UNIVERSAL BANKING AND THE RETURN OF 'GLASS-STEAGALL'

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Abstract

The article aims to consider the arguments for and against universal banking and considers universal banking within different systems of law. The author also provides insight into the discussions on the changes to the banking regulatory infrastructure and the implications which this may have.**

Keywords: Universal Banking, 'Glass-Steagall', Financial Intermediation, Risks, Regulation

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** *The article was previously published in the Second Edition of the Elsa Malta Law Review.*

1. Introduction

This research aims to consider the banking realm within different legal systems, seeking to analyse the possibility of a one-size-fits-all approach. Historically, different jurisdictions have shifted their approach from one extreme to another, all the while providing both opportunities and crises. Arguments which have been put forward along the years, both in favour as well as against universal banking, shall be considered.

Retail and commercial banking face different risks and objectives with respect to investment banking. Cranston states that while the former is mainly faced with credit risks, the later is focused on market risks.[1] Universal banking, however, provides an aggregation of those risks since it provides both retail and investment banking services.

The present analysis is mainly focused on risks which banks incur upon the use of depositors' funds through financial intermediation. Admittedly banks also earn substantial fees which help to offset losses incurred through their operations. Nevertheless, being a legal analysis rather than an economic analysis, the positive impact or otherwise of such fees is extraneous to the arguments considered below.

2. Universal Banking and Specialised Banking Contrasted

Universal banks offer an entire range of financial services.[2] Specialised banks, however, concentrate specifically on one main activity: either retail or investment banking. 'Retail banking' refers to the provision of deposit-taking, lending to individuals and SMEs, and operating the payments system.[3] 'Investment banking' typically serves large corporations, other financial institutions, and governments by advising and acting in the capital markets.[4]

Specialised investment banking activity tends to be much more focused upon Equity Financing structures (apart from the issuing of bonds), whereas retail banks predominantly use Debt Financing structures. Both these methods of financing provide funds in return for a claim on the company being financed; in Equity Financing, finance is provided in exchange for equity, while in Debt Financing, funds are provided upon becoming a company creditor. This study shall assume that investment banks are the prime providers of equity financing, and retail and commercial banks primarily provide debt financing activities.

Gerschenkron argues that universal banking developed as a result of continental Europe not being able to finance industrialisation internally (contrary to the United Kingdom) due to a scarcity of capital, technology, and entrepreneurship, causing banks to combine short-term with long-term business.[5] On the other hand, Verdier argues that joint-stock banks moved from investment banking towards more profitable and less risky deposit banking.[6] He states that left unhindered, such as in Britain, joint-stock

[1] R. Cranston, *Principles of Banking Law* (OUP 2002) 97.
[2] G. Benston, 'Universal Banking' in *The Journal of Economic Perspectives* (American Economic Association 1994) 121; Cranston (n 1) 97; C. Colvin, 'Universal Banking Failure? An Analysis of the Contrasting Responses of the Amsterdamsche Bank and the Rotterdamsche Bankvereeniging to the Dutch Financial Crisis of the 1920s' in Working Papers No. 98/07 *London School of Economics* (2007) 24-25.
[3] Independent Commission on Banking, 'Interim Report' (London, April 2011) 77; Which?, 'The Future of Banking Commission Report' (United Kingdom 2010) 25.
[4] Ibid.
[5] Colvin (n 2) 15.
[6] Ibid., 17-18.

banks completely left the business of investment banking behind. In contrast, in countries with a strong degree of segmentation, such as Germany, these banks were left mid-course.[7]

Universal banking has long been considered as risky. In the 1920s, Netherlands experienced its first banking crisis after a short experiment with universal banking.[8] In the United States, following the Great Depression, a strict separation on activities was imposed in the Glass-Steagall Act.[9] On the other hand, German law has long sanctioned universal banking.[10]

3. Equity and Debt Financing

Upon providing Equity Financing, investment banks become shareholders with their rights being dependent upon the company's Constitution. Rather than being third-party creditors (as in debt financing), investment banks become joint owners of the company. On the contrary, retail banks, as providers of Debt Financing, do not get shareholder advantages. However, as third-party creditors they are in a more advantageous position upon the insolvency of the funded entity, ranking before shareholders.[11] Therefore, when universal banking is compared with specialised retail banking, assets securing deposits have a lower ranking. They are faced with wider risks, including market risks and the wide variances which capital markets are subject to.

Therefore, when universal banks combine investment banking with retail banking, there is an aggregation of different risks which money collected from deposits in retail banking business becomes subject to; hence, leading to widespread systemic risks.

4. Arguments For Universal Banking

Universal banks can diversify their risks, being able to withstand unexpected economic changes better.[12] Thus, Benston argues that concerns about the failure of banks should be dealt with by allowing greater diversification (and better regulation of their capital structures), stating that both the US Savings and Loan Crisis and the Great Depression occurred due to a lack of diversification.[13] Furthermore, Barclays argue that diversification protected shareholders from the worst effects of the global financial crisis.[14] Similarly, Rawlings argues that retail banks may struggle to survive separately.[15]

Both the Future of Banking Commission (hereinafter '**FBC**') and Rawlings note that the global economy has sophisticated financial needs, which can only be catered for by means of universal banking systems.[16] Consequently, Barclays feel that universal banking is necessary in light of globalisation.[17] Avgouleas also suggests that restricting bank activities may hinder bank development and thus economic growth.[18]

Universal banks gain from economies of scale, leading to a higher degree of cost-efficiency.[19] Taking a leaf out of Schumpeterian economics, Avgouleas argues that since this leads to higher profitability, universal banks tend to foster innovation.[20] Both Benston and Barclays also argue that universal banking serves to enhance capital and funding efficiencies.[21] Furthermore, universal banks obtain more accurate information on a company's situation, reducing information asymmetries.[22]

The Bank for International Settlements has argued that universal banking helps in the creation of liquidity.[23] Moreover, Gleeson states that investment activities are the most efficient way to cover the 'high level of liquidity mismatch' by which all banks are affected.[24]

Kroszner and Rajan argue that the pre-Glass-Steagall period shows no evidence of conflicts of interest in universal banks and that the public rationally accounted for this possibility, constraining banks to underwrite high-quality securities.[25] Benston argues that the charges of conflicts of interest prior to Glass-Steagall, were almost all unsupported, and that one expects conflicts of interest to occur at smaller, specialised institutions.[26]

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[7] Ibid., 18.
[8] Ibid., 1-2.
[9] Cranston (n 1) 98.
[10] Ibid.
[11] *Raiffeisen Zentralbank Österreich AG v Royal Bank of Scotland plc* [2010] EWHC 1392 (Comm) para 105.
[12] J. Canals, *Universal Banking* (Clarendon Press 1997) 127; Barclays PLC, 'Annual Report 2009' (2010) 16-17; E. Avgouleas, *The Reform of 'Too-Big-To-Fail' Banks: A New Regulatory Model for the Institutional Separation of 'Casino' from 'Utility' Banking* (2010) 16 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1552970&rec=1&srcabs=1589511> accessed August 2012; Colvin (n 2) 25; G. Benston, *The Separation of Commercial and Investment Banking* (OUP 1990) 212.
[13] Benston (n 2) 126.
[14] Barclays PLC (n 12) 8.
[15] P. Rawlings, 'Bank Reform in the UK: Part I – The Future of Banking Commission' in *International Corporate Rescue* (Chase Cambria Publishing 2010) 3-4.
[16] Which? (n 3) 27; Rawlings (n 15) 3.
[17] Barclays PLC (n 12) 8.
[18] Avgouleas (n 12) 16.
[19] Canals (n 12) 102, 160; Avgouleas (n 12) 16; K. Lannoo, 'Challenges to the Structure of Financial Supervision in the EU' (2000) 2 4 *Journal of International Financial Markets* 99.
[20] Avgouleas (n 12) 15.
[21] Barclays PLC (n 12) 16-17; Benston (n 2) 130; Benston (n 12) 212.
[22] Canals (n 12) 160; Colvin (n 2) 25.
[23] J. Santos, 'Bank Capital Regulation in Contemporary Banking Theory: A Review of the Literature' in *BIS Working Papers No.90* (Bank of International Settlements 2000) 6.
[24] C. McErlane, 'Was the Banking Act 2009 a Justified, Proportionate and Effective Response to the Credit Crisis, Having Regard to its Structure, Drafting and Interaction with Foreign Law?'(UCL LLM Dissertation 2009) 11.
[25] R. Kroszner and R. Rajan, 'Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking before 1933' in *The American Economic Review* (American Economic Association 1994) 810, 829-830.
[26] Benston (n 12) 213.

It is also difficult to define the limits between retail and investment banking in order to distinguish between them or separate them.[27] This was one of the main weaknesses of the Glass-Steagall Act.

It would also be difficult for a country to act alone in separating banks' different sectors since banks may relocate elsewhere.[28]

5. Arguments Against Universal Banking

Investment banking activities, valuable though some of them are […] some of them are not […] and the trouble we've got into is when the non-valuable activities have been combined with an excess of leverage which has put the whole organisation at risk.

Sir Martin Taylor, Former CEO Barclays[29]

Specialisation promotes efficiency since banks would be specialised in their particular expertease.[30] Avgouleas states that although access to finance is an essential ingredient of economic growth, there is no bank-size preference as long as banks efficiently offer intermediation services to users of finance.[31]

Universal banks lead to an excessive concentration of risks.[32] The Independent Commission on Banking (hereinafter '**ICB**') also recognised that universal banking may easily enhance contagion.[33] Avgouleas thus questions the policy of allowing universal banks to freely enter into financial innovation when their failure was subject to systemic risk.[34]

Canals states that since specialised banks tend to be smaller in size, they are likely to give rise to less social problems.[35] Universal banks depend on a high volume of deposits, and due to deposit guarantee schemes, the economic and social cost of rescuing a universal bank is much higher.[36] Due to the implicit government guarantee, universal banks tend to adopt a too-big-to-fail approach.[37]

Universal banks attract conflicts of interest: they may grant loans to customers to buy shares in the bank, or to companies in difficulties whose issues on the capital markets are led by the same universal bank.[38] Banks which partly own or manage a client firm may not be willing to see their client defaulting on loans, thereby fostering inefficiencies.[39] Problematic bank debtors may incentivise the bank to underwrite public issues for the proceeds to be used to repay bank loans.[40] Furthermore, universal banks may easily obtain inside information.[41] Universal banks may also constrain customers, who are highly reliant on the bank (through debt or equity), to acquire further products from the same bank.[42]

Colvin argues that universal banks' assets are geared towards the long-term, being difficult to liquidate.[43] On the other hand, specialised *commercial* banks are better geared to be able to meet consumer demands for deposit withdrawal, while specialised *investment* banks are less prone to bank runs (than universal banks) because of long-term relationships with their clients.[44]

Buiter argues that universal banks' economies of scale are easily exhausted, and that banks use their size to exploit market power and shelter riskier activities.[45] The FBC argues that diseconomies of scale also come into play, especially in light of the complexity of the universal banking model.[46] Avgouleas states that instead of taking advantage of economies of scale, banks foster a culture of short-termism and aggressive speculation to boost executive compensation and returns to their shareholders.[47]

In Canals' view, universal banks lead to monopoly practices.[48] Furthermore, upon a separation of investment banking from commercial banking, more competition would ensue due to lower barriers to entry.[49] Avgouleas also argues that large universal banks significantly contributed to homogenous investment behaviour, stating that banks adopted a 'follow the leader' strategy and were subject to herding.[50]

6. Comparative Law

6.1 Strength of Capital Markets

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27 Rawlings (n 15) 3; PricewaterhouseCoopers LLP, *Back to the Future* (2009) 16 <http://www.pwc.com/en_GR/gr/surveys/assets/government-back-to-the-future.pdf> accessed August 2012.
28 Ibid.
29 Which? (n 3) 29.
30 Canals (n 12) 102, 127; Avgouleas (n 12) 42.
31 Avgouleas (n 12) 43.
32 Canals (n 12) 160; Which? (n 3) 31.
33 Independent Commission on Banking (n 3) 74, 76, 82-83; Cranston (n 1) 97; Avgouleas (n 12) 26; Independent Commission on Banking, 'Issues Paper' (London, September 2010) 32.
34 Avgouleas (n 12) 21-22.
35 Canals (n 12) 127.
36 Canals (n 12) 128; Independent Commission on Banking (n 33) 32; Which? (n 3) 26.
37 Avgouleas (n 12) 5-6, 16-17, 44; Guardian.co.uk (Editorial), 'Obama has Shown the Way on Bank Control' (January 2010) <http://www.guardian.co.uk/commentisfree/2010/jan/24/obama-banking-controls> accessed August 2012; Benston (n 2) 123; Benston (n 12) 139-162; Which? (n 3) 28; Independent Commission on Banking (n 3) 76.
38 Canals (n 12) 130; Benston (n 12) 21; Colvin (n 2) 15, 26; Avgouleas (n 12) 43; Which? (n 3) 28.
39 Colvin (n 2) 26.
40 R. Kroszner and R. Rajan (n 25) 814.
41 Canals (n 12) 130; Which? (n 3) 31; Independent Commission on Banking (n 33) 32-33.
42 Canals (n 12) 129.
43 Colvin (n 2) 25.
44 Ibid., 26.
45 W. Buiter, 'Regulating the New Financial Sector' (February, 2009) Financial Times Maverecon Blog <http://blogs.ft.com/maverecon/2009/02/regulating-the-new-financial-sector> accessed August 2012.
46 Which? (n 3) 26, 31.
47 Avgouleas (n 12) 4-5.
48 Canals (n 12) 129.
49 Avgouleas (n 12) 43; Which? (n 3) 33; Independent Commission on Banking (n 33) 32-33.
50 Avgouleas (n 12) 17-24.

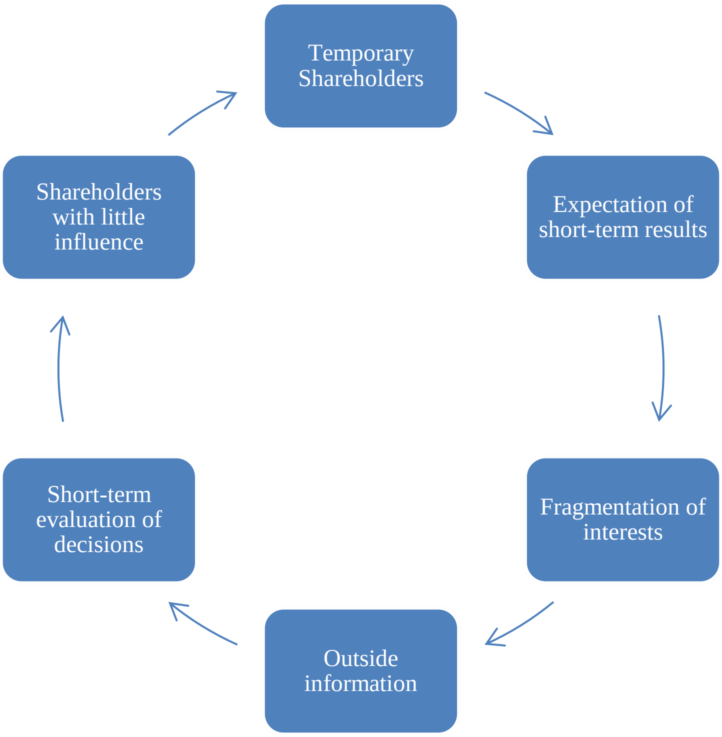
The major models of organisation of the financial system are the Anglo-Saxon model and the Continental model (Canals (n 12) 72).

In the Anglo-Saxon system, capital markets are much more developed and serve as the primary nexus for flows between savings and investments (Ibid). In Continental financial systems banks play a more dominant role (Lannoo (n 19) 98; Canals (n 12) 72).

The Anglo-Saxon model stimulated tough competition between intermediaries and provided the environment in which capital market financing, specialisation and innovation flourished (Lannoo (n 19) 98-99; Canals (n 12) 21, 41).

The following diagram lists the main characteristics of the Anglo-Saxon model, described as the fluid capital system: since shareholders are temporary and have little interest in the company, they do not consider capital markets for the longer term, thus leading to fluid capital markets (Canals (n 12) 44):

Figure 1. The Fluid Capital System



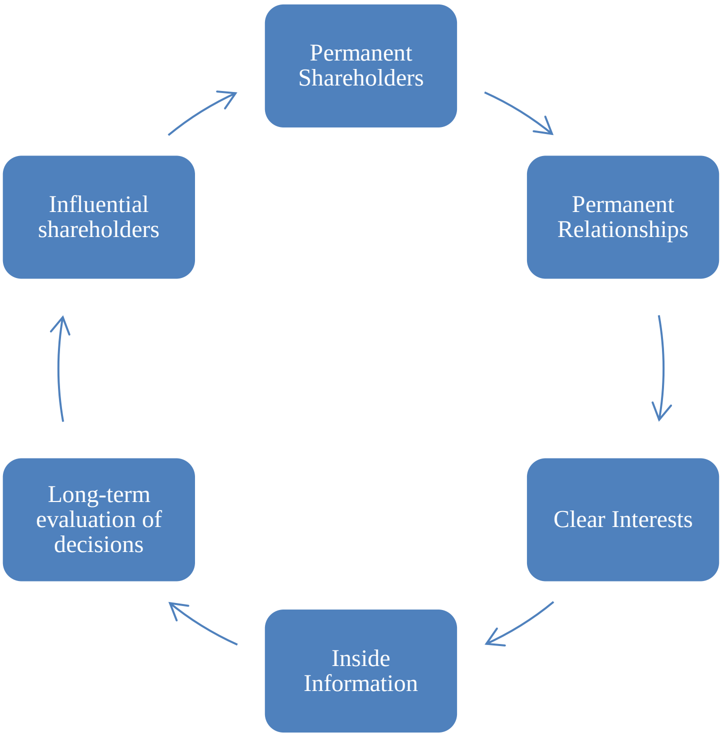
In the Continental model, financial intermediation retains a strong influence. In addition, there are less developed capital markets. The existence of significant bank presence in capital markets ensures an indirect manner in controlling their growth and sharing in the results.[51]

The German *hausbank* and the Japanese *keiretsu* are characterised by banks holding equity securities, having the biggest share of the financial business of firms, and being represented on their supervisory boards.[52] Here the bank has a special responsibility to rescue firms in financial trouble with loans, capital, and reorganisation leadership.[53]

The following diagram lists the main characteristics of the Continental model, described as the committed capital system, where due to the level of involvement of banks, shareholders tend to look at the longer term, leading to less activity on the capital markets and more influential shareholders:[54]

[51] Canals (n 12) 21.
[52] Benston (n 2) 129.
[53] Ibid.
[54] Canals (n 12) 45.

Figure 2. Committed Capital System



6.2 United States

The Glass-Steagall Act

The National Banking Act 1864 prohibited banks from offering securities and insurance products and services, and from 1902, national banks no longer had legal authority to underwrite corporate securities.[55] National banks responded by creating holding companies that could underwrite corporate securities and engage in securities dealings.[56]

In 1913, the Federal Reserve Act removed restrictions on national banks, and by the 1920s, banks were underwriting, distributing, and facilitating the issue of securities on a large scale.[57] The McFadden Act 1927 allowed national banks to underwrite securities approved by the Comptroller of the Currency.[58]

The 1929 stock market crash led to the revival of a legal separation.[59] The *Grey-Pecora Hearings* of 1933 found that the directors had significant conflicts of interest which did not align with the interests of stockholders and creditors.[60] Furthermore, the direct involvement of commercial banks in the securities business increased the bank's risks.[61] Banks were also investing on their own account, putting commercial and savings deposits at risk.[62]

According to Volcker, bank affiliates underwrote and sold unsound securities, pushed misleading prospectuses, manipulated securities' prices, engaged in insider dealing, and made unsound loans to assist their affiliates; all the while, the public was confused as to whether it was dealing with a bank or a securities affiliate.[63] This notwithstanding, Benston states that historians have documented these events incorrectly.[64]

The Glass-Steagall Act was introduced in 1933. Section 16 (as amended in 1935) prohibited Federal Reserve member banks from purchasing securities for their own account, though it permitted commercial banks to deal in securities directly for and on behalf of customers.[65] National banks may have purchased and held investment securities up to 10% of their capital and surplus.[66] Sections 16 and 21 also forbade deposit-taking institutions from issuing, underwriting, selling, or distributing of securities (with some exceptions, including obligations of the US

[55] Benston (n 2) 122; R. Kroszner and R. Rajan (n 25) 812; Cranston (n 1) 99; J. Hendrickson, 'The Long and Bumpy Road to Glass-Steagall Reform: A Historical and Evolutionary Analysis' (2001) 60 4 *American Journal of Economics and Sociology* 854-855.
[56] Hendrickson (n 60) 855; R. Kroszner and R. Rajan (n 25) 812.
[57] Cranston (n 1) 99.
[58] Hendrickson (n 60) 855.
[59] Cranston (n 1) 99; Hendrickson (n 60) 855.
[60] Benston (n 2) 122; R. Kroszner and R. Rajan (n 25) 810; Hendrickson (n 60) 856.
[61] R. Kroszner and R. Rajan (n 25) 811.
[62] Benston (n 12) 10-11.
[63] Ibid., 12.
[64] Ibid., 215-222.
[65] Benston (n 12) 7; R. Dale, 'Glass-Steagall and US Banks' Securities Activities' in (1990) 5 8 *Journal of International Banking Law* 321; Canals (n 12) 75; Avgouleas (n 12) 12.
[66] Benston (n 12) 7; Dale (n 70) 321.

government, government agencies, and States and political subdivisions).[67]

Under Section 20, member banks were prohibited from affiliating with a company 'engaged principally' in the issue, flotation, underwriting, public sale, or distribution of stocks, bonds, debentures, notes or other securities.[68]

Section 32 forbade member banks from having interlocking directorships or close officer or employee relationships with firms 'principally engaged' in securities underwriting and distribution (even if there was no common ownership or corporate affiliation between the commercial bank and the investment company).[69] This sought to limit conflicts of interest.[70]

Commercial banks were, however, not forbidden from underwriting and dealing in securities outside of the US.[71]

Repealing the Glass-Steagall Act

Initially, US banks had little inclination to diversify into securities activities; yet the statutory provisions were viewed as creating an impenetrable barrier.[72] Thus, the Glass-Steagall approach replicated itself throughout the entire financial sector.[73]

In the 1970s, commercial banks faced new competition from the creation of market mutual funds and the increasing use of commercial paper.[74] Banks started avoiding some of the Act's prohibitions, while regulators and Courts adopted a more liberal interpretation of legislation.[75] Although the Federal Reserve ruled that banks could participate in non-underwriting activities of the commercial paper market, most of the securities business was still prohibited.[76]

It was argued that banks' lending activities had proved to be as risky as securities activities, and that economic efficiency, greater competition, and customer convenience demanded removing restrictions.[77]

The Act also gave rise to a number of legislative uncertainties. The definition of 'security' as defined by the 1933 Securities Act could not cater for innovative financial products which eventually developed.[78] Moreover, securities-brokers' cash management accounts, were functionally identical to cheque accounts, and were not considered to be 'deposits'.[79] The Glass-Steagall Act did not prohibit banks from lending money to securities traders, hence, banks were still exposed to risks which securities traders entered into.[80] Furthermore, the Glass-Steagall Act did not apply to non-member banks and savings and loan associations, which remained free to affiliate with securities firms.[81] The introduction of bank holding companies in the 1960s also paved the way for providing securities activities in the 1980s.[82]

The Glass-Steagall Act was also criticised by a number of academics. Benston, Roe, and White all saw the Glass-Steagall Act as an overreaction to the universal banks' role in the Great Depression.[83] Canals also refuted the implication that universal banks' activities brought about greater conflicts of interest.[84] Raab argued that if Glass-Steagall were not repealed, it should have been interpreted to allow banks to underwrite and deal in securities backed by their own assets.[85] He also believed that conflicts of interest and bank safety could be controlled by means of developed regulation instead of Glass-Steagall.[86] Langevoort argued that Courts should have permitted securities activities that would not have diverted bank funds to speculative uses.[87] Furthermore, Scagliarini argued that the Glass-Steagall approach became untenable since the differences between the various services became increasingly blurred.[88]

The gradual development of the industry also aided in bringing down the Glass-Steagall Act. In the 1970s, Citibank was allowed to offer units in collective investment trusts to the public. In addition, in 1985, the Act was interpreted to allow national banks to deal in mutual shares as agents, since such securities were 'legally transparent'.[89] As from 1985, banks were allowed to offer discount brokerage services through subsidiaries, and in 1987 national banks were able to offer brokerage services and investment advice to the public, while acting as advisers to mutual funds or unit investment trusts. [90] In 1998, Citicorp (banking corporation) merged with a financial conglomerate, with several insurance subsidiaries, and a securities firm in order to produce

[67] Benston (n 12) 7; Dale (n 70) 321; Avgouleas (n 12) 12-13.
[68] Benston (n 12) 8; Dale (n 70) 321; Canals (n 12) 75; Avgouleas (n 12) 13.
[69] Benston (n 12) 9; Dale (n 70) 321; Avgouleas (n 12) 13.
[70] Dale (n 70) 321.
[71] Benston (n 12) 9.
[72] Dale (n 70) 321.
[73] G. Scagliarini, 'Pooling of Funds and the New Financial Intermediation in the United States', in (1994) 9 9 *Journal of International Banking Law* 367.
[74] Hendrickson (n 60) 860-861; M. Raab, 'The Transparency Theory: An Alternative Approach to Glass-Steagall Issues' (1988) 97 4 *The Yale Law Journal* 604; Scagliarini (n 78) 362.
[75] Cranston (n 1) 99; Dale (n 70) 321.
[76] Hendrickson (n 60) 861.
[77] Cranston (n 1) 99.
[78] A. Alcock, 'Are Financial Services Over-Regulated?' in (2003) 25 5 *Company Lawyer* 366-367; Raab (n 79) 608-609.
[79] Benston (n 12) 9.
[80] Canals (n 12) 80.
[81] Benston (n 12) 9.
[82] J. Hagendorff et, 'Bank Deregulation and Acquisition Activity: the Cases of US, Italy and Germany', in (2007) 15 2 *Journal of Financial Regulation and Compliance* 202.
[83] Canals (n 12) 76.
[84] Ibid., 82.
[85] Raab (n 79) 605, 610-611.
[86] Ibid., 606, 615-622.
[87] Ibid., 606, 610.
[88] Scagliarini (n 78) 367.
[89] Benston (n 12) 7-8; Raab (n 79) 607-609.
[90] Benston (n 12) 8.

Citigroup.[91] This preceded, and probably 'coerced' the repeal of Glass-Steagall.[92]

The regulatory approach also watered down the segregation along the years. The Bank Holding Company Act generally precluded a bank holding company from owning more than 5% of the voting stock of a non-banking company.[93] However, as from 1972, the Federal Reserve Board (hereinafter '**FRB**') allowed them (and their non-bank subsidiaries) to act as investment advisers to various types of investment companies; in addition, in 1983, it approved acquisitions of discount brokerage firms by bank holding companies.[94]

Since the mid-1980s, the FRB contributed to a gradual meltdown of Glass-Steagall's restrictions, in light of the increased use of bank holding companies.[95] This prompted a number of legislative attempts aimed at repealing or amending the Glass-Steagall Act.[96] When Congress passed reform legislation, Courts and regulators had already dismantled many of the barriers.[97] Under the Gramm-Leach-Bliley Act (1999), banks remained prohibited from acquiring securities, engaging in underwriting, and dealing in securities; while securities firms could not accept deposits.[98] Nevertheless, it was possible for banks which were members of the Federal Reserve System to be affiliated with securities firms within a holding group.[99]

The US came under international pressure to liberalise its banking regime. EEC officials closely involved with the drafting of the Second Banking Directive suggested that the Commission should have pursued an active strategy of negotiations in order to persuade the US to liberalise its banking regime (making specific mention of the Glass-Steagall Act).[100]

Post Glass-Steagall, the existing boundaries between traditional banking and investment firms broke down.[101] Globalisation and financial innovation gave rise to 'mega-banks' by means of a merger wave.[102]

Legislative Reform

The implication for Goldman Sachs or any other institution is, do you want to be a bank? […] If you don't want to follow those [banking] rules, you want to go out and do a lot of proprietary stuff, fine, but don't do it with a banking licence.

Paul Volcker[103]

Some policymakers argued that Glass-Steagall's repeal helped create the 2008 global financial crisis.[104] In January 2010, Obama announced the 'Volcker Rule' to ban deposit-taking institutions from owning, investing in, or sponsoring hedge funds or private equity funds, and from engaging in proprietary trading.[105] Thus, by virtue of the Dodd-Frank Act, US banks will have to separate their proprietary trading divisions, and banks will not be allowed to use their capital for 'trading unrelated to serving customers'.[106]

6.3 United Kingdom

Parliament has conferred many privileges on "banks" and "bankers", but it has never defined what is a "bank" and who is a "banker". It has said many times that a banker is a person who carries on "the business of banking", but it has never told us what is the business of banking. It has imposed penalties on persons who describe themselves as a "bank" or "bankers" when they are not, but it has never told us how to decide whether or not they are bankers.

Lord Denning[107]

Notwithstanding the fact that as a matter of tradition commercial banks were separated from investment banks, UK law originally remained silent on the matter.[108] However, this changed in the 1960s and 1970s, as banks acquired or established investment bank subsidiaries.[109] This was encouraged by the 1980s 'big bang' and financial liberalisation.[110] Deregulation allowed big universal banks to emerge because of what were considered to be new market conditions of global market integration and financial innovation.[111]

United Dominions Trust Ltd v Kirkwood allowed banks to provide services other than traditional banking services.[112] United Dominions Trust (hereinafter '**UDT**') risked not being considered

[91] Avgouleas (n 12) 14.
[92] Ibid.
[93] J. Coffee, 'Liquidity versus Control: The Institutional Investor as Corporate Monitor' (1991) 91 6 *Columbia Law Review* 1313; Avgouleas (n 12) 13.
[94] Dale (n 70) 322; Benston (n 12) 9.
[95] Dale (n 70) 322-327.
[96] Ibid., 327.
[97] Hendrickson (n 60) 850, 862.
[98] Cranston (n 1) 99.
[99] Ibid., 99-100.
[100] M. Dassesse, 'Banking in Europe – Restrictions and Freedoms' in *International Banking Law* (1991) 9 8 391.
[101] R. Tomasic, 'Establishing a UK Rescue Regime for Failed Investment Banks' in *Corporate Rescue and Insolvency* 2 (LexisNexis 2010) 60.
[102] Avgouleas (n 12) 1.
[103] C. Freeland and F. Guerrera, ''Volcker Rule' Gives Goldman Stark Choice', (2010) <http://www.ft.com/cms/s/0/121fe9d0-1753-11df-94f6-00144feab49a.html#ixzz19gGYMZcD> accessed August 2012.
[104] M. Benjamin and C. Harper, 'Glass-Steagall's Specter Returns to Haunt Wall Street (Update 2)' (2009) <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ad_KRWTbPsJw&refer=home> accessed August 2012.
[105] Avgouleas (n 12) 7-8.
[106] Ibid., 7.
[107] *United Dominions Trust Ltd v. Kirkwood* [1966] 1 All ER 968.
[108] Cranston (n 1) 98.
[109] Ibid.
[110] Ibid.
[111] Avgouleas (n 12) 4; Canals (n 12) 9-10.
[112] [1966] 1 All ER 968.

a 'bank' in light of activities it entered into (the case was about a hire-purchase transaction). Nevertheless, the Court of Appeal concluded that UDT was a bank due to its reputation among other bankers. This judgment allowed banks to develop according to what the industry considered to fall within the definition of 'banking', thereby encouraging financial innovation and encouraging banks to adopt new methods, following other banks in the industry.

Furthermore, while the US was repealing the Glass-Steagall Act, the UK was adopting a single-regulator approach by means of the Financial Services and Markets Act 2000, which together with the Financial Services Authority (hereinafter '**FSA**') would cater for all specific financial sectors. This approach was necessary in light of the comingling of different financial industries.

Prior to the global financial crisis, the FSA moved further towards principles-based regulation in order for regulation to keep up with the changing markets, while supporting development and innovation.[113] High-level principles already formed part of the Securities and Investment Board's regulation, and eleven high level standards were also included in the FSA Handbook in 2001.[114]

In light of the universal banking model which the UK developed, the FSA Handbook adopts the position taken by the Credit Institutions Directive and combines prudential regulation of Banks and Investment Firms (as well as Building Societies) under the BIPRU Module, while Insurers are regulated separately under INSPRU. GENPRU also provides for general prudential regulations.

The definition of 'deposits' and 'investments' is also intermingled. The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 outlines the 'specified kind' of *investment* activities in line with Section 22 of the Financial Services and Markets Act, and thereby, Chapter II of the Regulated Activities Order specifies 'accepting deposits' as such.[115]

Section 2 of the Banking Act 2009 also makes reference to the 'regulated activity of accepting deposits', within the meaning of Section 22 of the Financial Services and Markets Act.[116]

Legislative Reform

[…] if the directors of Barclays Capital, or its equivalent, want their bank to become the world's largest casino that's up to them, but only if there is no question of the British taxpayer guaranteeing it.

Vince Cable[117]

Before the US announced the 'Volcker Rule', Mervyn King argued that separation of bank activities would stop universal banks from free-riding over on the implicit government guarantee.[118] This was criticised by Chancellor Darling and Turner.[119]

The FBC considered the integration of the industry as having played a major role in the financial crisis, noting that a global financial crisis was avoided during the 65-years of Glass-Steagall, one such crisis occurred within a decade of the Act being repealed.[120] The Commission believed that universal banking symbolised a mentality of 'anything goes in finance'.[121]

Sassoon, from the Conservative Party, 2009, recommended investigating a possible Glass-Steagall approach.[122] Both the Conservative Party as well as the Liberal Democrats proposed, in their 2010 electoral manifestos, the prohibition of retail banks from engaging in proprietary trading.[123]

Gleeson argues that the Banking Act (2009) may lead to a greater separation between retail and investment banking since it subordinates the interests of market creditors to those of depositors, resulting in the former bearing a greater risk of non-payment during a winding-up process.[124]

The ICB recognised the importance of ensuring that banks fail safely, thereby reducing systemic risks.[125] Thus, according to the ICB, a reform must envisage a balance between the benefits given to society by making banks safer and the costs of such process.[126] It acknowledged that while full separation might provide the strongest firewall to protect retail banking services from contagion, it would simultaneously lose some of the benefits of universal banking.[127]

The ICB has argued that the best way forward is by:

1. internal ring-fencing within universal banks to isolate UK retail banking services; and
2. higher capital requirements, together with measures to make bank debt effectively loss-absorbing.[128]

The ICB therefore recommended isolating retail banking activities within a universal bank and placing them into a separately capitalised subsidiary (hereinafter a '**Retail Ring-Fence**').[129] This would

[113] FSA, 'Principles-Based Regulation' (April 2007) 6-7 <http://www.fsa.gov.uk/pubs/other/principles.pdf> accessed August 2012.
[114] FSA (n 118) 4, 9; FSA Handbook PRIN 2.1.1.
[115] UK Financial Services and Markets Act 2000; UK Financial Services and Markets Act (Regulated Order) 2001.
[116] UK Banking Act 2009.
[117] Rawlings (n 15) 4.
[118] Avgouleas (n 12) 8; Which? (n 3) 27.
[119] Rawlings (n 15) 3; Which? (n 3) 27.
[120] Which? (n 3) 27, 29.
[121] Ibid., 27.
[122] J. Hindle, 'The Future of Regulation' (2009) 17 4 *Journal of Financial Regulation and Compliance* 422.
[123] J. Ames, 'Coalition Concerns' in *European Lawyer* 96 (FutureLex 2010) 16; Conservative Party, 'Invitation to Join the Government of Britain', (United Kingdom 2010) 29; Liberal Democrats, 'Liberal Democrat Manifesto 2010', (United Kingdom 2010) 16, 21-22.
[124] C. McErlane (n 24) 10-11.
[125] Ibid.
[126] Ibid., 8.
[127] Ibid., 8.
[128] Ibid., 64.
[129] Ibid., 76.

allow for the continuation of universal banking and the benefits it provides, while seeking to minimise its negative effects.[130] Upon bank failure, vital retail operations could be saved, while other operations could be resolved or restructured without taxpayer support, hence doing away with the problem of contagion.[131] This was endorsed by both Chancellor Osborne, as well as the Commons Treasury Committee.[132]

This approach had been put forward by Cranston, who argued that 'firewalls' used to segregate risks could be effective in order to reduce contagion, by insulating the banking side from the securities side.[133] He states that the parent should be able to walk away from the securities subsidiary without fear that the corporate veil will be pierced.[134]

The IMF also noted that this may facilitate the 'orderly wind-down of systemically important financial groups in the event of failures'.[135]

The ICB argued that ring-fencing would ensure that minimum levels of capital are available for retail services in times of economic stress, leading to reduced perceived government guarantees since investment banking branches would be left to fail.[136] Furthermore, subject to minimum capital ratios and loss-absorbing debt, banks would still be able to transfer capital between their UK retail and other banking activities.[137] However, ring-fencing could also include a series of restrictions, such as limits on the exposures between the retail subsidiary and the rest of the bank.[138]

The ICB recognised that additional rules could reduce the chances of contagion and financial stability of a ring-fence; this may however reduce bank efficiency.[139]

According to the ICB, the main problems in implementing and enforcing retail ring-fencing would be definitional issues and the fact that foreign banks could open branches in the UK while remaining subject to their home licence.[140]

6.4 Japan

Despite widespread bank failures in the 1920s, securities markets were undeveloped and insignificant.[141] Thus, the Banking Act 1927 introduced more stringent capital requirements, yet did not attempt to separate commercial from investment banking.[142]

During the American occupation, authorities liquidated the *zaibatsu* (family-owned, bank-centred holding companies) and introduced a Glass-Steagall equivalent, expecting American-style public corporations to evolve.[143] This Act, however, fulfilled no domestic policy purpose and existed only due to historical accident.[144]

Article 65 of Japan's Securities and Exchange Law 1948 prohibited banks from engaging in securities business.[145] Nevertheless, banks could deal in securities for the accounts of clients, or for their own investment purposes (contrary to US banks, Japanese banks could acquire equity holdings without limits).[146] The prohibition did not apply to government bonds and debt guaranteed by Government.[147]

Article 11 of the Anti-Monopoly Act prohibited banks from owning more than 5% of the stock of domestic corporations.[148] Nevertheless, through cross-shareholdings in related companies, they did acquire controlling interests in securities affiliates.[149]

Except for underwriting in the strictest sense (which was prohibited), banks continued to perform investment banking functions.[150] Since banks could purchase corporate securities for their own investment portfolios, they tended to purchase the new issues of companies with which they had strong business relationships.[151] Therefore, in contrast to the US, Article 65 allowed banks to engage in securities business closely related to underwriting.[152]

Successor coalitions to the *zaibatsu* became known as *keiretsu*, with the internal structure typically consisting of a diversified confederation of companies clustered around a 'main bank' that provides loans to the members of the group as their chief source of financing.[153] The main bank would usually be both a major shareholder and the principal creditor of the companies; although this main bank

130 Ibid., 77.
131 Ibid., 7, 77, 80-81.
132 G. Parker and others, 'Osborne Backs High Street Banks Firewalls' (2011) <http://www.ft.com/cms/s/0/f9cf7b86-96b6-11e0-baca-00144feab49a.html#ixzz1PKAYkYPu> accessed August 2012; BBC, 'Chancellor to call for Retail Banks to be Ring-Fenced', (2011) <http://www.bbc.co.uk/news/business-13770746> accessed August 2012; BBC, 'Retail Banks not Competitive says Treasury Committee' (2011) <http://www.bbc.co.uk/news/business-12935228> accessed August 2012.
133 Cranston (n 1) 100.
134 Ibid., 100-101.
135 Independent Commission on Banking (n 3) 80.
136 Ibid., 77, 80, 87-88.
137 Ibid., 8.
138 Ibid., 95.
139 Ibid., 95-96.
140 Ibid., 96-97.

141 R. Dale, 'Japan's "Glass-Steagall" Act' in (1987) 2 3 *Journal of International Banking Law* 138.
142 Ibid.
143 Coffee (n 98) 1294; Dale (n 146) 138; Benston (n 2) 122; Alcock (n 83) 133.
144 Dale (n 146) 140.
145 Dale (n 146) 138-139, 145; Coffee (n 98) 1294; J. Haines, 'Financial Regulation – A British Experience' (1999) 6 4 *Journal of Financial Crime* 336.
146 Dale (n 146) 138-139.
147 Ibid., 138.
148 Coffee (n 98) 1294; Dale (n 146) 139.
149 Dale (n 146) 139; Cranston (n 1) 99.
150 Dale (n 146) 140.
151 Ibid.
152 Ibid.
153 Coffee (n 98) 1295; Benston (n 2) 122-123.

would in turn be owned by its subsidiaries and affiliates.[154] Thus, the *keiretsu* functions as a miniature common market where each member generally relies on the others as its principal trading partners, preferring them to external sources as suppliers, customers, and creditors.[155]

As from the 1980s, there was a gradual migration towards liberalisation of financial services.[156] The scope of banks' permitted dealing in national bonds remained unclear, and in 1981 Article 65(2) was added, which allowed banks to engage in underwriting and public distribution of national bonds (subject to authorisation from the Ministry of Finance).[157] Following this, Japanese banks were gradually allowed to engage in sales of long-term Government bonds, over the counter sales of medium-term Government bonds and deal in public bonds, and were permitted to sell public bonds on the same basis as security houses.[158]

In 1987, the Ministry of Finance authorised 43 domestic banks under the Investment Advisory Act to give investment advice, breaching one aspect of Article 65.[159] Banks were also authorised to trade for their own account in overseas financial futures transactions and foreign commercial banks were allowed to set up separate securities subsidiaries (provided that at least 50% of the equity of such subsidiary was held by a non-financial institution).[160]

In 1992, legislation was introduced whereby financial institutions were permitted to establish separate subsidiaries in financial market segments other than those in which the parent financial institution specialised.[161] This decision was the result of pressures from worldwide deregulation trends, the desire to protect Tokyo's status as an international financial centre, and the perceived need to promote competition in the financial services industry.[162] Banks were also concerned that they were losing business to the securities markets.[163] Furthermore, it was anomalous that, whereas Japanese financial institutions combined banking and securities business in other financial centres, they were denied this in Japan.[164]

[154] Coffee (n 98) 1295.
[155] Ibid.
[156] Haines (n 150) 336.
[157] Dale (n 146) 138.
[158] Ibid., 139.
[159] D. Petkovic, 'Liberalisation of International Banking Operations: Lessons from Asia's Mature Financial Centres' (1992) 7 10 *Journal of International Banking Law* 395.
[160] Ibid.,
[161] B. Semkow, 'Japan's 1992 "Big Bang" and other Financial Reform' (1992) 7 3 *Journal of International Banking Law* 89; Petkovic (n 164) 395.
[162] Haines (n 150) 337.
[163] Dale (n 146) 140.
[164] Ibid .

6.5 Germany

Germany has long had a universal banking system.[165] Institutions have faced few restrictions on the blending of commercial banking and securities activities.[166] The only exception is an institutional separation between banking and insurance, which can be circumvented, usually through *Allfinanz* financial holding companies.[167]

There is an extensive network of relationships between large banks and large companies, where universal banks mainly control the ownership and management of German companies.[168] German *hausbanks* perform a function similar to that of the Japanese banks in a *keiretsu*: while several banks may hold shares in a company, only one bank will be the *hausbank*, which acts as shareholder and leads a large part of the companies' financial operations.[169] Although the importance of the *hausbank* has started to diminish (particularly for larger companies), it still retains an important role.[170]

The presence of banks in equity or debt financing of companies, or through directors, or company's supervisory boards, is much more significant than in Anglo-Saxon countries.[171] Banks benefit from economies of scale in information collection, company monitoring, and supervision; yet, financing costs for a company that has bank representatives on its supervisory boards may be lower.[172]

Control is effectively held by the major German banks; this is because they provide the country's stockbrokerage services, and shares in German corporations are generally deposited by their owners with the banks, which can vote in relation to the shares on behalf of their owners.[173] Thus, the German proxy voting system produces a functional analogue to the Japanese *keiretsu*.[174]

6.6 EU Legislation

As from 1992, a set of banking Directives were implemented in order to remove any impediments to financial innovation, while simultaneously seek the exploitation of economic advantages which stem from economic integration and globalisation.[175] In light of international deregulation, upon harmonising legislation and providing for cross-border provision

[165] Canals (n 12) 178.
[166] Hagendorff (n 87) 206.
[167] Hagendorff (n 87) 206; Benston (n 2) 121.
[168] Canals (n 12) 161, 178.
[169] Ibid., 168.
[170] Germany Trade & Invest, 'Debt Financing', (2011).
[171] Canals (n 12) 178.
[172] Ibid.
[173] Coffee (n 98) 1303.
[174] Ibid.
[175] T. Pantos and others, 'The Greek Three-Pillar Functional System in the Presence of the European Union Banking Directives' (2005) 13 2 *Journal of Financial Regulation and Compliance* 169.

of banking services, the Second Banking Directive (eventually replaced by the Credit Institutions Directive) adopted the universal banking model, which followed the Continental system (which excludes insurance, though banks can have insurance subsidiaries).[176]

The abovementioned Directive led to a large number of cross-border mergers and acquisitions, creating large complex financial conglomerates.[177] Due to the possibility of providing cross-border banking services, continental universal banks could carry out universal banking activities throughout the EU within a single corporate structure, while being subject to a single regime of financial regulations applied by its home country.[178]

Despite supposed harmonisation, in 2009 de Larosière reported excessive diversity in EU banking supervision; although some countries have an extended definition of 'credit institutions', others have maintained a much more limited approach.[179] It also noted that particular attention needs to be given to institutions which engage in proprietary trading.[180]

7. Analysis

7.1 Universal Banking in Anglo-Saxon and Continental Systems Compared

This study argues that there are two fundamental differences between Anglo-Saxon and Continental systems.

The first difference relates to the banking culture within particular jurisdictions. The Continental model of bank financing owes much to the development of the *hausbank* in Germany and the *keiretsu* in Japan. These methods pushed the idea of having finance raised internally, through the idea of a 'common market', with the bank having its shareholders as its primary customers. During the American occupation, the separation imposed in Japan did not work due to the strength of this system. Banks using the Continental model are based upon a system which is intrinsically focused upon universal banking; however, this has traditionally been limited to the closed circle of customers and shareholders of the bank which all fall within the same pool. This differs fundamentally from universal banking within Anglo-Saxon jurisdictions; since shareholders and bank customers are different persons, banks have mainly focused their attention on shareholder returns (and executive pay), rather than caring also for the long-term development of their customers.

The second difference refers to the development of the capital markets. Capital markets are mostly developed in Anglo-Saxon jurisdictions. However, while Continental systems have long provided functioning universal banking models, Anglo-Saxon jurisdictions have provided leading universal banks which were able of expanding their operations very quickly during economic booms, yet these were the first to fall during economic recession, mirroring the developments which capital markets were facing at the time. The author argues that this is also influenced by the difference between the fluid capital system and the committed capital system seen above. Since in the former model, universal banks (as shareholders) tend to be temporary shareholders, they devote much less interest to companies being financed. As Coffee has pointed out, these shareholders prefer 'exit' to 'voice', and they look at the capital markets as a means to express this 'exit', rather than care for the longer term of the companies they own (as shareholders).[181]

It is perhaps unsurprising that authors have been influenced by the specific time of writing, with most arguments against universal banking being brought after the Great Depression and post the 2008 financial crisis, while most arguments in favour of universal banking were brought in the late 1920s as well as in the 1980s and 1990s. Notwithstanding that most arguments made are logical, despite reaching different outcomes, the author is of the view that authors such as Benston have been flawed when assuming that the German universal banking system will work identically well in Anglo-Saxon jurisdictions. Unfortunately, the differences identified here have been sidelined and ignored by academics, citing the German example as a system which could easily be adopted, without considering the differences which lie at the basis of the different systems.

7.2 A Comment on the Banking Reform

The main systems of banking reform considered in both the US and the UK were a return to Glass-Steagall separation, the Volcker Rule, Narrow Banking, and a half-way structure of Retail Ring-Fencing.

A full Glass-Steagall type separation has been quickly discounted by both the US and the UK as being too complicated and costly to implement. This system has proven unable to withstand financial innovation and the will of the industry to eventually move towards universal banking. Nevertheless, history has proven this system to be successful and safe, as long as it was properly implemented.

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176 Second Council Directive 89/646/EEC on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions [1989] OJ L386; Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions [2006] OJ L177; Avgouleas (n 12) 14-15; Lannoo (n 19) 99; Cranston (n 1) 100; Dassesse (n 105) 389.

177 Avgouleas (n 12) 15.

178 Dassesse (n 105) 389; Cranston (n 1) 100.

179 J. de Larosière, 'Report', *The High-Level Group on Financial Supervision in the EU* (Brussels, February 2009) 28.

180 Ibid., 24.

181 Coffee (n 98).

The Volcker Rule has been considered by the US as being the best compromise to achieve limitations on most of the causes of the problems which banks have faced, leading up to the global financial crisis. In the author's view however, the Volcker Rule may eventually still remain subject to the problems which Glass-Steagall separation faced. As to the limits set out in the Dodd-Frank Act, it is still too early to comment on their robustness—they still need to stand the test of time, and there remains no guarantee that financial innovation will still not find ways and means around the limits imposed.

In the author's view, Narrow Banking is very interesting, academically, but is likely to have its own limitations in practice. Banking has been considered as necessary for the creation of liquidity through financial intermediation, either through debt or equity financing. Investing all retail deposits in government bonds would mean that banks would not be able to lend money to consumers of financial services, while governments will need to issue a disproportionate amount of bonds which will also make it difficult to administer and provide any returns for. Furthermore, such a system would probably lead to investors investing directly in government bonds, rather than bother putting their money in retail deposits.

With regard to Retail Ring-Fencing, the author commends the fact that the proposed system attempts to eliminate the problems faced by universal banking while seeking to preserve its benefits. This structure should therefore do away with universal banks' belief that they are too-big-to-fail, relying upon implicit government guarantees.

However, the author is inclined to criticise the policy adopted by primarily looking at the costs needed for a change to take place, rather than considering the safety of new systems. The current system has unfortunately brought about drastic crises. As a consequence, it is the author's view that drastic changes are needed. Patching up the current system may not be good enough in the long-term. If changes are simply seen as temporary, then the author would adhere to the 'cost' argument. On the other hand, if changes are made with a view to keeping eternal stability in the financial sphere, it may be worth having a one-time drastic and costly change if this leads to a much safer system for years to come.

The author sees Retail Ring-Fencing as providing a solution to jurisdictions which prefer to play the 'universal banking game'. Nevertheless, in light of the above, the author argues that universal banking primarily has proved to function in Continental systems rather than Anglo-Saxon systems. Having a strict separation between retail and investment banking, while encouraging the continuance of a principles-based approach to regulation, which would promote this end, would ensure that bank deposits remain safe from speculation and proprietary trading. This would also keep banks from failing, rather than merely introducing mechanisms for banks to fail safely.

A strict separation may also encourage reconsideration as to the applicability of capital adequacy rules and the classification and activities of investment banks generally.

7.3 Capital Adequacy Rules

Despite the importance of the Basel requirements in banking, the author argues that should there be a split between retail and investment banking, the application of the Basel requirements to investment banks should be reviewed. Currently, both investment banks and investment firms are subject to capital adequacy requirements. However, originally the Capital Adequacy Directive was mandated on non-bank securities firms out of fear that universal banks would be at a competitive disadvantage, and therefore sought to impose a level playing field.[182]

The ICB has hinted that if retail banks are ring-fenced it would favour less capital requirements, as long as banks can fail without affecting the taxpayer.[183] Furthermore, in putting forward the narrow banking model Kay is of the view that financial entities which provide commercial lending and proprietary trading do not need to be subject to capital and liquidity regulations.[184]

While the Basel requirements require banks to save for future losses, as well as being required to keep sufficient liquidity at hand, specialised investment banking would be immune to such systems and would not harvest systemic risks as universal banks do. Investment banks would not be obliged to return the amount invested back to the clients - being merely investors as opposed to depositors - if investments were to go wrong.

One must look at investment banks' risks in a twofold manner. In one regard, banks' risks are diminished; if an investment bank is an intermediary between an investor and a company seeking investors, the bank would not be incurring any risks, since risks would be passed on directly to the investor. In such a case, the bank would be in the ideal position of collecting fees upon intermediation and possibly administration of funds however the ultimate risk upon the investment would lie with investors.

On the other hand, investment banks engage in proprietary trading, providing Equity Financing to companies in need from their own funds. This increases banks' risks drastically. Nevertheless, only the investment banks' own funds are at risk here, rather than depositors' funds. Investment banks will therefore have to carry out their own risk analysis and

[182] Cranston (n 1) 101.
[183] The Economist Online, 'Vickers in a Twist' (2011) available on: <http://www.economist.com/blogs/newsbook/2011/01/banks_after_crisis> accessed August 2012; Independent Commission on Banking (n 3) 8.
[184] FSA (n 118) 23.

ensure that they are trading within reasonable parameters. The breakdown between retail and investment banks would therefore result in investment banks not being 'too-big-to-fail'.

Although investment banks remain more likely to make super profits during good times (mainly due to their dependence upon capital markets) and are more likely to suffer in bad times, depending largely upon pro-cyclical effects, customers would share the same fate as the bank. This would however also mean that the investment bank would have fewer obligations towards its customers.

In light of the above, the author argues that capital adequacy requirements should not be imposed upon investment banks which do not participate in retail or commercial banking activities.

7.4 Investment Banks classified as 'Investment Firms'

Investment banks, divorced from commercial banks, would have a much more defined role to play and would mainly deal with securities and capital markets rather than with 'capital guaranteed deposits'. This therefore leads to assess the regulatory implications as to how specialised investment banks should be regulated.

The author argues that, in light of the reduced activities which specialised investment banks would undertake, they should fall to be classified as 'investment firms' under securities regulation, and be regulated as such, rather than as 'banks' or 'credit institutions' under banking laws. Similar arguments were made upon the introduction of the bonus tax in the UK, where entities such as Rothschild and Lazard claimed that they were not technically banks due to the limited activities they carried out.[185]

Credit institutions are defined in Article 1 of the EC Directive 2000/12/EC as undertakings 'whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account'.[186] Receiving deposits or other repayable funds from the public is the main distinguishing factor between a specialised retail (or commercial) bank and a specialised investment bank. Money given to investment banks to be invested into securities is not a 'repayable fund' since there is no 'capital guarantee' requirement. Currently most entities providing investment banking activities are still considered as 'banks' in light of the fact that they are currently more akin to universal banks rather than specialised investment banks.

On the other hand, 'investment firms' are defined in Article 4 of Directive 2004/39/EC (the Markets in Financial Instruments Directive) as:

any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis.[187]

In turn, both the 'investment services and activities', as well as the 'financial instruments' outlined in Sections A and C respectively of Annex I of the same Directive encompass matters which pertain to functions of investment banks.[188]

7.5 Depositor Guarantee Schemes

Canals raises the question as to whether deposit insurance should extend to activities performed by banks that are not directly related to traditional banking activity.[189] He states that prudence in bank supervision seems to advise that deposit insurance should only cover those activities that are strictly related to traditional commercial banking.[190] Avgouleas also hints at the idea of there being no deposit insurance for investment banks which do not accept deposits.[191]

Retail and commercial banks are fundamental to economies since they hold deposits of both households as well as businesses. They therefore tend to concern the public at large in light of the duties they owe to the general public and the systemic risks they pose.

One of the main reasons arguing for a split between retail and investment banking has been that universal banks use depositors' funds, collected from the retail side of the bank, for their investment banking activities and purposes. Therefore, separating the two would mean that the retail arm and the investment arm would operate completely separately from each other, with funds also being kept separately.

The author therefore argues that a natural consequence of investment banking being separated from retail banking is that depositor guarantee schemes, as regulated by Directive 94/19/EC would not be applicable to investment banks. Article 1 of the Directive on deposit-guarantee schemes, clearly refers to 'deposits' as: any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable,

[185] L. Armitstead and P. Aldrick, 'Pre-Budget Report: Bankers May Evade Alistair Darling's Bonus Tax' (December 2009) <http://www.telegraph.co.uk/finance/budget/ 6783027/Pre-Budget-report-Bankers-may-evade-Alistair-Darlings-bonus-tax.html> accessed August 2012.

[186] Directive 2000/12/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions [2000] OJ L126 art 1.

[187] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments [2004] OJ L145 art 4.

[188] Ibid., Annex I.

[189] Canals (n 12) 78-79.

[190] Ibid., 79.

[191] Avgouleas (n 12) 38-41.

and any debt evidenced by a certificate issued by a credit institution.[192]

Furthermore the European Commission Proposal COM(2010)368 final shall also further specify (while amending slightly the aforementioned definition) that an instrument shall not be a deposit if its principal is not repayable at par, or if its principal is only repayable at par under a particular guarantee provided by a credit institution or third party.[193]

This definition clearly refers to the activities entered into by retail and commercial banks, rather than investment banks. Since specialised investment banks do not have any depositors to whom they need to respond, it follows that they should not be subject to Depositor Guarantee Schemes.

Though certain 'investment-linked' products provided by investment banks may still be referred to as 'deposits' in the industry, they should still not be subject to the depositor guarantee scheme since they are not 'capital-guaranteed deposits'. They should, however, be subject to the more limited scope of the investor compensation scheme.

8. Concluding Remarks

This study argues that authors such as Benston were wrong in adopting a one-size-fits-all approach. Anglo-Saxon jurisdictions have different legal traditions from Continental jurisdictions, and both the banking system and culture and the strength of the capital markets are fundamentally different. Both the fluid capital system and the committed capital system give rise to a chain reaction as to the importance of capital markets, the way in which shareholders look at companies, and the influence which shareholders seek to have on companies they are involved in. Therefore, while universal banking has solid grounds in Continental systems, it has lead to vast problems in Anglo-Saxon systems.

In light of the above, reforming universal banking models in Anglo-Saxon jurisdictions is critical. Both the US and the UK identified the comingling of deposits with securities activities as having caused systemic risks leading up to the global financial crisis. Thus, reform in this area is commended. Both the Volcker Rule as well as Retail Ring-Fencing are steps in the right direction, though the regulation being introduced tries to enter into a very fine balancing act between securing depositors' funds, reducing systemic risks, entering into reform at minimum costs, while keeping the industry happy.

Nevertheless, the author argues that outright separation should not have been discounted so easily, and that a Glass-Steagall-type separation should further prompt a rethink of other regulatory matters applicable to specialised investment banks. A case is therefore made for specialised investment banks to be classified as 'investment firms', without being subject to capital adequacy requirements. Furthermore, since specialised investment banks would not hold deposits, they would not be subject to depositor guarantee schemes, but rather to the more limited investor protection schemes.

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192 Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes [1994] OJ L135 art 1.

193 Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes [2010] COM/2010/0368 final.