (Emerging Issues Series, Federal Reserve Bank of Chicago, 1999), in the U.S.A. this would mean persons or families with an income of at least USD 100 000 or the net equity of above USD 500 000. Certain private banks demand assets suitable for investment in the amount of at least USD 1 million.



a model of separate banking, a model of a holding company and a model of a subsidiary.⁴

A universal banking model is represented by a banking system in which universal banks concurrently pursue both commercial banking (in the banking intermediary market) and investment banking (operating as an investment firm in the securities market). Their universal nature is due to the fact that the banks take deposits, make loans, trade in securities for their own account, provide for issuing operations, manage their clients' assets and execute payments. In addition to universal banks, operators in the securities market also include independent investment firms. Commercial banking is usually interconnected with investment banking in accounting terms and there is a free flow of information between the two organisational subdivisions of banks. This model is a prevailing model for banking in the continental Europe, also having been accepted by Member States of the European Union. The universal model is in principle embodied by a principle of a uniform banking license covering both of these basic lines of business.

A separate banking model is marked by a distinct division of commercial and investment banking. Deposit and lending business is pursued and payments are executed by commercial banks, whilst investment operations are performed by investment banks and likewise by other specialised entities. The separate banking model was formed because of market reasons (a market model) or as a result of regulation (a regulatory model).

In the past, a typical example of a separate banking model was represented by British banking. In the 70's during the 20th century, a gradual transition to a universal banking model or a subsidiary model started in British banking.

A regulatory model of separate banking is characteristic of the U.S.A and Japan. As for the U.S.A., commercial banking was separated from investment banking pursuant to the Glass-Steagall Act of 1933, which was adopted following to a wave of bank bankruptcies in 1929 to 1933. It strived to stifle a conflict of interest resulting from a united commercial and investment banking and create a less risky banking system. Nevertheless, the borderline between commercial and investment banking started to be disrupted in the 80's of the past century. Regulators (the Office of the Comptroller of the Currency, OCC and the Federal Reserve System, FRS) permitted commercial banks and bank holdings to conduct, to a limited extent, activities relating to securities (operations in securities, mortgage bonds, financial consultancy and brokera-

ge), and bank holdings to hold investment firms as subsidiaries. Since then bank lobbyist groups exerted strong pressures to abolish the Glass-Steagall Act, which to a certain extent disadvantaged American banks in international competition. The Financial Services Modernization Act (the Gramm-Leach-Bliley Act) of 1999 allowed for the cancellation of barriers between commercial banking, investment banking, collective investment and insurance business, permitting the conduct of these activities directly by a financial holding, that is, not just through subsidiaries as until that time.

In Japan, investment banking was separated from commercial banking after the Second World War as a result of legislative changes following the American example. There were differences compared to the American model though. From the end of the 80 's of the last century there was a growing pressure to do away with the separate banking model. In 1992, the Financial System Reform Law was passed, which opened a road to the model of universal banking. The separate banking model should be definitively terminated through the implementation of measures adopted in 1998.

A holding model. A holding is a business corporation founded to perform control over one or several companies. A bank holding (BH) controls a bank and investment firm with a subsidiary relationship to each other. This means that investment activities are carried on by a separate legal entity. A commercial bank must be separated from the subsidiary investment firm by a "wall" restraining personnel, information and trading links between the commercial and investment banking. This model was most highly developed in the U.S.A., where such companies were already formed during the 19th century. They mainly served the purpose of circumventing the ban on combination of commercial and investment banking.

The Act on Bank Holdings of 1956 (initiated by the FRS) set forth the rules for foundation and business of bank holdings, i.e. companies holding more than a 25% ownership interest in a bank's share capital. As a result, also bank holdings became subject to the Glass-Steagall Act of 1933 and bank holdings were not permitted to acquire a direct or indirect controlling interest in non-banking entities, including investment companies. In 1987, the FRS allowed adequately capitalised bank holdings to own investment firms as their subsidiaries, which could also perform operations forbidden under the Glass-Steagall Act; the revenue from such operations however could not exceed 25% of the total revenue of such subsidiaries. At the turn of the 80 's and 90 's of the past century, large American banking corporations practically transferred to the holding

⁴ Musílek, P.: Trhy cenných papírů (Securities Markets). Eko-press, s. r. o., Prague 2002.



model in order to incorporate investment banking. In 1997, the FRS modified the "wall" system by new rules for operation.

A subsidiary model is typified by the principle that a parent bank only pursues commercial banking and concurrently controls a separate legal entity, that is a company which pursues investment banking. Such a model can be formed either through regulatory or market action.

The regulatory subsidiary model was introduced in order to limit a conflict of interest between commercial and investment operations. There is a barrier restraining information, personnel and financial connections between a parent bank and an investment firm. This model for integrating the investment banking into a subsidiary investment firm was applied in Denmark and Hungary.

The market subsidiary model is a result of a bank's decision, which prefers to transfer investment banking or selected investment operations off to a subsidiary, which is a specialised investment firm. This is primarily driven by a wish for a more effective cost control, the separation of investment risk from commercial banking risks and enhancement of trustworthiness of the business done by the entire financial group. Over the last years, this model started to be also employed by some European universal banks that have acquired specialised investment firms (largely of Anglo-Saxon provenience) through acquisitions and integrated them into their financial groups.

Investment Banking under the Conditions of the European Union, Slovak legislation and the Banking System in the SR

The concept of a universal bank selling a variety of services is deep-rooted in Europe.⁵

By virtue of the basic EU banking directive (Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions), a universal model for banking was adopted. It is reflected in the principle of a single banking license under which licensing (supervisory) authorities of Member States jointly authorise banks to perform both lending and investment activities. The list of such activities is annexed to the directive.

In terms of an institutional set-up of commercial and

investment banking, the banking system in the Slovak Republic also falls under the universal banking model, nevertheless taking into account the necessity of separated conduct of these activities. 18 banks and 3 branch offices of foreign banks with a universal banking license operate in Slovakia. In 2003, they conducted more than 90% of the total volume of investment services⁶ on the top of banking operations.

By way of a banking license, the National Bank of Slovakia authorises a bank to pursue both lending and investment business (§ 2(1&2) of the Banking Act). The granting of a banking authorisation to conduct investment activities must however be preceded by the grant of an authorisation from the Financial Market Authority for the provision of investment services under the Securities Act, i.e. for the establishment of a securities dealer.

Under the Act, the term of lending business refers to activities relating to the provision of loans, including guarantees (§ 34(3)). For these purposes, investment business is taken to mean activities related to investment in securities, trading in securities, trading in the rights attaching to securities or derived from securities, participation in the issuance of securities and the provision of related services as well as the management of securities, including consulting (§ 34(4)).

Nevertheless, in order to prevent a potential conflict of interest between commercial banking and investment operations of the same bank, the Banking Act imposes upon banks an obligation to separate lending operations from investment operations. It sets forth that in its Articles a bank is obligated to lay down and divide powers and accountability for separated conduct of lending and investment business (§ 23(1e)).

Unless publicly accessible information is involved, a bank is not allowed to use information obtained in connection with its lending business in conducting investment operations and conversely, it may not employ information acquired during investment operations in transacting the business of lending. Likewise, a bank is not allowed to use in-house any information gained in connection with investment operations performed for the account of its client, and also may not use in favour of the client any information obtained as part of investment operations conducted for its own account. In order to meet these requirements, a bank is obligated to take such measures with regard to its organisational, management and control system as to

⁵ For example, approximately 90% of mutual funds here were sold by universal banks, whilst in the U.S.A. universal banks sold about 35% of such funds. (Ježek, K.: Dva modely bankovníctví v EU [Two models of banking in the EU], Bankovníctví, No. 6/99, p. 31).

⁶ The major black sheep have already vacated the market. A quote from a comment made by S. Šťastný, the Vice-President of the Board of the Financial Market Authority, concerning the most frequented complaints in the area of investment (Pravda, 19.2.2004).



separate lending and investment business from each other. Investment operations for the client's account may only be conducted by a bank under the terms and conditions favourable for the client, especially at the price favourable for the client, and taking due professional care. A bank is also obligated to maintain separate records on investments made for its own account and for the account of its clients.

Recent years witnessed sustaining and strengthening tendencies towards universal banking in Europe.

Owing to this development (especially the introduction of euro, declining interests and margins) certain large European universal banks shifted their focus from wholesale to retail banking and the winning of new markets (e.g. in Central and Eastern Europe). As a result of investment banking becoming more attractive, they concurrently tried to gain a more significant share in the investment banking market by building up their own investment operations on the one hand and through acquisition of smaller investment banks on the other.