The grass may not be greener: Commercial banks and investment banking

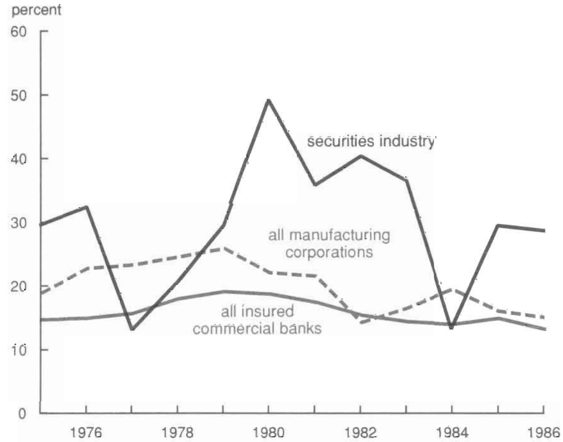
Betsy Dale

As profitability in traditional commercial banking services has increasingly come under pressure, some banks have attempted to bolster shrinking profits by expanding into fee-intensive activities, many of which have been dominated by the securities industry since the 1930s. Persistently higher overall earnings in this industry relative to others have led to a widespread perception that at least certain parts of the securities business are substantially more profitable than commercial banking.[1] (See Figure 1.) Consequently, some commercial banks have increased their permissible securities operations and they have escalated their efforts to chip away at the legislative and regulatory barriers that currently prohibit them from engaging in a broader range of securities activities.

The securities activities of commercial banks are principally governed by the Banking Act of 1933 (or Glass-Steagall Act) and the Bank Holding Company Act of 1956. These laws imposed limitations on bank and bank holding company participation in many securities activities and prohibited others completely. But, through a succession of regulatory rulings and court decisions over the years, banking firms have won approval to engage in many previously restricted activities. (See Table 1.) Commercial banking organizations are now able to participate in securities activities that generate more than half of the gross revenues of all securities firms and may underwrite securities of types that account for at least 80 percent of the dollar value of all new issues.[2] Some of the investment banking activities of commercial banks, however, still have restrictions and limitations placed on them that do not apply to investment banks. As a result, this hinders the ability of commercial banking firms to compete successfully with investment banks.

This article examines the success of commercial banks in providing permissible investment banking services and analyzes the profit potential for recently approved and currently proscribed activities.[3] At this time, commercial

Figure 1
Profitability comparisons*



*Net income before taxes as a percent of average equity capital.

banks seem to have done well in areas where they are permitted to compete, but still do not enjoy the market shares that investment banks command. However, banks' experience with new underwriting powers is too recent to make a fair judgement regarding their future success, but immediate profitability in these areas does not look too promising. As for commercial bank entry into currently impermissible areas, significant barriers will remain even if legal prohibitions are removed. These barriers may make it difficult for many banks to break successfully into these markets and may delay their profitability for several years while they gain expertise and build market share.

Permissible activities

During the 1980s, an increase in nonbank competition for certain types of lending services and a booming securities market, which en-

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Table 1
Selected permissible domestic commerical bank securities activities*
(August 1988)

	Year started**
Underwriting, distributing, and dealing	
U.S. Treasury securities	Always
U.S. federal agency securities	Various years
Commercial paper (third party)	1988
Mortgage and consumer paper-backed securities	1988
Municipal securities	
General obligation	Nearly always
Some revenue bonds	1968
All revenue bonds	1988
Private placement (agency capacity)	Always
Mergers and acquisitions	Always
Offshore dealing in Eurodollar securities	Always
Brokerage	
Limited customer	Always
Public retail (discount)	1982
Securities swapping	Always
Financial and precious metal futures brokerage and dealing	1983†
Financial advising and managing	
Closed-end funds	1974
Mutual funds	1974
Restricted	Always
Research advice to investors	
Separate from brokerage	1983
Combined with brokerage	
Institutional	1986
Retail	1987

*Federal Reserve member banks or bank holding company affiliates.

**After the Civil War. Different dates may apply to national and state banks and among state banks. With some exceptions, the earliest date is shown. Regulatory rulings frequently concluded that a specific activity was permissible before the date of ruling. If the activity was halted by enactment of the Glass-Steagall Act, the date of renewed activity is given.

†Restricted to futures contracts for which banks may hold the underlying security or that are settled only in cash.

SOURCE: Updated from George G. Kaufman and Larry R. Mote, "Securities Activities of Commercial Banks: The Current Economic and Legal Environment," *Staff Memoranda*, Federal Reserve Bank of Chicago, 88-4 (1988).

couraged corporate borrowers to raise funds directly through capital markets, narrowed spreads on traditional commercial banking services. Rather than lose valued clients, banks found ways to unbundle their lending activities and to play a role in their customers' direct financings in the capital markets. In addition to providing off-balance-sheet guarantees and selling loans, U.S. commercial banks have been aggressively expanding the operations of the securities activities in which they are permitted to engage. Such activities include brokerage services, advice on mergers and acquisitions, private placement of securities, underwriting general obligation bonds of states and municipalities, and investment banking activities abroad. The lure of hefty fees and commissions has prompted new interest in these activities which, though they have long been open to banks, were considered incidental to their primary services.

These activities not only offer attractive fees, but are also logical areas for bank expansion. Banks already have close contacts with a large base of business and municipal customers to whom they have provided credit and other services over the years, putting them in a favorable position to expand the scope of services they offer to an existing client base. Moreover, banks have engaged in these activities to some extent for many years and already have a degree of expertise. Until recently, however, banks played only a minor role in these nonbanking areas and active expansion came only after banks recognized the need to develop sources of noninterest income to augment declining revenues from both domestic and international lending.

Overall, commercial banks have made significant strides in most securities activities in which they are competing directly. It has been estimated that in 1986 commercial banks had a composite market share of 10 to 30 percent in such activities.[4] Nevertheless, most banks are still only minor players whose market shares are dwarfed by Wall Street firms. (See Table 2.) Aside from the fact that commercial banks have been aggressive competitors in these areas for only a few years, a number of other reasons can explain their current competitive position.

Municipals

In the tax-exempt market, for example, a number of factors came into play that diminished both the opportunities and the profitability in this area. Over the years, banks have been active participants in underwriting municipal bonds despite the fact that they have been excluded from a large segment of this market. Commercial banks may underwrite general obligation (GO) bonds, which are backed by the full credit and taxing power of the issuing municipality, but until very recently have been prohibited from underwriting most kinds of municipal revenue bonds.[5] Banks' market share of the municipal GO market averaged 60 percent in the early 1970s, but de-

Table 2
Comparative market shares
1987

	Top 10 commercial banks		Top 10 investment banks	
	$volume	deals	$volume	deals
	(--------------percent--------------)			
Municipal underwriting	9.5	5.4	54.0	22.3
GO bonds	20.3	8.7	41.2	13.1
Revenue bonds	5(e)	3(e)	60.2	30.7
Private placements*	25.3	30.0	61.5	58.1
Mergers & acquisitions**	4.0	4.5	77.3	30.1
Eurobond underwriting	6(e)	n.a.	19(e)	n.a.

*Market shares of 8 top commercial and investment banks.
**Figures are approximations reflecting an adjustment for multiple credits on advisory assignments.
n.a.—Not available.
(e)—Estimate.

NOTE: Commercial and investment banks that rank among the top 10 are not necessarily the same in each activity.

SOURCE: IDD Information Services; IDD Information Services/PSA Municipal Database; and author's estimate.

clined fairly steadily in the early 1980s to about 27 percent in 1984.[6]

While many large and medium-size banks have been attempting to strengthen public finance operations during the last 10 years, some investment banks, flush with profits from the bull market of recent years, began aggressively entering this market as a means of diversifying. Profitability soon came under pressure because some investment banks viewed their activities in this market as a loss leader. Valuing relationship-building more than profits, investment bankers were willing to cut margins very thin.[7] Further compounding this situation was a change in the tax law in 1986, which reduced the attractiveness of municipal securities and contributed to a dramatic decline in the volume of new issues.[8] (See Figure 2.) The intense competition created by an increasing number of players competing for a declining volume of business narrowed spreads and reduced profitability to the point where some commercial and investment banks pulled out of the tax-exempt market.

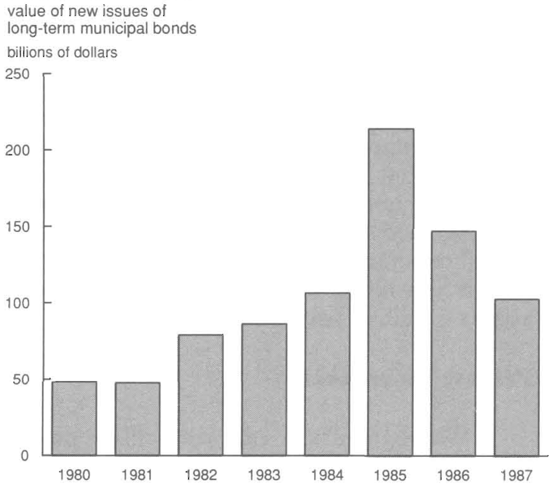
As banks scramble for a bigger slice of a shrinking pie, investment banking firms have increasingly gone after smaller regional issues that they would not have bothered with a few years ago. In the past, these issues were handled largely by commercial banks, but banks have found it difficult to compete effectively with the superior capital base, proven expertise, and distribution capabilities of some Wall Street firms now bidding for these deals. Banks are recognized leaders in the distribution of municipal bonds and are frequently included in networks managed by others, but to increase market share they must not only work to retain existing relationships with local government borrowers, but also convince a broader group of issuers of their underwriting capabilities. One thing holding them back is the shortage of recognized talent in the field, together with banks' reluctance to change a corporate culture that is unwilling to pay salaries adequate to attract qualified personnel.[9]

Private placements

While there are still restrictions on the kinds of public underwriting banks may engage in, banks may privately underwrite virtually all types of securities. These transactions involve placing an entire issue with a limited number of large investors rather than through a public offering.[10] In the past, many banks viewed such placements as a consolation prize for failing to win a corporation's loan business and neither welcomed nor solicited such business. From 1975 to 1984, banks' market share of all placements was between 4 and 9 percent.[11] More recently, banks have been attracted by the fee income generated by such services, usually based on a percentage of the offering price. By 1986, their overall market share of traditional deals involving debt securities had increased to an estimated 26 percent.[12]

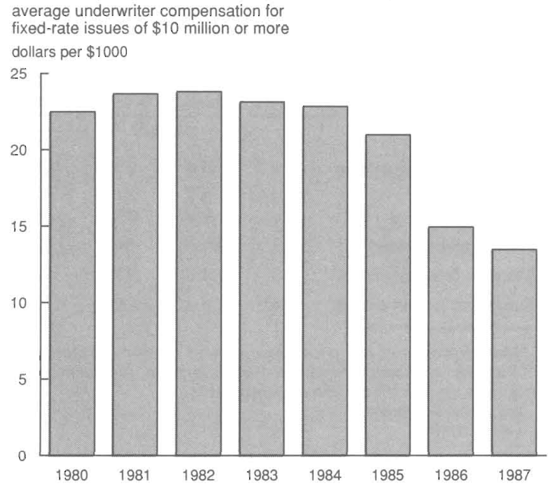
Despite these recent gains, the private placement market continues to be dominated by the large Wall Street firms. In 1987, the eight largest commercial bank competitors placed $34 billion of the dollar value of securities placed by all firms. By contrast, the top eight securities firms completed deals worth $83 billion, more than twice the value of placements completed by the top banks. Banks have made their greatest strides in placing "plain vanilla" deals requiring only a small group of investors. But, because banks' network of contacts with professional investors is still less extensive than that of their Wall Street rivals, their ability to compete is impaired when wider distribution outlets are needed. Industry experts also say that commercial banks have yet to take full advantage of their contacts with corporate borrowers because of poor coordi-

Figure 2
The municipal bond market
Volume of new issues has declined . . .



SOURCE: *Federal Reserve Bulletin.*

. . . and underwriting has become less profitable



SOURCE: *Wall Street Journal* and Securities Data Co.

nation between their commercial loan operations and capital markets groups.[13]

Mergers and acquisitions

Although some commercial banks have made impressive strides in offering merger and acquisition advisory services, even the largest bank merger operations continue to be overshadowed by Wall Street firms in the business.[14] Bankers Trust, for example, was the top ranked commercial bank advisor in 1987, completing 42 deals worth $6.2 billion. By contrast, the top investment bank advisor (Goldman Sachs) completed 134 deals worth a total of $63.5 billion.[15] While this provides a good indication of the distance between the most successful commercial and investment bank advisors, the measurement of overall market shares is more difficult. Many deals, especially large ones, have a number of advisors on both the acquirer and target sides, and available data on rankings gives full credit to each advisor on the deal. Nevertheless, by this measure commercial banks were advisors in only 7.4 percent of the $216.7 billion volume completed in 1987, while the top four investment bank advisors were involved in 90 percent.[16] Based on these figures, it is clear that banks are included in only a small portion of advisory assignments, so far.

Aside from the relatively recent entry of banks as active participants in this arena, several factors prevented them from being among the top players. Once again, banks' progress has been slowed by their inability or unwillingness to offer compensation adequate to attract top deal makers. Another factor is that banks have usually backed away from deals involving hostile takeovers of longtime clients that might jeopardize lending relationships.[17] Banks are generally more active in friendly deals, which tend to be at the low end of the market in transaction size.

Perhaps the most significant factor, however, is the Glass-Steagall restrictions. Underwriting and dealing in corporate securities are fundamental to many merger strategies. The fact that commercial banks are prohibited from engaging in these activities has limited their access to and experience with trading markets. While banks are developing knowledge and skill in these markets, they will have to overcome the perception that they lack adequate expertise to accurately gauge markets and provide sound advice in structuring a deal.

Overseas activities

Glass-Steagall prohibitions do not apply to the activities of U.S. banks in the Euromarket, and many of the nation's largest commercial banks have operated offshore outlets there for years. Until a few years ago, however, their dominance in the market for international syndicated loans kept their primary focus on traditional lending services. In the early 1980s, the percent of capital raised in international markets by such loans fell dramatically while the share of capital raised by bond issues rose sharply.[18] This massive shift in market preference for funding vehicles prompted an attempt by banks to offset lost interest income with fees from underwriting and trading in Eurobonds and from currency and interest rate swaps. Banks' success in these areas is far from uniform.

So far, the role of U.S. banks in underwriting international bonds remains quite small. In 1986, they were estimated to have only 10 percent of this market.[19] One reason for this poor showing is the degree of competition to participate in new Eurobond issues. Many houses fiercely compete not only for the role of lead manager but also for a position on tombstones. Furthermore, aggressive bidding for new issues has led to mispricing and low profit margins.[20]

The intensity of this competition has made breaking into the ranks of top managers, or even being included in distribution syndicates, particularly difficult.[21] Subsidiaries of U.S. banks are also disadvantaged by their relatively short track record in this area. Even U.S. investment banks, which have used their domestic freedom to develop both expertise and customer relationships in offshore markets, have to fight for prominence among their European and, increasingly, Japanese peers.[22] Thus, the small Eurobond market share captured by U.S. banks may be explained partly by a reluctance of some to expend a great deal of effort in a market where the competition is stiff and the profits are slim.

Although they have enjoyed little success in Eurobond underwriting, U.S. banks have found other international securities activities more rewarding. In fact, some banks that maintain a presence in this market have more interest in secondary market trading than in managing new issues.[23] An increasing proportion of international bond issues are driven by currency and interest rate swaps, and commercial banks are the clearly dominant participants in this area. In 1986, U.S. banks accounted for 70 percent of the activity in foreign exchange markets, and five money center banks alone generated over $1 billion in foreign exchange trading income that year.[24]

New underwriting powers

In 1987, rulings by two regulatory agencies granted banks certain additional securities underwriting powers. Banks were not immediately able to launch into these new areas, however, as there was considerable uncertainty as to whether the courts and Congress would allow these decisions to stand.

The first of these decisions was by the Federal Reserve, which ruled in April that commercial banks could underwrite commercial paper, municipal revenue bonds (MRBs), and mortgage-backed securities (MBSs).[25] The activities were to be conducted through nonbank subsidiaries and limitations were imposed on the extent to which banks could engage in these new areas. In July, the Fed also approved underwriting of securities backed by consumer receivables (CRBs).[26] But, after a suit filed by the Securities Industry Association (SIA) challenging the Fed's initial ruling resulted in a stay on the new powers being imposed by the courts, the Fed stayed the effect of their approval to underwrite CRBs as well. Even without this suit, however, implementation would have been delayed. Congress imposed a moratorium beginning in March which prohibited all federal banking agencies from granting any new nonbanking powers for one year. The moratorium was designed to halt bank entry into new areas until the Congress could consider the issues further.[27]

The second ruling came in June when the Office of the Comptroller of the Currency issued its opinion that national banks could underwrite and deal in MBSs and CRBs directly, without limitations on the extent of involvement in such activities and without segregating them in a nonbank subsidiary.[28] This position was expressed in a letter to Security Pacific supporting its bid to sell mortgage pass-through securities under this interpretation. Security Pacific's issuance and underwriting of a major portion of that issue became the subject of another suit by the SIA.[29]

However, even while the congressional moratorium was in effect and challenges to the legality of these powers were still before the courts, several large banks began to participate in the underwriting of issues they brought to market. Marine Midland Bank co-managed a $600 million issue backed by auto loans in June[30] and Citibank helped underwrite $150.1

million of mortgage-backed securities in September.[31] In April 1988, Chemical Bank went furthest in testing the limits of Glass-Steagall when it became the first bank to lead-manage a $257.4 million issue backed by its own auto loans.[32] Others expressed interest in lead-managing their own receivables deals, but were hesitant to do so until they had a clear go-ahead from regulators.

At this writing, the legal status of these underwriting powers is only partially resolved. The congressional moratorium ended without any legislative action on this issue, so the ban on further regulatory approvals was lifted. The Fed's ruling was allowed to stand when, in June 1988, the Supreme Court refused to review a lower court's decision upholding Fed approval of these activities.[33] This cleared the way for the twelve large banking companies thus far granted authority to begin exercising the new powers.[34] The issue of whether national banks can underwrite asset-backed securities directly is still pending before the court. So, while some banks continue to gingerly test the waters under the Comptroller's ruling, most have chosen to remain inactive until the legality of the new powers is clarified.

Meanwhile, commercial banks have gained considerable experience in privately placing asset-backed securities. In 1987, eight commercial banks or subsidiaries of BHCs privately placed 136 issues (32 percent of the market), valued at $7.9 billion. Three commercial banks ranked among the top 10 firms to privately place asset-backed securities.[35]

Small spreads

Unfortunately, spreads on these new underwriting instruments appear small, and anecdotal evidence on the profitability of underwriting these securities is not encouraging. In fact, profits from underwriting commercial paper, mortgage-backed securities and municipal revenue bonds were so slim that a number of commercial and investment banking firms have scaled back operations or pulled out of these markets. Salomon Brothers, the nation's leading underwriter, created a stir in the market when it announced in October 1987 that it was dismantling its commercial paper operations and closing its 200-person municipal finance department.[36] But soon afterward, other firms announced they were also exiting the public finance business in whole or in part, and several others announced plans to trim commercial paper operations.

The commercial paper market is generally not a high-margin business, and spreads have narrowed as a result of increased competition. Underwriting margins on new municipal revenue bonds, suffering the pressures of the tax-exempt market noted above, are half what was common a few years ago,[37] although spreads may improve somewhat as players exit the market. The spreads for underwriting mortgage-backed pass-through type securities have declined as this market has matured and the deals have become standardized.

As for underwriting securities backed by consumer loans, investment bankers are reporting only meager profits so far and do not expect them to increase until deals in this fledgling market become more standardized. The structure of a deal depends in part on the character of the underlying assets. It is also affected by the objectives of the originator and the legal, regulatory, and accounting environment in which the issuer operates. Vehicles are being developed which allow issuers of asset-backed securities to make continuous offerings with a minimum of additional work, but packaging most deals is still very labor-intensive and costly. Fees tend to be thin because while most deals are similar, none are identical and they can take up to a year to complete.[38] Underwriting spreads appear to be lower on repeated transactions of a similar type by a particular issuer, and to be higher on first issues and rise with the complexity of the deal.

Implications for currently proscribed powers

Of all the securities activities currently prohibited for banks, perhaps the most coveted is the ability to underwrite corporate stocks and bonds. One reason for banks' eagerness to enter this area is that it appears to be highly profitable.[39] The ability to underwrite these securities could also assist banks in strengthening their foothold in other areas, such as mergers and acquisitions, and enable them to develop expertise that could enhance their competitive position abroad. But, while this activity appears attractive, the obstacles to successful entry are immense.

Underwriting involves three major functions: origination, underwriting, and distribution. Origination includes designing the issue in terms of the type and quantity of the security to be offered, pricing, timing, and other features. This function also often includes handling the paperwork and administration, or "managing the books," for the issue. Underwriting proper is a risk-bearing function, as the underwriter purchases the new securities and runs the risk of having to resell them at a lower price than was paid to the issuer. The distribution function is the actual resale of the acquired securities to the public. The origination function is usually performed by one lead firm, sometimes with a co-manager, and a group of other firms is brought in on the deal to spread the risk and help distribute the securities.

The most lucrative of these functions is being the lead manager of an issue. The benefits which accrue to this firm go beyond the extra fee earned by managers, which is usually 20 percent off the top of the gross spread.[40] Additionally, firms compete for this position because it adds to a firm's reputation and prestige, thereby enhancing the chances of acquiring the business of other issuers as well as the repeat business of existing clients. Moreover, the managing firm's ability to select the other firms that may participate in the distribution syndicate, as well as set the size of each firm's participation, is perceived as a form of market power.

Table 3
Concentration in corporate underwriting management
1987

	Dollar volume of issues managed by:*		
	Top 5	Top 10	Top 15
	(----------- percent ----------)		
All issues	63.5	86.3	92.7
Debt issues	68.2	91.3	96.8
Straight debt	68.7	91.7	97.0
Convertible debt	58.1	82.0	92.4
Mortgate-related debt	63.9	89.0	96.6
Asset-backed debt	95.7	99.9**	--
Equity issues	50.4	77.0	87.5
Common stock	46.4	72.5	84.3
Preferred stock	64.9	93.4	99.3
Initial public offering	49.3	69.2	81.7

*Full credit given to lead manager.
**Reflects the top 8 lead underwriters.

SOURCE: IDD Information Services, as reported in *Investment Dealers' Digest*, January 11, 1988.

Obstacles to banks

Breaking into the ranks of top managers would be a formidable task for banks because of the structure of this market and the barriers that limit entry. Underwriting management is highly concentrated in a small number of firms. (See Table 3.) This situation has persisted for years and is the result of many factors. Most corporations solicit public funds infrequently; the success of an issue can be critical to their future prospects, so they must select a managing underwriter carefully. Issuers place a high value on an investment bank's reputation, track record, personnel quality, and size. Expertise in the issuer's industry is especially important. As investment banking firms often specialize in certain industries, the number of houses with qualified personnel is limited. The result has been the relatively stable relationships of issuing firms with particular underwriters that have come to characterize this market.[41]

Although becoming one of the top managers would be very difficult, there could be avenues open for new bank entrants to acquire the necessary expertise that do not appear to be insurmountable. Leading underwriters cater mainly to the largest issuers, roughly the Fortune 1000.[42] Small and medium-sized firms are not large enough to attract the attention of large Wall Street firms, and rely on smaller regional broker-dealers who act as managing underwriters for local issuers. The number of regional firms that perform as managing underwriters is relatively small and banks might find that they could enter these more local markets with somewhat greater ease. Participation in these smaller issues could then aid banks in building a reputation for successful deals that could earn them the attention of larger corporations.

The requirements for entry into the cadre of top distribution syndicates are slightly less onerous, but not insignificant. The first requirement is adequate capitalization. Not only must firms have sufficient funds to commit to large blocks of securities before they are resold, but the SEC requires that underwriters also have net excess capital to cover 30 percent of the estimated value of the securities underwritten. In and of itself, this should not present a serious obstacle for quite a number of banking organizations, some of which are more highly capitalized than large investment banking firms. The resources needed to establish and operate an underwriting affiliate are likely to be quite high, however, and may eliminate smaller organizations as potential entrants. The greater risks associated with underwriting and dealing in corporate securities is likely to raise regulatory minimum capital requirements for banks that establish such operations. In addition, these nonbank operations would need to be adequately insulated from the banking activities of the organization, requiring additional capital to maintain separate personnel and organizational structures.

The second requirement is the need for extensive and proven capabilities to distribute securities quickly. The success of major players stems from their extensive retail outlets or networks of institutional investors who purchase large blocks of securities. Though banks have developed some distribution channels through participation in municipals and private placements, these activities do not bring them into contact with some of the major investor categories of corporate securities. This suggests that commercial bank distribution capabilities would need to be broadened and strengthened considerably before they could meet this requirement. Barriers to entry are further reinforced by the underwriters' desire for cooperative relationships in distribution syndicates, which leads them to rely repeatedly on the same group.

Rule 415

A Securities and Exchange Commission (SEC) rule that went into effect in March 1982 may have mixed implications for commercial bank participation in both managing and distributing certain corporate issues. Rule 415 enables corporations to register their securities with the SEC but leave them on the shelf for up to two years until the markets are advantageous. Use of this shelf registration rule has increased since implementation, and in 1987 accounted for 46 percent of the dollar value of publicly offered corporate securities.[43] One result has been that issuers have shown more willingness to shop around for underwriting firms to handle deals still on the shelf.[44] This has caused some weakening in longstanding client-firm relationships that could improve the chances for commercial bank entry.

Another aspect of this off-the-shelf underwriting does not augur as well for banks. Because securities are registered in advance, issues can be brought to market more quickly than in a traditional filing. The underwriter therefore has a shorter time to price the issue, scout for buyer interest, build a syndicate, or determine the accuracy of information disclosed by the issuer.[45] This accelerated processing has tended to lead to the use of smaller syndicates, more "internalized" (or nonsyndicated) deals, and more "bought deals" where the underwriter takes the whole issue. Managing such issues requires sufficient capitalization to carry large blocks of the new issue, in-house distribution capabilities, and personnel with appropriate expertise to price the issue and gauge the market quickly, all of which tend to favor the large investment banks.

The preceding discussion illustrates that, aside from the legal roadblocks to bank participation in corporate underwriting, there are a number of other obstacles as well. Time and considerable resources would be needed to build these operations. And, because it would be new terrain for banks, the relative level of expertise they could bring and the lack of a successful track record would put them at a considerable disadvantage, making it very difficult to make significant inroads. All of these factors imply that if legal prohibitions to bank entry into underwriting corporate securities were lifted, banks would not only need to have strong capitalization and trained personnel to enter this market but would also have the difficult task of luring clients away from firms with a 50-year head start both in establishing successful client-firm relationships and in building market share.

Impact of greater commercial bank penetration

It is difficult to project how deeply commercial banks will be able to penetrate into these new markets or how profitable nonbanking activities will be in the long run. It does appear, however, that bank expansion and profitability in these areas will be limited by two factors. First, given the huge startup costs, and in some instances the level of capitalization required, it is quite possible that only a handful of the nation's 14,000 commercial banks will be able to establish significant investment banking operations. Even in currently permissible activities, not all banks have the willingness or wherewithal to participate.[46] Small banks that do engage in these activities in their local market are unlikely to do so on a scale that would significantly affect the dominance of Wall Street firms. This implies that the number of new entrants that will be competing for market share with the major investment banks may be limited.[47]

Second, the legal ability to enter new nonbanking areas is no guarantee of profitability. The increased competition caused by commercial bank entry into currently proscribed activities can be expected to reduce spreads somewhat. Also, as banks gain experience and reputation, there could be more competitive pressure in areas where they currently operate, reducing these spreads further. Banks that commit substantial resources to building nonbank operations and survive the early lean years to achieve respectable market shares may not be rewarded with the hefty fees that previously prevailed.

Thus far, most commercial banks have had only limited success in their quest for noninterest income through nonbanking activities. However, investment banking divisions at large commercial banks have been in place for less than 10 years, and it is obvious that these banks already have some of the necessary ingredients to succeed. Banks that have developed a strong presence have done so in specific market niches, largely because they developed strategies that reflected their existing customer base and areas of expertise.

Despite these encouraging advances, most still report that expansion into these areas has contributed only marginally to profitability.[48] These banks have apparently been willing to forego immediate rewards and remain in the market for other reasons. Theirs is a longer-term strategy based on the hope that identification with investment banking products and a growing reputation will eventually lead to an increase in market share and thus provide leverage for entering into other areas.

Overall, though, bankers have discovered that what they thought were the greener pastures of high investment banking fees are not so easily attained. Profitability is not assured to those who enter and years of unprofitable operation may be required.

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[1] One reason for these higher returns is that some of the activities in which securities firms engage involve more risk than permissible commercial bank activities. Although the issue of risk is central to the controversy surrounding the wisdom of repealing or liberalizing prohibitions against increased bank participation in securities activities, it is beyond the scope of this article. See, for example, Elijah Brewer, III, Diana Fortier, and Christine Pavel, "Bank Risk From Nonbank Activities," *Economic Perspectives*, Federal Reserve Bank of Chicago, (July/August 1988), pp. 14-26 and John H. Boyd and Stanley L. Graham, "Risk, Regulation, and Bank Holding Company Expansion into Nonbanking," *Quarterly Review*, Federal Reserve Bank of Minneapolis, Vol. 10 (Spring 1986), pp. 2-17.

[2] George G. Kaufman and Larry R. Mote, "Securities Activities of Commerical Banks: The Current Economic and Legal Environment," Federal Reserve Bank of Chicago, *Staff Memoranda* 88-4 (1988), pp. 29-30.

[3] Throughout this article, "commercial bank" refers to banks as well as their nonbank affiliates.

[4] Jed Horowitz, "There's Life after Glass-Steagall for Wall Street, Report Says," *American Banker*, December 2, 1987, pp. 3, 8.

[5] Revenue bonds are issued to finance corporate undertakings such as the construction of health care, pollution control, and public power utilities. This type of issue is considered more risky because interest payments are tied to revenues from the projects they finance and are not backed by the governmental unit that issues them. Andrew Albert, "Bankers Trust First in Tax-Exempt Financing," *American Banker*, July 16, 1987, pp. 1, 11-12, 15. A few exceptions to this general prohibition were made in the late 1960s, permitting banks to underwrite issues for housing and higher education.

[6] *Recent Trends in Commercial Bank Profitability: A Staff Study*, Federal Reserve Bank of New York, 1987, p. 321.

[7] Andrea Bennett, "Regionals Expect to Fill Gap in Municipal Bonds," *American Banker*, December 23, 1987, pp. 1, 2, 14.

[8] The Tax Reform Act of 1986 ended the 80 percent tax deduction banks could take for the cost of buying and carrying municipal bonds and undercut the tax-exempt status of the bonds for some investors. Matthew Kreps, "Tax Act Pushes Banks to Cut Municipal Bond Holdings," *American Banker*, December 23, 1987, p. 16. See also Alexandra

From Cash Cow To a White Elephant," *American Banker*, December 4, 1987, pp. 1, 12.

[9] For a discussion of the compensation issue and other internal impediments banks must overcome, see Terese Kreuzer, "Can Banks Be Top Notch Investment Bankers?" *Bankers Monthly*, October 1987, pp. 43-50.

[10] The SEC does not require registration of securities involved in these private sales. In order to qualify for this exemption, however, the issue must meet certain criteria. Except for some smaller issues, no general solicitation of the public is allowed, and there are limitations on the number and sophistication of purchasers. Because disclosure laws do not apply, a private sale of unregistered securities is generally limited to investors who are capable of independent evaluation of the merits and risks of a prospective investment.

[11] *Recent Trends in Commercial Bank Profitability: A Staff Study, op. cit.*, p. 321.

[12] "There's Life after Glass-Steagall for Wall Street, Report Says," *op. cit.*, p. 3.

[13] Brad Rudin, "Investment Banks Retain Dominance," *Pensions and Investment Age*, October 5, 1987, pp. 17, 20.

[14] Andrew Albert, "Citibank Tops Bankers Trust as No. 1 in Mergers," *American Banker*, July 14, 1986, pp. 1, 19.

[15] Jed Horowitz, "Banks Garner Few Domestic Merger Deals," *American Banker*, April 7, 1988, pp. 1, 22-23.

[16] Phyllis Feinberg, "M&A Rankings Show Increased Concentration," *Investment Dealers' Digest*, January 25, 1988, pp. 44-47.

[17] In 1988, however, Morgan Guaranty advised F. Hoffmann-La Roche & Co. in an unsuccessful $4.2 billion bid for Sterling Drug Inc., a longtime client of Morgan. "Banks Garner Few Domestic Merger Deals," *op. cit.*, p. 23.

[18] From 1982 to 1986, the percent of international capital raised by syndicated bank loans fell from 55 percent to 13.5 percent. Over the same period, the share of capital raised by bond issues rose from about 42 to 65 percent. M. S. Mendelsohn, "US Banks Keep a Hand in International Bonds," *American Banker*, July 18, 1986, pp. 1, 15.

[19] "There's Life after Glass-Steagall for Wall Street, Report Says," *op. cit.*, p. 3.

[20] Richard M. Levich, "A View from the International Capital Markets" in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market*, edited by Ingo Walter (New York: John Wiley & Sons, 1985), p. 275.

[21] This is significant because in Eurobond underwriting, the returns are even more heavily skewed toward managers than in the domestic market. In a typical underwriting, the lead manager and co-manager (if any) will claim half the fees, the underwriting group would share about 38 percent of the fees, and the selling group would share the remaining 12 percent. *Ibid*, p. 275 (footnote 58), quoting from M. S. Mendelsohn, *Money on the Move*, (New York: McGraw-Hill, 1980, pp. 184-190).

[22] In 1987, only three U.S. investment banks were among the top 10 Eurobond bookrunners, and only seven were included among the top 50. Five Japanese firms ranked among the top 10 in 1987, up from only three in 1986. "Annual Financing Report," *Euromoney*, March 1988, pp. 4-6.

[23] "US Banks Keep a Hand in International Bonds," *op. cit.*, p. 15.

[24] "There's Life after Glass-Steagall for Wall Street, Report Says," *op. cit.*, p. 3.

[25] This ruling was in response to a series of applications filed by three large bank holding companies in 1987. The Fed held that underwriting and dealing in commercial paper, MRBs, and MBSs were permissible under the BHC Act and did not violate the Glass-Steagall Act as long as a subsidiaries' underwriting and dealing in such securities constituted no more than 5 percent of its total gross revenues and the subsidiary underwrote no more than 5 percent of the domestic market in such securities. See "Citicorp, J. P. Morgan & Co. Incorporated, and Bankers Trust New York Corporation," *Federal Reserve Bulletin*, Vol. 73 (June 1987), pp. 473-508.

[26] Although the bank holding companies included in the initial decision had also sought to underwrite securities backed by consumer loans, the Fed delayed approval until it could consider the issue further. Authorization to underwrite CRBs came in July, and was made subject to similar limitations. See "Chemical New York Corporation, The Chase Manhattan Corporation, Bankers Trust New York Corporation, Citicorp, Manufacturers Hanover Corporation, and Security Pacific Corporation," *Federal Reserve Bulletin*, Vol. 73 (September 1987), pp. 731-735.

[27] The moratorium was contained in the Competitive Equality Banking Act of 1987 (CEBA), and prohibited regulatory approval of any new securities, real estate, or insurance activities. CEBA was enacted in August, but the moratorium was imposed retroactively, to be in effect from March 6, 1987 to March 1, 1988.

[28] The Comptroller's decision was based, among other things, on a national bank's authority to sell its own or "any other lawfully acquired assets." Jed Horowitz, "Comptroller Approves Asset-Backed

Securities," *American Banker,* June 19, 1987, pp. 1, 14.

[29] The SIA had been pressing the Comptroller to issue a written opinion on recent deals of this kind so it would have a basis to bring a lawsuit against the regulator. *Ibid,* p. 1.

[30] "Marine Plays it Safe In Asset-Backed Offering," *Asset Sales Report,* November 16, 1987, pp. 1, 5. This issue came to market before the Comptroller's letter to Security Pacific.

[31] "Citibank Stretches the Limits," *Asset Sales Report,* October 19, 1987, p. 3.

[32] "Chemical Bank Offers First Deal," *Asset Sales Report,* April 25, 1988, p. 5.

[33] Robert Guenther, Robert E. Taylor, and Stephen Wermiel, "Supreme Court Backs Fed's Approval for Securities Underwriting by Banks," *Wall Street Journal,* June 14, 1988, pp. 3, 18.

[34] The twelve banks affected by this ruling are Bankers Trust, Chemical, Citicorp, Chase, Manufacturers Hanover, Morgan, Security Pacific, PNC Financial Corp., Marine Midland Banks Corp., First Interstate Bancorp., Bank of New England, and Bank of Montreal. *Ibid,* p. 18.

[35] "First Boston Tops Private Placements," *Asset Sales Report,* March 21, 1988, p. 5.

[36] "Salomon Sheds Low-Margin Businesses," *American Banker,* October 13, 1987, pp. 1, 23.

[37] Michael Quint, "Into the Breach," *United States Banker,* June 1988, pp. 12-13.

[38] See Janet Lewis, "The Asset-Backed Explosion," *Institutional Investor,* April 1988, pp. 191-195.

[39] Direct data on the profitability of investment banking services is difficult to obtain, but studies have suggested that there is a lack of competitive vigor in certain types of underwriting that enables investment banks to maintain spreads, and therefore profits, at levels that exceed the cost of providing such services and earning a reasonable rate of return for the level of risk involved. For a discussion and further references, see Thomas A. Pugel and Lawrence J. White, "An Analysis of the Competitive Effects of Allowing Commercial Bank Affiliates to Underwrite Corporate Securities" in *Deregulating Wall Street: Commercial Bank Penetration of the Corporate Securities Market,* edited by Ingo Walter (New York: John Wiley & Sons, 1985), pp. 93-139. See also Kaufman and Mote, *op. cit.,* pp. 22-23.

[40] The gross spread is the difference between the price the issuer receives for its securities and the price investors pay for them, usually expressed as a percentage of the gross proceeds of the issue.

[41] See Pugel and White, *op. cit.* pp. 100-112. The authors discuss studies by Hayes, et al. on corporate affiliations with investment banking houses. [Samuel L. Hayes III, A. Michael Spence, and David Van Praag Mark, *Competition in the Investment Banking Industry,* (Cambridge: Harvard University Press, 1983).] The results generally suggest that larger, high-quality clients tend to affiliate with leading firms.

[42] *Ibid,* p. 106.

[43] Based on data in SEC *Monthly Statistical Review,* August 1988, Vol. 47 No. 8, tables M-450 and M-465.

[44] Pugel and White, *op. cit.,* p. 116.

[45] The Securities Act of 1933 requires issuers to disclose information pertinent to the public's decision about whether to purchase a firm's securities. It also requires investment banks to ascertain whether the information is true and complete. The shortened processing time of issues brought to market under this rule leaves little time for this "due diligence." For this reason the SEC has limited the use of Rule 415 to larger, better known, publicly owned corporations. *Ibid,* p. 114.

[46] Indeed, where state regulators have granted more liberal securities powers for state chartered banks than are permitted for either federally chartered banks or bank holding companies, few banks seem to be taking advantage of the expanded powers. See Barbara A. Rehm, "State Banks Wary of Using New Powers," *American Banker,* April 11, 1988, pp. 1, 6.

[47] Of course, if Glass-Steagall restrictions were to be substantially eliminated, and with them the prohibition against bank affiliation with securities firms, major bank holding companies could "buy" rather than compete for market share by acquiring an existing securities firm.

[48] See Andrew Albert, "Why Banks Bother with Public Finance, and How the Big Three Are Succeeding," *American Banker,* July 16, 1988, pp. 1, 12, 14 and "US Banks Keep a Hand in International Bonds," *op. cit.*.

ECONOMIC PERSPECTIVES—Index for 1988

	Issue	Pages
Banking, credit, and finance		
Does regulation drive innovation?	Mar/Apr	3-15
Loan sales have little effect on bank risk	Mar/Apr	23-31
Daylight overdrafts: Rationale and risks	May/Jun	18-29
Banking 1987: A year of reckoning	Jul/Aug	3-13
Bank risk from nonbank activities	Jul/Aug	14-26
Financial services in the year 2000	Sep/Oct	13-15
The grass may not be greener: Commercial banks and investment banking	Nov/Dec	3-13
A note on the increase in noninsured commercial banks	Nov/Dec	16-20
Economic conditions		
Economic events of 1987—A chronology	Mar/Apr	17-22
Government spending and the "falling rate of profit"	May/Jun	11-17
Capital market imperfections and investment fluctuations	Sep/Oct	3-12
New directions for economic development—the banking industry	Sep/Oct	17-24
Money and monetary policy		
An interest rate-based indicator of monetary policy	Jan/Feb	3-14
Looking back: The use of interest rates in monetary policy	Jan/Feb	15-29
A policymakers' guide to economic forecasts	May/Jun	3-10
Real boats rock: Monetary policy and real business cycles	Nov/Dec	21-28