**01. Introduction to Investment Banking**

After going through this chapter, students will have knowledge of the following sub-topics:

1. Introduction

1.1 What is Investment Banking?

1.2 Features of Investment Banking

 1.3 Functions of Investment Bank / What do investment Banks do?

1.4 Types of Investment Banks

1.5 Investment Banking Activities

1.6 Evolution of Investment Banking

1.7 Evolution of American Investment Banks

1.8 Regulation of Industry Post1929

1.9 Birth of American Universal Banks

1.10 Emergence of Quantitative Finance

1.11 Deregulation of Financial Sector

1.12 Expansion of I-Banking Business

1.13 Formation of Financial Conglomerates and TBTF Institutions

1.14 Conglomerating of US Investment Banks

1.15 European Investment Banks

1.16 Investment Banking in UK

1.17 Spread of US Banks to Europe

1.18 Pure Investment Banks

1.19 US Investment Bank Crisis in2008

1.20 Gramm-Leach-Bliley Act in November 1999

1.21 History of Investment Banking

1.22 Controversy over Glass Steagall.

1.23 Mergers among Commercial Banks, Investment Banks & Insurance
 Companies

1.24 Scope of investment Banks

1. 25 Stakeholders in an Investment Bank

1.26 Pros & Cons

1.27 Capital Gearing and related issues

1.28 Problems on Capital Gearing

1.29 Trading on Equity

1.30 Assessing the Learning’s

1.31 Sums for practice

1.32 Case study for discussion

1. **Introduction:**

The term [**Investment Banking**](https://imarticus.org/certified-investment-banking-operations-program/) has gone through a sea change in the last two decades with it becoming almost synonymous with Financial Services. With the scope of commercial bank and traditional investment banks constantly overlapping, there is no one definition. With the repealing of the historical Glass Steagall Act of 1933 in 1999, the walls separating investment banking activities and commercial banking activities have been dissolved. Even traditional retail banks like ICICI and SBI have investment banking arms today. The crisis of 2008 however has thrown light on these conflicts and Chinese walls are being adhered to more carefully now. The term Investment Banking however is a term still used loosely to describe any institutional financial services offering. Traditional Investment Banking comprises of Mergers &Acquisitions (M&A) and Corporate Finance Advisory. In a broader sense however, it can also include the entire Securities industry, which includes Sales & Trading, Clearing and Corporate Support. Extending their scope even further, investment banks now offer Asset Management and Private wealth managed services as well. At its heart however lies the job of the intermediary, the key link between buying and selling, raising and lending. In the series we intend to break down Investment Banking not just into its academic components but its functions and careers. One can profile the Front Office Analysts and Private Equity Analysts to understand what they do every day.

* 1. **Investment Banking Defined:**
1. Investment banks are institutions that do not provide the core banking services of accepting Deposits and Giving Loans,; instead provide advisory services to corporate and Government.
2. An Investment Bank is a financial institution that raises capital, trades securities and manages corporate mergers and acquisitions. Investment banks profit from companies and governments by raising money through issuing and selling securities in capital markets (both equity, debt) and insuring bonds (e.g. selling credit default swaps), and providing advice on transactions such as mergers and acquisitions. A majority of investment banks offer strategic advisory services for mergers, acquisitions, divestiture or other financial services for clients, such as the trading of derivatives, fixed income, foreign exchange, commodity, and equity securities.
3. Investment banking is a specific division of banking related to the creation of capital for other companies, governments, and other entities.
4. Investment banking is a special segment of banking operation that helps individuals or organisations raise capital and provide financial consultancy services to them. They act as intermediaries between security issuers and investors and help new firms to go public.
5. Investment banking is a special segment of banking operation that helps individuals or organisations raise capital and provide financial consultancy services to them.
6. They act as intermediaries between security issuers and investors and help new firms to go public. They either buy all the available shares at a price estimated by their experts and resell them to public or sell shares on behalf of the issuer and take commission on each share.
7. Investment Banking is among the most complex financial mechanisms in the world. They serve many different purposes and business entities. They provide various types of financial services, such as proprietary trading or trading securities for their own accounts, mergers and acquisitions advisory which involves helping organizations in M&As; leveraged finance that involves lending money to firms to purchase assets and settle acquisitions, restructuring that involves improving structures of companies to make a business more efficient and help it make maximum profit, and new issues or IPOs, where these banks help new firms go public.

**1.2 Features of Investment Banks:**

The basic features of Investment Banking include:

1. Ability to take direction well and ensure that all issues faced are addressed appropriately.
2. Work as a Team player, with all the stakeholders participating in the decisions made.
3. Excellence in software with expertise in Excel, Word, and PowerPoint so that analysis and its presentation is done correctly and to the satisfaction of the client.
4. Strong accounting and finance knowledge so that all facts get properly analyzed, understood and presented before the client.
5. Giving high attention to detail in all matters put before it for advice.
6. Willingness to work extremely long hours so that the timelines get followed stringently.
7. Excellent financial modeling skills for proper analysis of data.
8. Proven strong numerical and analytical skills.
9. Excellent team leadership skills where the members are guided properly on the challenges faced and tasks assigned.
10. Professional communication and interpersonal skills.
11. Excellent Project and time management ability.
12. Strong dedication, energy and commitment towards the goals being pursued.
13. Self-confidence and the ability to make difficult decisions, even when conditions and environment are adverse.
	1. **Functions of Investment Banking / What do Investment Banks do?**

An Investment Banking is responsible for the following activities:

1. IPO management
2. Providing advice on Mergers and acquisitions.
3. Risk Management services that aim at minimizing the risk involved.
4. Client Specific Research on financial issues.
5. Structuring of Derivatives.
6. Providing Merchant banking activities
7. Providing investment and portfolio management services
8. Providing financial consultancy services
9. M&A bankers that specialize in providing companies with strategic advice when they plan to go in for either a merger with a competitor or acquire a smaller firm
10. Underwriting the public issue being planned by a company
11. Raising capital through private equity
12. Contacting and identifying Venture Capitalists for raising finance for the new venture or activities planned.
	1. **Types of Investment Banking:**

Investment Banks can be of the following types depending on the services they provide and the nature of their activities:

### Bulge Bracket Investment Banks:

### Bulge Bracket Investment Banks are investment banks that are also known as a full-service investment banks. The examples include well-known names such as Goldman Sachs, Deutsche Bank, Credit Suisse, Morgan Stanley, etc.

These banks are mammoth in size, and a majority of their clients include Fortune 500 companies. They frequently aid multi-billion dollar deals and provide all the investment banking services to their clients across the globe. Geographical borders do not limit the activities of these banks as they offer services in all the major countries and markets across the world.

1. **Regional Boutique Investment Banks:**

These banks are completely on the opposite end of the spectrum from bulge bracket banks. These banks are the smallest in size, and as the name suggests, their services are concentrated in a particular region only and they specialise in specific services only. In fact, they do not offer the whole range of services as well. The example of a regional investment bank would be a California based investment bank dealing in M&A transactions only. These banks have very few employees, a few dozen at the best. They usually focus on one specific product, geography, or industry; exit opportunities are more limited as well., whose deal ranges from USD 50 to 100 million.Most boutique investment banks focus on [M&A](https://mergersandinquisitions.com/ma-investment-banking/) Advisory or restructuring because it’s difficult to compete in areas like Equity Capital Markets and Debt Capital Markets without much bigger teams. The common examples under this category are Lion Tree Advisors and Athelon Capital in Minneapolis.

1. **Middle Market Investment Banks:**

Middle market investment banks occupy the market space between regional boutique banks and bulge bracket banks. They are bigger than the regional boutique banks but smaller than bulk bracket banks. These banks may offer full services or may specialize in one or two specific services like Mergers and acquisition advice or IPO management. Geographically they are wider than regional boutique banks, they may cover an expanse of more than one state or region, but they are not multinational. They are involved in deals ranging from USD 50 million to 500 million. Some of the most well-known middle-market investment banks are William Blair Co., Stifel- a diversified global wealth management and investment banking company focused on building relationships that help individuals, families, and institutions and corporations Lincoln International, Robert W. Baird & Co., etc.

1. **Elite Boutique Investment Banks**:

Elite boutique Investment Banks are a little different from all the above-mentioned types. In the dollar value of the deal size, elite boutique banks are parallel to bulge bracket investment banks. However, unlike bulge bracket banks with thousands of employees, elite boutique banks have a much smaller employee pool. They have operations in multiple regions but are usually stronger in some regions than others. These banks usually provide a full range of services but are observed to be strong in one or few services. They may also have specialization in a particular sector, for example, an investment bank specializing in M&A deals in the oil and gas industry. Rothschild in Europe is a classic example of an elite boutique bank. The examples of this category of Investment Banks include Lazard LLC, Ever core Group LLC, and Moelis& Company.

* + 1. **Advantages of a Boutique Bank:**

The of a Boutique Banks are: Investment banks are:

* Boutiques are good for **initial internships and entry-level roles** if you got started late, changed your major or career path, or had other issues during undergrad.
* You could get a lot more **deal exposure** in terms of interaction with executives and counterparties.
* And someboutique banks have great **cultures** where you’re treated like a human, you spend less time on pointless tasks, and you work more like 60-70 hours per week.
* At the **senior levels,** cash compensation could be higher than cash compensation at larger banksif you perform well and close many deals*.*

**1.4.2 Disadvantages of a Boutique Bank:**

The common disadvantages of working in Investment Banks at a Boutique Banks include:

* At the **senior levels**, cash compensation could be higher than cash compensation at larger banks if you perform well and close many deals.
* Deals tend to be **smaller and simpler**, which may limit the technical skills you gain.
* Regional boutique banks rarely give **full-time return offers** to interns, so you’ll have to recruit elsewhere once your internship is done.
* Most boutiques (of all types) have **small Analyst classes,** which limits your network.
* **Bonuses**, at least at regional boutiques, are significantly lower.
* It’s not great to be **“in the middle”** of the hierarchy at these firms because there are fewer spots for Associates, VPs, and Directors, and compensation fluctuates significantly due to profit-share schemes.
* **Highly variable work** experience and culture, ranging from work-Analysts-to-death at some firms to relax-and-barely-work-more-than-a-standard-corporate-job at others.
* **Reduced exit opportunities** because you’re unlikely to win traditional Private Equity or Hedge Fund roles. The main options include [corporate development](https://mergersandinquisitions.com/investment-banking-to-corporate-development/), [corporate finance](https://mergersandinquisitions.com/corporate-finance-career-path/), another bank, and maybe[growth equity](https://mergersandinquisitions.com/growth-equity/) or [venture capital](https://mergersandinquisitions.com/venture-capital/), depending on your industry

**1.5Investment Banking Activities:**

The major Investment banking activities include:

1. Public Offering of Securities
2. Private Placement of Securities
3. Trading of Securities
4. Mergers, acquisitions, and ﬁnancial restructuring advising
5. Merchant banking
6. Securities ﬁnance and prime brokerage services
7. Asset Management

Let’s understand how an investment bank earns money by providing acquisition advisories. Imagine that an entity named PQR Limited is targeting to buy another company KLM Limited. PQR is unsure how much company KLM is really worth and what will be the long-term benefits in terms of revenues, costs, etc. So they appoint an investment Banker to go through the process of due diligence in detail and try to determine the value of the company, settle the deal by helping PQR prepare necessary documents and advising it on the most appropriate timing of the deal. Here the investment bank works on the buy side and in the same manner some other investment banks may be working on the sell side to help KLM. The bigger the deal size, the more commission the bank earns. Bank of America, Barclays Capital, Citigroup Investment Banking, Deutsche Bank, and JP Morgan are some of the largest investment banks in India.

**1.6Evolution of Investment Banking:**

There are few job profiles that inspire so much awe, respect and curiosity similar to Investment Banking. Despite the heavy hit the industry took during the financial crisis, investment banks undoubtedly still retain their appeal for those considering pursuing finance as a career. And it is no wonder since 2007, was not the first time that banks have hit a bump in the road like they do in every decade. The history of investment banking has not been straight-forward as presumed by many dreaming of making a career in this industry. Over the period the industry has lived through worse but has still somehow managed to rise again to prosperity like the proverbial phoenix from the ashes. This is what surprises any and they are all awe struck.

The obvious question here is how did all this began? While the term ‘investment bank’ gained popularity in the late 19th – early 20th century, and largely in relation to the US, investment banking services existed long before Wall Street came into existence. Most of the oldest investment banks started out as merchants trading in commodities such as spices, silk, metals and so on. In the UK, London still remains one of biggest financial centres of the world; the term used is ‘merchant bank’ to describe an investment bank.

The nineteenth century saw the rise of several prominent banking partnerships such as those created by the [Rothschild’s](https://www.rothschild.com/), the Barings and the Browns. At this point, investment banking had started to evolve into its modern form, with many banks underwriting and selling government bonds. It was a situation similar to tasting blood, since it opened up new revenue streams for the banks. So the traditional banks continued with this activity albeit without giving any thought to it, that it does not fall under the traditional banking industry. They used a new banner investment banks.

It was not long before investment banks emerged on the other side of the Atlantic where the industry received a boost during the Civil War. A time period when banking houses were syndicated to meet the federal government’s need for money that it desperately required to fund and fight the war. The 1800s also saw the birth of some of the most famous investment banks, some of which operate and exist even today, such as JP Morgan and Goldman Sachs.

The 19th and the beginning of the 20th century saw a rather dramatic expansion for the investment banking industry which benefitted from the prosperous years following the First World War. This phase quite naturally was referred to as the golden age for investment banking. The evolution can be studied under the following important heads

* 1. **The financial crisis:**

This dramatic rise, however, was not without consequences. The unprecedented growth was accompanied with excessive market speculation, and unsustainable surge in the stock prices. All this eventually triggered the market crash of 1929, which in turn sparked the Great Depression and the global economy started taking a downturn. The Great Depression was a difficult time for investment banks, that were forced to merge in order to stay afloat and survive. The crash also triggered more stringent regulation for the industry, including the famous Glass-Steagall Act of 1933 which required a clear demarcation between the traditional commercial banking from investment banking. As a result, entities like JP Morgan were forced to spin off its securities underwriting division to form Morgan Stanley & Co as an independent investment bank. The second half of the 20th century marked another golden age for investment banks, which benefitted from a surge in deal making, commonly referred to as Mergers and Acquisitions. Banks profited immensely from being advisers on mergers and acquisitions as well as public offerings of securities.

* 1. **The second golden phase:**

This trend started changing in the 1980s when the focus shifted from deal making to trading. This process was facilitated by advances in computer technologies which enabled banks to use algorithms to develop and execute trading strategies, profiting from even small changes in stock prices. This spirit of the times was perfectly captured in Oliver Stone’s 1987 blockbuster movie ‘Wall Street’.

The second golden age of investment banks continued in the 1990s, characterized by the dot-com boom and bubble. The end of the decade, however, brought the repealing of the Glass-Steagall Act, which effectively removed the separation between Wall Street investment banks and commercial banks, aggravating the undesirable financial crisis of 2007.

## ****The Financial Crisis:****

The biggest hit to investment banks since the Great Depression was brought by the speculative bubble in housing prices, as well as overreliance on sub-prime mortgage lending which damaged financial institutions globally and brought them to their knees.

Among the investment banking victims of the global financial crisis were Bear Stearns and Lehman Brothers. On the other side of the Atlantic, the UK government was forced to bail out Royal Bank of Scotland and Lloyds, while investment banks like Barclays turned to the Middle East to raise capital privately for their survival. The financial crisis triggered consolidation in the industry, with JPMorgan & Chase acquiring Bear Sterns, while Bank of America snapped up Merrill Lynch.

* 1. **On Stranger Tides:**

While the financial crisis now remains in history, its repercussions can still be felt even today. We feel the aftershocks even today and remember it as the consequence of the financial crisis that hit the global economy. One of the most notable consequences is the weakened dominance of Wall Street which, however, has partly facilitated the rise of new financial centres around the world, such as Singapore and Hong Kong which are taking advantage of the economic boom in China and South-east Asia. Also, much like in the wake of the Great Depression, banks are facing more stringent regulations such as stress tests, while the UK for instance is looking to implement ring-fencing rules which, similarly to the Glass-Steagall Act, aim to separate lenders’ retail operations from riskier investment banking operations.

Still, despite the heavy hit from the financial crisis, trust in the investment banking industry has started to creep back. Investment banks are also seeing their profits rise, benefitting from the M&A frenzy seen in the past few years, which is now soaring to pre-crisis levels. And while even the best of experts would have a hard time predicting where the industry is currently headed, if the seemingly cyclical history of investment banking is anything to go by, then another golden age might as well be on the cards in the near future. They are being aided by the start-up frenzy hitting the economies across the globe

**1.7 Evolution of American Investment Banks:**

Philadelphia financier Jay Cooke established the first modern American investment bank during the Civil War era. Though the private banks were providing investment banking functions since the beginning of the 19th century and many of these evolved into investment banks in the post-bellum era. It implies the Post-war period following the American Civil War. It is a synonym to the reconstruction era dating to 1863–1877. But the evolution of firms into investment banks did not follow a single trajectory. In fact some currency brokers such as Prime, Ward & King and John E. Thayer and Brother moved from foreign exchange operations to become private banks, taking over some investment banking functions. Other investment banks evolved from mercantile firms such as Thomas Biddle and Co. and Alexander Brothers that are organizations designed to collect, record, and distribute to regular clients information relative to the standing of commercial firms. They thus act as a sort of clearing house of information on customers' reliability. In 1933 a new deal separated investment from commercial banking through the Glass-Steagall Act. That law was no longer in effect in the late 1990’s thus opening the way for the power of investment banking to accelerate. Its growth was a response to new demands for investment services, technological changes, deregulation, and globalization. Investment banks were at the heart of shadow banking system. Investment banking played a major role in the outbreak of the global financial crisis of 2007–9. In the aftermath of the financial crisis leading American investment banks were converted into bank holding companies, and brought under new regulations.

**1.8 Regulation of Industry Post1929:**

The stock market crash of 1929 began on Thursday, Oct. 24, 1929, when panicked investors sent the Dow Jones Industrial Average (DJIA) plunging 11% in heavy trading. The 1929 crash was preceded by a decade of record economic growth and speculation in a bull market that saw the Dow Jones Industrial Average skyrocketing over five years. Other factors that led up to the stock market crash include unscrupulous actions by public utility holding companies, overproduction of durable goods, and an ongoing agricultural slump. This stock market crash paved the way for the Great Depression that followed in 1930’s and lasted till World War II. The Congress passed a series of important federal regulations that aimed at stabilizing the markets, such as the Glass Steagall Act of 1933.These regulations were aimed at generating customer satisfaction and laid to rest the unhappiness customers had over the activities of bank.

**1.9 Birth of American Universal Banks**:

In 1791, the American Congress chartered the First Bank of the United States. This bank that was jointly owned by the federal government and private stockholders was a nationwide commercial bank which served as the bank for the federal government and operated as regular commercial bank acting in competition with the existing state banks. One could call it the first American universal bank. When the depositors brought state bank notes to First Bank of the United States, it would present these notes to the state banks, demanding gold. This hampered the state banks' ability to issues notes and maintaining adequate reserves. When First Bank of the United States' charter came up for renewal in 1811, it was met with a great deal of opposition from state banks as they thought would pose unprecedented challenges for them and the renewal legislation could not be passed.

Subsequently, the Second Bank of the United States opened in January 1817; six years after the First Bank of the United States lost its charter. The predominant reason that the Second Bank of the United States was chartered was that in the War of 1812, the U.S. experienced severe inflation and had difficulty in financing its military operations. Subsequently, the credit and borrowing status of the Treasury was at its lowest level ever. At this time private banking exploded rapidly after the war ended in 1815, culminating in the Panic of 1819.

**1.10 Emergence of Quantitative Finance:**

The Science of Quantitative finance arose in the middle of the late 20th century as it was a time when the financial markets were evolving and had become larger and more complex. It was then that the need for quantitative finance was felt. Although some of the key models and theories had appeared even earlier.

#### (i) In the early 1800, the first development in the field of Quantitative Finance took place. It was in the year 1827, one of the main concepts in quant finance originated in the field of biology with a Scottish Botanist Robert **Brown**, observed the movement of particles trapped inside grains of pollen on a pool of water. He noted the seemingly random patterns in which these particles moved in. These random movements became known as “Brownian motion,” a cornerstone of quant finance that were based on the notions of drift and diffusion.

####  (ii) Subsequently in the late 1800s i.e. in 1860’s, **Jules Augustin Frederic Regnault** used the concept of the “random walk” to explore the modern theory of stock price changes in his book, Calcul des Chances et Philosophies de la Bourse.  The fact is Regnault, a French stock broker’s assistant, was one of the earliest writers to create a ‘stock exchange science’ based on statistical and probabilistic analysis.

### (iii) The early 1900’s a major milestone for the world of derivatives was set in 1900 when a French mathematician named Louis **Bachelier**, published his PhD thesis, ‘The Theory of Speculation’, in which he modeled the stochastic process now called Brownian motion and used it effectively to evaluate stock options. Bachelier is credited with being the first person to do this and his Bachelier model has been pioneering in the development of other widely used models, including the Black-Scholes model. This was followed by an English mathematician and biostatistician, **Karl Pearson,** introducing the term “random walk” in 1905. Karl Pearson was largely credited with establishing the discipline of mathematical statistics and themes from his book, ‘The Grammar of Science’. This was later used in the theories of Albert Einstein and other scientists. By the mid-1900s, economists were laying the foundation for a more developed theory of financial markets, with the work of, **Friedrich Hayek**, on efficient markets in the 1940s, and the emergence of Modern Portfolio Theory following the publication of **Harry Markowitz**’s thesis “Portfolio Selection” in 1952. Modern Portfolio Theory is now widely used by institutional investors and financial advisors for asset allocation, risk control, and attribution analysis. In 1990, Markowitz went on to win the Nobel Prize in Economic Sciences for his work on portfolio theory. In the late 1900’s specifically in the early 1970s, American economist, **Eugene Fama**, built on this foundation and advanced the field with his efficient market hypothesis (EMH) in the early 1970s. Fama is often referred to as the ‘Father of Finance’ as his work developed much of the groundwork for financial economics today. Since Fama’s work, the development of a diverse range of quantitative models has been a natural progression for those seeking to analyze stocks, assess the efficient risk-reward frontier, and engaging in portfolio optimization. There were other figures central to the evolution of quant finance in the late 1900’s including **Edward Thorp**, a mathematician who came to finance through his work on probability and statistics as deployed on the blackjack tables of Las Vegas. Thorp’s book, ‘Beat the Dealer’, published in 1966 explored his blackjack game theory and is often considered the original guide to card counting. Likewise another notable quant of this period was **Emanuel Derman**, one of the first physicists on Wall Street, who developed a number of models that remain in use today – including the Black-Derman-Toy model (BDT). With the rise of option pricing and quant trading in the 1970s and 1980s, following the work of **Fischer Black**, **Myron Scholes**, and **Robert Merton** on the eponymous Black Scholes (Merton) equation in 1973, quant methods and advanced computing became omnipresent in the derivatives market too.

**1.11 Deregulation of Financial Sector:**

Deregulation f Financial Sector is a mechanism that allows implementation of monetary policy to move away from the use of reserve and liquidity ratios of banks to the use of market operations to influence short-term market interest rates and, through that channel, the interest rates that all lenders charged on loans. In 1980, the interest rate ceilings on bank deposits were removed and restrictions on minimum and maximum terms of deposits were removed progressively too, by 1984 these restrictions were ended. The last credit directive was issued in September 1981 and the system formally ended the following June. The deregulation in the financial industry enabled banks and other financial institutions the autonomy to decide how they would use and allocate their capital. It allowed banks to compete with international competitors and invest their money into securities without regulations to restrain them from doing so. In short, Deregulation was the removal or reduction of government regulations in a specific industry. The goals were to allow industries to operate businesses more freely, make decisions efficiently and remove corporate restrictions. The main objective of deregulation is to remove barriers to competition so that a particular industry can compete in the international market more effectively. Deregulation of an industry occurs only through legislation, issuance of an executive order from the President, or when a central agency stops enforcing the existing regulation.

### 1.11.1 Benefits of Deregulation: Deregulation generates the following benefits for the sector being deregulated:

* It **stimulates economic activity** because it eliminates restrictions on new businesses to enter the market, which increases competition and helps the market to grow and expand.
* Since there is more competition in the market, it leads to **improvement in innovation** and **increases market growth** as businesses compete with each other more freely. When more businesses compete with each other, the overall prices of products and services on offer goes down for consumers.
* Companies are no longer required to utilize resources and capital to comply with the restrictions and the existing regulations. In turn, they can use the resources rendered surplus to **invest in**[research and development](https://corporatefinanceinstitute.com/resources/knowledge/accounting/research-and-development-rd/) **further improving the quality of the services on offer.**
* Businesses can operate **without worrying about restrictions and extra regulations** that govern them. They are allowed to develop new products, set their own prices, venture into foreign countries, purchase new assets, and interact with consumers without restrictions to hold them back.

### 1.11.2 Consequences of Deregulation:

### Deregulation creates the following consequences:

* Without any restrictions in place, small businesses are at a higher risk of being driven out of the market by larger businesses and more established companies. The larger companies enjoy the capability of **creating monopolies** to take control of the market and for dictating terms for market to operate.
* In some cases, deregulation may **not protect the consumers’ best interests**. For example, regulation in the [banking](https://corporatefinanceinstitute.com/resources/knowledge/finance/banking-fundamentals/)industry requires a bank to maintain a certain amount of cash in hand, which restricts individual freedom of withdrawing their money.
* Companies may **not provide insight and transparency** to the public about how businesses in a deregulated industry are operating. For example, regulations in the financial sector govern how public organizations need to publish a financial statement, which allows investors to understand the company and enables them to take their investment decisions.
* Without rules and control from the government, businesses can **commit fraud** more easily putting the consumers at risk. This changes when markets are deregulated.

This can be understood better with the following example**.** Deregulation in the financial industry enabled the banks and other financial institutions the autonomy to decide how they would use and allocate their capital. It allowed banks to compete with international competitors and invest their money into [securities](https://corporatefinanceinstitute.com/resources/knowledge/accounting/trading-securities/) without regulations to restrain them from doing so. In the U.S., banks became deregulated due to the repeal of the Glass-Steagall Act in 1999. The law was initially introduced in 1933 as a way to prevent banks from using funds and deposits from their clients to buy risky securities for fear of losing their clients’ money. The repeal of the legislation meant that banks were allowed to invest their resources in low-risk securities only. However, banks did not follow this and began investing in high-risk financial derivatives instruments instead. As a result, many countries blamed the deregulation of the banking industry for the Global Financial Crisis of 2008.

**1.12 Expansion of I-Banking Business:**

The face of banking has changed with increase use of IT in the industry. The other IT related trends noticed in banking industry include:

* Augmented Data Management.
* BI & Visualization.
* Big Data Engineering.
* Data Governance Intelligent Cloud.
* Data Sciences.
* Embedded Analytics.
* Fraud and Risk Analytics.
* HR Analytics

While, ttraditional banking is built on four pillars: SME lending, insured deposit taking, access to lender of last resort, and prudential supervision. Modern banking is IT driven with usage of IT done to make services more effective and efficient. It is information technology which enables banks in meeting such high expectations of the customers who are more demanding and are also more techno-savvy compared to their counterparts of the yesteryears. They demand instant, anytime and anywhere banking facilities. Banks use IT for a variety of reasons. Firstly, they help in storing the account information of customers and verifying the financial records in a matter of seconds. Secondly, computers help banks in carrying out quick transactions and making successful payments.

Efficient and quick service to customer can be provided with the help of modern technologies.

**Handling of Information:** Creation of up-to-date monitoring and information system and strengthening internal control and housekeeping and reporting functions are provided.

 The arrival of card-based payments

* Introduction of Electronic Clearing Services
* Introduction of RTGS/NEFT
* Introduction of Cheque Truncation System (CTS) or Image-based Clearing System (ICS)
* Introduction of Core Banking Solutions (CBS)
* Introduction of Automated Transaction Managements System.

Broadly one can say IT helps banks provide. The benefits of IT usage by banks include:

* **Increase in Efficiency**
* **Handling of Information**
* **Cost Reduction**
* **Accuracy**
* **Customer Service**
* **Easy Communication**

**Formation of Financial Conglomerates and TBTF Institutions:** The Reserve Bank of India defines a financial conglomerate(FC) as a cluster of companies belonging to a Group which has significant presence in at least two financial market segments out of banking business, insurance business, Mutual Fund business and NBFC business (deposit taking and non-deposit taking)A financial conglomerate involved primarily with banking would typically be one in which the parent company is either itself a banking institution under supervision, or is a financial holding company whose most dominant subsidiary is an authorised credit institution. It is defined as a group or subgroup of companies that operate both in the banking or investment sector and in the insurance sector. It was deemed necessary to supervise these financial groups at the conglomerate level in addition to solo and group supervision. All conglomerates are corporations, but not all corporations are conglomerates. Conglomerates differ from corporations in that a conglomerate must have wholly or partially owned subsidiary companies. A subsidiary is a company that is owned by another company. Corporations may or may not have subsidiaries. Examples of conglomerates are Berkshire Hathaway, Amazon, Alphabet, Meta (formerly Face book), Procter & Gamble, Unilever, Diageo, Johnson & Johnson, and Warner Media. All of these companies own many subsidiaries. The Indian Examples are ICICI Bank, HDFC Bank limited, Kotak Mahindra Group, SBI, Stan chart Bank, etc.

The purpose of a conglomerate is to save corporation money by operating more than one company under the parent company. The primary purpose of having controlling interests in different companies is to diversify risks in order to lessen the impact of major financial setbacks. A Conglomerate is a coarse-grained rock that is often formed in riverbeds. The pebbles and sand can be composed of many different minerals, but it is usually quartz-based minerals. Conglomerate has a variable hardness, and it often looks like concrete. It is usually found in mostly thick, crudely stratified layers.

Despite its rarity, conglomerate mergers have several advantages: diversification, an expanded customer base, and increased efficiency. Through diversification, the risk of loss lessens. If one business sector performs poorly, other, better-performing business units can compensate for the losses. It aims at making an organisation that is “too big to fail.” The term TBTF refers to banking and financial institutions that have expanded into many economies. And the failure of these would have a direct impact on the national and global financial system. “Too big to fail” describes a business or sector whose collapse would cause catastrophic damage to the economy. The U.S. government may intervene in situations where failure poses a grave risk to the economy. One example of such intervention was the Emergency Economic Stabilization Act of 2008, which included the $700 billion Troubled Asset Relief Program (TARP).The entities that are too big to fail are The Bank of New York Mellon Corp. Citigroup Inc., The Goldman Sachs Group Inc., JPMorgan Chase & Co., etc.

**Conglomerating of US Investment Banks:** Investment banks mainly help large corporates and governments to raise capital required. So investment banking is inherently a global industry. Some of the world’s largest investments banking companies are not based in the U.S., but these international banks still take up a large portion of the market stateside. The top investment banking companies include JPMorgan Chase, Bank of America, Wells Fargo, and Citi — considered America’s Big Four banks. These investment banking companies are the largest U.S.-based commercial banks based on consolidated asset data released by the Federal Reserve. The Consolidated assets of these investment Banks include stocks, loans, properties, and reserves. Some other names included in the list are JPMorgan Chase, Goldman Sachs, BofA Securities, Morgan Stanley, Citigroup, UBS, Credit Suisse, Deutsche Bank. Of these the following are labelled as Tier 1 investment banks such as JP Morgan, Goldman Sachs, Citigroup, Morgan Stanley and Bank of America. But Merrill Lynch failed because it accumulated significant losses attributed to the drop in value of its large and unhedged mortgage portfolio in the form of collateralized debt obligations. Trading partners' loss of confidence in Merrill Lynch's solvency and ability to refinance money market obligations ultimately led to its sale.

**European Investment Banks (EIB):** The European Investment Bank is the lending arm of the European Union. They are the biggest multilateral financial institution in the world and one of the largest providers of climate finance. With its headquarters in Luxembourg, the European Investment Bank also has offices in the different regions in which it operates. These play a key role in cultivating relations between the EIB and its public and private sector customers and in strengthening cooperation with local institutions and partners. The European Investment Bank (EIB) is jointly owned by the EU countries. It seeks to:

* boost Europe's potential in terms of jobs & growth
* support action to mitigate climate change
* promote EU policies outside the EU

The Bank **borrows money** on capital markets and **lends it** on favourable terms to projects that support EU objectives. About **90 %** of loans are made **within the EU**. None of the money comes from the EU budget.

The EIB provides 3 main types of products and services:

* **Lending** – about 90 % of its total financial commitment. The Bank lends to clients of all sizes to support growth and jobs, and this support often helps to attract other investors
* **'blending' -** allowing clients to combine EIB financing with additional investment
* **advising** and technical assistance - maximising value for money

The EIB makes loans **above EUR 25 million directly.** Where **smaller loans** are involved, it opens **credit lines** for financial institutions that then lend funds to credit

All EU countries are shareholders in the EIB. Decisions are taken by the following bodies:

* the Board of Governors, comprising ministers (mostly finance ministers) from all EU countries. It defines general lending policy.
* the Board of Directors, chaired by the EIB President, which comprises 28 members appointed by the EU countries and one appointed by the European Commission. It approves lending and borrowing operations.
* the Management Committee, the Bank's executive body, which handles day-to-day business.

The Audit Committee checks that EIB operations are conducted in a proper manner.

The Bank's departments implement management decisions.

It makes borrowing and lending decisions, based on the merits of each project and the opportunities offered by financial markets. Within the EU, it has specific lending priorities. Outside the EU, it supports the EU development and cooperation policies worldwide.

As an independent body, the Bank takes its own borrowing and lending decisions. It cooperates with other EU institutions, especially the European Commission, the European Parliament, and the Council of the EU.There is another body known as the European Invetment Fund wherein the EIB is the majority shareholder of the European Investment Fund (EIF), which provides funding to **small and medium-sized enterprises** (SMEs) through **venture capital** and **risk finance** instruments. Other shareholders are the European Commission and **financial institutions** from across Europe. Established in 1994, the Fund is active in all EU countries, prospective member countries, Liechtenstein and Norway.

EIF products include:

* **Venture capital** and **micro-financing** for SMEs, particularly new and innovative companies
* **Guarantees** for financial institutions, to cover loans to SMEs
* Help for EU countries and those in the process of joining the EU to develop their **risk capital markets**
* **Investment Banking in U K:** Since investment banking is a huge part of the financial institutions and business deals, it’s quite clear that London (UK) is one of the best places to be an investment banker. Companies in this industry mainly undertake underwriting activities and offers financial advisory services. The Investment Banks in UK provide the following services: financial advisory, capital raising, financing and risk management services to corporations, government and financial institutions across the world. **In addition to these they also provide Corporate Advisory & Broking, Investment funds, Mergers & Acquisitions advisory, IPOs issue and management and managing Institutional Equities.**

 The four biggest Investment Banks in UK are:

* HSBC
* Barclays
* Lloyds Banking Group and
* NatWest Group.

Of these Barclays is the Barclays is the best investment bank in the UK. Goldman Sachs is generally regarded as the leading investment bank in most business areas and it is the toughest to break into Bulge Bracket investment bank. Goldman has a very strong reputation within the industry and among corporations. They advise on the majority of high profile M&A deals and other major transactions.

The investment Banks get classified into:

* **Tier 1:** These banks capital displays the financial strength of a bank as it shows the bank's core capital including equity capital and disclosed reserves. Regulators use tier 1 capital for the purpose of ensuring that banks have enough capital in case of unexpected losses.
* **Tier 2:** These banks are designated as the second or supplementary layer of a bank’s capital and are composed of items such as revaluation reserves, hybrid instruments, and subordinated term debt. It is considered less secure than Tier 1 capital, the other form of a bank's capital because it's more difficult to liquidate.
* **Tier 3:** In these banks **C**apital is capital the banks hold to support market risk in their trading activities. Unsecured, subordinated debt makes up tier 3 capital and is of lower quality than tier 1 and tier 2 capital. Banks and credit card companies are Tier 3 lenders.
* **Tier 4**: This category represents investors. Tier 4 is a move outside of institutional lending and commercial credit to the world of venture capitalists, angel investors and other private investors. Alongside cash, shares, bonds and property, gold is an asset that can provide investors with the all-important element of diversification. Diversification is useful, because it offers a form of financial protection when one asset class say shares underperforms.
* The top investment Banks in UK are:



 **Source: Wall street Mojo**

If one looks at the safest bank in UK it is Santander. It is rated as the safest bank in the UK, with a AA rating from S&P. Similarly Money is safest when it is put into UK banks or building societies that are authorised by the Prudential Regulation Authority. It is protected by the Financial Services Compensation Scheme (FSCS). The FSCS deposit protection limit is £85,000 per authorised firm. For those with bigger savings, in the unlikely event a bank or building society went bust, the golden rule followed in UK is not to put more than £85,000 in any one financial institution.

**Spread of US Banks to Europe:** Interest rate spread is the interest rate charged by banks on loans to private sector customers minus the interest rate paid by commercial or similar banks for demand, time, or savings deposits. The terms and conditions attached to these rates differ by country, however, limiting their comparability.

In other words, Spread in trading is the difference between the buy (offer) and sell (bid) prices quoted for an asset. The spread is a key part of contracts for Difference (CFD) trading, as it is how both derivatives are priced. Many brokers, market makers and other providers will quote their prices in the form of a spread. A key characteristic of a data set is how spread apart the numbers are from each other. Three common ways to measure spread are: range, inter-quartile range, and standard deviation.

Spreads are of three types and mainly include: vertical, horizontal and diagonal. A vertical spread strategy sometimes known as money spread uses two options with identical expiry dates but different strike prices.

Net interest rate spread refers to the difference between the interest rate a financial institution pays to depositors and the interest rate it receives from loans. In other words, it is the difference between the borrowing and lending interest rates of the bank. Measures of spread include the range, quartiles and the inter-quartile range, variance and standard deviation.

Banks earn money in three ways:

* They make money from what they call the spread, or the difference between the interest rate they pay for deposits and the interest rate they receive on the loans they make.
* They earn interest on the securities they hold. The common types of spreads are bid-ask, yield, option-adjusted, zero-volatility, and credit.
* In Forex trading, the spread is the difference between the bid (sell) price and the ask (buy) price of a currency pair. There are always two prices given in a currency pair, the bid and the ask price.

Negative spread is a condition when the selling price or the current price is cheaper than the purchase price from the price fluctuation of target investment. Furthermore, in some cases, negative spread also refers to the condition where the price have become quite different from that naturally original expected price. Typically, a low spread indicates that there is a period of low volatility, high liquidity, or both. This means that the price isn't experiencing huge swings or lots of traders are in the market, making it easy to buy large numbers of contracts without much market impact.

* **Pure InvestmentBanks:** Pure investment banks are chiefly responsible for raising funds for businesses, governments, and municipalities by registering and issuing debt or equity and selling these investments on an open market through initial public offerings (IPOs).  The critical difference between the two types of banks viz. Pure Commercial Banks and pure investment Banks is who they provide services to. Commercial banks accept deposits, make loans, safeguard assets, and work with many small and medium-sized businesses and consumers. Investment banks provide services to large corporations and institutional investors.

**Difference between Pure Commercial Banks and pure Investment Banks**

|  |  |  |
| --- | --- | --- |
| **S.No. and Head of Difference** | **Investment Banking** | **Commercial Banking** |
| **01. ProvideServices to** | They Provides services to Large Corporations  | They work with different clients in general public |
| **02. Competitive- ness** | They are More Competitive | They are less competitive as are regulated by RBI |
| **03. Work environment** | They work for Long Working hours | They have less working hours offering a better work- life Balance |
| **04. Salary offered** | They pay higher salary and are good for career | Their salary is not as high as investment Banks |
| **05. Services offered** | Their services include Wealth and asset management, broker services, financial advisory services. They also assist institutional investors and corporations by fulfilling their financial needs. | The services include Mobile banking, credit cards, M&A services In addition to these they give loans, take deposits, and provide other account and banking services for their customers. These banks also offer services to small and medium-sized businesses, such as business loans and lines of credit. |
| **06. Source of Revenue** |

|  |  |
| --- | --- |
|  |  |

Their revenue comes from fees they charge on their services | Their main source of revenue comes from fees for services provided and interest. |
| **07. Jobs on Offer** | The jobs on offer ae include consultants, banking analysts, capital market analysts, research associates, trading specialists, and many others. | The jobs on offer include tellers, sales associates, trust officers, loan officers, branch managers, and technical programmers |

* **US Investment Bank Crisis in2008:** The 2008 financial crisis began with cheap credit and lax lending standards that fuelled a housing bubble. When the bubble burst, trillions of dollars of worthless investments was held in subprime mortgages.The seeds of the financial crisis were planted during years of rock-bottom interest rates and loose lending standards that fueled a housing price bubble in the U.S. and elsewhere. It began, as usual, with good intentions. Faced with the bursting of the dot-com bubble, a series of corporate accounting scandals, and the September 11 terrorist attacks, the Federal Reserve lowered the federal funds rate from 6.5% in May 2000 to 1% in June 2003. The aim was to boost the economy by making money available to businesses and consumers at bargain rates. The result was an upward spiral in home prices as borrowers took advantage of the low mortgage rates.
* The United States subprime mortgage crisis was a multinational financial crisis that occurred between 2007 and 2010 that contributed to the 2007–2008 global financial crisis The 2007-2009 financial crisis developed slowly and gradually. The main cause for this crisis was Home prices that began to fall in early 2006.In early 2007, subprime lenders i.e. Subprime lenders are creditors who offer loans to individuals who do not qualify for loans by traditional lenders.
* These subprime borrowers have below-average credit ratings and are therefore presumed to be at greater risk of defaulting on their loans, leading to banks extending them loans to file for bankruptcy. Eventually, interest rates started to rise and homeownership reached a saturation point. The Fed started raising rates in June 2004, and two years later the Federal funds rate had reached 5.25%, where it remained until August 2007. In June 2007, two big hedge funds viz.  Bear Stearns High-Grade Structured Credit Fund and the Bear Stearns High-Grade Structured Credit Enhanced Leveraged Fund failed, weighed down by investments in subprime loans. In August 2007, losses from subprime loan investments caused a panic that froze the global lending system. In September 2007, Lehman Brothers collapsed in the biggest U.S. bankruptcy ever. When the bubble burst, financial institutions were left holding trillions of dollars worth of near-worthless investments in subprime mortgages.The Great Recession that followed cost many their jobs, their savings, and their homes*.*There were **25** bank failures in 2008.

**BANKS THAT FAILED DURING THE SUBPRIME CRISIS**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **S.No.** | **Bank Name, City, ST** | **Approx. Asset(Millions)** | **Approx. Deposit(Millions)** | **Acquirer & Transaction** |
| 1 | Sanderson State Bank, Sanderson, TX | $37.0 | $27.9 | Pecos County State Bank, Fort Stockton, TX assumed all deposits. |
| 2 | Haven Trust Bank, Duluth, GA | $572.0 | $515.0 | Branch Banking and Trust Company, Winston-Salem, NC assumed all deposits. |
| 3 | First Georgia Community Bank, Jackson, GA | $237.5 | $197.4 | United Bank, Zebulon, GA assumed all deposits. |
| 4 | PFF Bank and Trust, Pomona, CA | $3,700.0 | $2,400.0 | In a transaction facilitated by the FDIC, U.S. Bank, National Association, acquired the banking operations of PFF Bank and Trust, and agreed to assume all deposits. |
| 5 | Downey Savings and Loan Association, F.A., Newport Beach, CA | $12,800.0 | $9,700.0 | In a transaction facilitated by the FDIC, U.S. Bank, National Association, acquired the banking operations of Downey Savings and Loan Association, and agreed to assume all deposits. |
| 6 | Community Bank, Loganville, GA | $681.0 | $611.4 | Bank of Essex, Tappahannock, VA agreed to assume all deposits. |
| 7 | Security Pacific Bank, Los Angeles, CA | $561.1 | $450.1 | Pacific Western Bank, Los Angeles, California agreed to assume all deposits. |
| 8 | Franklin Bank, SSB, Houston, TX | $5,100.0 | $3,700.0 | Prosperity Bank, El Campo, TX agreed to assume all deposits. |
| 9 | Freedom Bank, Bradenton, FL | $287.0 | $254.0 | Fifth Third Bank of Grand Rapids, MI agreed to assume all deposits. |
| 10 | Alpha Bank & Trust, Alpharetta, GA | $354.1 | $346.2 | Stearns Bank National Association, St. Cloud, MN agreed to assume the non-brokered insured deposits. |
| 11 | Meridian Bank, Eldred, IL | $39.18 | $36.88 | National Bank of Hillsboro, IL assumed all deposits. |
| 12 | Main Street Bank, Northville, MI | $98.0 | $86.0 | Monroe Bank & Trust of Monroe, MI agreed to assume all deposits. |
| 13 | Washington Mutual Bank, Henderson, NV | $307,000.0 | $188,000.0 | In a transaction facilitated by the FDIC, JPMorgan Chase acquired the banking operations of Washington Mutual Bank, and agreed to assume all deposits (approximately $188 billion). |
| 14 | Ameribank, Inc., Northfork, WV | $115.0 | $102.0 | Pioneer Community Bank, Inc., Iaeger, West Virginia agreed to assume all deposits at Ameribank's WV branches; The Citizens Savings Bank, Martins Ferry, OH agreed to assume all deposits at Ameribank's Ohio branches.. |
| 15 | Silver State Bank, Henderson, NV | $2,000.0 | $1,700.0 | Nevada State Bank, Las Vegas, NV agreed to assume the non-brokered insured deposits. |
| 16 | Integrity Bank, Alpharetta, GA | $1,100.0 | $974.0 | Regions Bank, Birmingham, AL agreed to assume all deposits. |
| 17 | Columbian Bank and Trust, Topeka, KS | $752.0 | $622.0 | Citizens Bank and Trust Company, Chillicothe, MO agreed to assume all deposits. |
| 18 | First Priority Bank, Bradenton, FL | $259.0 | $227.0 | SunTrust Bank, Atlanta, GA agreed to assume the non-brokered insured deposits. |
| 19 | First National Bank of Nevada, Reno, NV | $3,400.0 | $3,000.0 | Mutual of Omaha Bank, Omaha, Nebraska agreed to assume all deposits (approximately $3.0 billion). On June 30, 2008, First National Bank of Arizona, Scottsdale, Arizona, merged with First National Bank of Nevada and was included in this action. |
| 20 | First Heritage Bank National Association, Newport Beach, CA | $254.0 | $233.0 | Mutual of Omaha Bank, Omaha, NE agreed to assume all deposits (approximately $233 million). |
| 21 | IndyMac Bank, F.S.B., Pasadena, CA | $32,010.0 | 19,060.0 | Non-brokered insured deposits and substantially all of the assets were transferred to IndyMac Federal Bank, F.S.B., Pasadena, California. The FDIC was named Conservator. |
| 22 | First Integrity Bank, National Association, Staples, MN | $54.7 | $50.3 | First International Bank and Trust, Watford City, ND agreed to assume all deposits. |
| 23 | ANB Financial, National Association, Bentonville, AR | $2,100.0 | $1,800.0 | Pulaski Bank and Trust Company, Little Rock, AR agreed to assume the non-brokered insured deposits (approximately $212.9 million). |
| 24 | Hume Bank, Hume, MO | $18.7 | $13.6 | Security Bank, Rich Hill, MO agreed to assume the insured deposits (approximately $12.5 million). |
| 25 | Douglass National Bank, Kansas City, MO | $58.5 | $53.8 | Liberty Bank and Trust Company of New Orleans, LA agreed to assume all deposits (approximately $53.8 million). |

**Source: cservicefdicdal@fdic.gov**

**1.7 Gramm-Leach-Bliley Act in November 1999:**

The Gramm-Leach-Bliley Act (GBLA) seeks to protect consumer financial privacy. Its provisions limit when a "financial institution" may disclose a consumer's "non-public personal information" to non-affiliated third parties, which needs to be kept secret and confidential, the basis on which the customer shared this information with the financial institution. The Federal Trade Commission (FTC) enforces these provisions with regard to entities not specifically assigned by the provision to the Federal banking agencies or other regulators. Also, Sections 131-133 of the Act addressed these changes in the financial sector. It was intended to promote the benefits of financial integration for consumers and investors while safeguarding the soundness of the banking and financial systems. The GLBA requires companies that qualify as “financial institutions” to take several affirmative steps in order to prevent the unauthorized collection, use, and disclosure of Non Personal Information (NPI).There are three major components of the Gramm-Leach-Bliley Act including **a** Financial Privacy Rule, Safeguards Rule, and Pretexting Protection. Let us see the It imposes these obligations under three “Rules” viz.:

1. **the Privacy Rule:** The GLBA's privacy provisions mandate privacy notices and place limitations on the sharing of non-public personal information (NPI), defined as “personally identifiable financial information (i) provided by a consumer to a financial institution, (ii) resulting from a transaction or any service performed for the consumer and
2. **The Safeguards Rule.** The GLBA Safeguards Rule requires CU to implement safeguards to ensure the security and confidentiality of certain non-public personal information (NPI) that is obtained when CU offers or delivers a financial product or service to an individual for personal, family, or household purposes.
3. **Pretexting Protection:** This type of protections occurs when someone tries to gain access to non-public personal information without authority to do so. This may entail requesting private information by impersonating the account holder by phone, by mail or by phishing or spear phishing.

The Gramm-Leach-Bliley Act (GLBA) is also known as the Financial Services Modernization Act of 1999, was passed in November 1999. The law repealed the Glass-Steagall Act of 1933, which limited securities activities within commercial banks and interactions between commercial banks and securities firms.

There are three major components of the Gramm-Leach-Bliley Act including a Financial Privacy Rule, Safeguards Rule, and Pretexting Protection, as explained above. These rules cover most personal information like name, date of birth, Social Security number, etc. as well as transactional data like card, bank account numbers. It also covers private information you may acquire during a transaction for instance a credit report. The Glass-Steagall Act was repealed in 1999 amid long-standing concern that the limitations it imposed on the banking sector were unhealthy, and the proponents of the change felt that allowing banks to diversify would actually reduce risk and make banks more customer friendly and profitable. Since the goal of a GLBA risk assessment was to determine whether existing security measures sufficiently protect customer data -- that includes any known and anticipated threats, internally or externally -- examine the technical, physical, management and policy-based controls in place to verify that they are adequate in all respect. The Gramm-Leach-Bliley Act (GLBA) law repealed the Glass-Steagall Act of 1933, which limited securities activities within commercial banks and interactions between commercial banks and securities firms

**1.8 Controversy over Glass Steagall.** The Gramm-Leach-Bliley Act (GLBA), also known as the Financial Services Modernization Act of 1999, was passed in November 1999. The law repealed the Glass-Steagall Act of 1933, which limited securities activities within commercial banks and interactions between commercial banks and securities firms. The law prohibited bank affiliation with firms that were “engaged principally” in underwriting and were dealing exclusively with securities. This made it possible for bank holding companies to create subsidiaries or acquire firms involved in some underwriting or dealing, so long as their activities were otherwise permissibleconsolidation.

**1.9 Mergers among Commercial Banks, Investment Banks & Insurance Companies:** Mergers, acquisitions, and cooperation between financial sectors, mainly commercial banking, investment banking, and insurance, are the wave of the future. The crucial Question is what has been the likely effect of the Gramm-Leach-Bliley Act on financial​consolidation. This legislation has further stimulated financial consolidation of the banking industry. ​ Thus, more financial mergers were likely to occur that will increase both the size and complexity of financial institutions in the future. With the passage of the Gramm–Leach–Bliley Act, commercial banks, investment banks, securities firms, and insurance companies were allowed to consolidate. Furthermore, it failed to give to the SEC or any other financial regulatory agency the authority to regulate large investment bank holding companies.

A financial institution must provide an annual notice of at least once in any period of 12 consecutive months during the continuation of the customer relationship. Generally, new privacy notices are not required for each new product or service.

**1.10 Scope of investment Banks:**

Investment banks help the government raise money, trade securities and buy or sell crown corporations. Bankers help institutional investors to manage other people's money in trading securities and providing reliable first-hand information tested through detailed research. They also help private equity firms to acquire financial sound portfolio companies very easily. Investment banking is a kind of rewarding job with rewards both in monetary terms as well as personal and career growth. It is a fast-paced job along with good scope of learning. Investment Banking gives you pathways to bigger career like entrepreneurship, wealth management and venture capital.M&A Advisory Services

Merger and Acquisition is the process of helping corporations and institutions find, evaluate, and complete acquisitions of businesses. Bankers advise on both sides of M&A transactions but represent either the buy-side or sell-side of the deal and help negotiate on their client’s behalf.

Following are the steps involved in the M&A process:

1. Acquisition Strategy
2. Acquisition Criteria
3. Searching for target
4. Acquisition Planning
5. Valuing and Evaluating
6. Negotiation
7. Due Diligence
8. Purchase and Sales Contract
9. Financing
10. Implementation

**1.11 Banking clients**

Investment bankers advise a wide range of clients, and these clients can be located around the world.

They include:

* 1. **Corporations-** Every business needs to raise additional capital to grow and expand. Therefore, both private and public companies work with bankers to help them go public (IPO), make acquisitions, sell the business unit, and provide general corporate financial advice.
	2. **Governments-**As business needs capital to grow, the government also needs capital to fund different sectors for smooth functioning. Investment banks help the government raise money, trade securities and buy or sell crown corporations.
	3. **Institutions-**Bankers help institutional investors who manage other people’s money in trading securities and providing research. They also help private equity firms to acquire portfolio companies.
	4. **Investors:** Investors get tested research data for making portfolio investments that are rewarding and profitable.

The ones who can demonstrate their ability to add value to an organization are the ones who succeed in this increasingly competitive financial industry.

# **1.12 Stakeholders in an Investment Bank:**

# (1) **Stakeholders**

## (a) Clients:

A strong client focus is the basis of the investment banking business model, and is enshrined in our business approach adopted by them. They aspire to build a sustainable franchise through long-term relationships with our clients and clear and sustainable solutions. Our clients include corporations, entrepreneurs, institutional investors, financial sponsors and retails clients. We have organised our company in two main business areas to make sure we have our corporate and retail clients’ best interests at heart.

## (b) Employees, former employees, pensioners:

Our people are an important stakeholder and our most important asset.  We invest in personal and professional development and nurture an environment where employees are treated with respect, and where diversity and differences are valued.  NIBC employees must act in accordance with our Code of Conduct, handling their business with integrity, dealing with sensitive information appropriately and considering all stakeholders in their actions. NIBC Work's Council represents our employees in negotiations with management.

## (c)Investors:

Investment bank stress on maintaining good relations with their debt and equity investors, and thus look to deliver solid and sustainable investment returns to them. As part of our dialogue with investors and analysts we provide them with regular updates on our company. We are transparent and provide accessible information on our financial and non-financial performance. We apply the latest standards of the Global Reporting Initiative (GRI).

## (d) NIBC and regulators:

NIBC Bank is a commercial bank of Netherlands and is regulated by the Dutch Central Bank (DNB) and The Netherlands Authority for Financial Markets (AFM). Through the international branches they maintain relationships with the regulatory bodies abroad. They comply with all legal and regulatory requirements and aim to maintain strong and open relationships with regulators and other supervisory bodies on an ongoing basis.

## (e) NIBC and Rating agencies:

Rating agencies provide NIBC with credit ratings at a corporate level and for certain products and programmes. Maintaining a healthy creditworthiness is key for NIBC and we therefore have regular dialogue with rating agencies such as Moody's, Fitch and S&P.

## (f) NIBC and Society at Large:

NIBC wants to play a role in addressing the environmental and social issues in the communities where we are active by being a responsible corporate citizen. NIBC ambition is to be a trustworthy, transparent and sustainable bank, and to minimise our impact on the environment and contribute to building a sustainable society for future generations. To achieve this, we encourage our employees to participate in social initiatives within their local communities and also provide financial support. Our impact on society and environment is managed through our Sustainability Policy Framework, which applies to all aspects of our business. This is based on internationally recognised conventions and codes of conduct, such as the UN Guiding Principles on Business and Human Rights, UN Global Compact, and the Equator Principles. This ensures we do not provide financing to clients and projects where social and environmental impacts are not sufficiently managed.

## (g)Peer banks:

We engage with peer banks as counterparties, investors, co-financiers or clients. As a transparent and a trustworthy partner, we operate with integrity in the securities and financial. To safeguard our integrity and reputation, our peer banks and the banking system as a whole, due diligence checks are required prior to engaging in business with a client. NIBC is member of the Dutch Banking Association (NVB).

## (h) Suppliers

Through the products and services that it purchases from suppliers, we have an impact on society and the environment. We aim to minimise negative impacts by purchasing more sustainable solutions. Our most important suppliers are located in high-income OECD countries, which generally means that the potential impact is limited or not significant.  In every case, we aim to know our suppliers and expect them to act as responsible corporate citizens and to meet our sustainability standards. We include sustainability criteria in all supplier contracts, and where appropriate, discuss sustainability opportunities with suppliers.

**1.13 Who are the 3 main stakeholders?**

As a general rule, stakeholder priority can be divided into three levels. The first and most important comprises **employees, customers, and investors**, without whom the business will not be able to operate. Secondary to them are suppliers, community groups and media influencers.

**1.14Advantages and Disadvantages of Investment Banks:**

Investment Banks generate the following Pros and Cons:

**Advantages:** The advantages of Investment Banks include:

1. High earning potential.
2. Valuable benefits packages. Another area where the compensation in this career can be appealing is in the benefits package to the employees.
3. Working with driven peers making the work environment healthy and competitive.
4. Powerful networking with clients help in future growth
5. Continued development takes place as the employee deals with a wide variety of issues working for an investment Bank.
6. Investment banks control lots of capital. For this reason, these banks can finance big projects like a dam, railroad, etc. Without the support of investment banks, large infrastructural projects are not possible. These banks contribute a lot to the nation’s economy
7. The investment of the banks in the business helps major businesses to flourish. These banks also work as a mediator between large corporations and make big business deals possible.

**Disadvantages of Investment Banks:** The key disadvantages of Investment Banks include:

**(a)** Long working hours that can irritate and drain out the employees

**(b)** High competition levels which often causes stress to the employees.

**(c)** The security infrastructure of investment banks is very tight.

**(d)** They are comparatively free from any major corruption or frauds.

* 1. All investment banks do not serve common people or small businesses. Ordinary people cannot deposit or take a loan out of the banks, because the investment avenues require huge resources. Thus, these banks only serve wealthy individuals and big businesses.
	2. Another problem of investment banks is that these banks do businesses with lots of capital. For this reason, any problem with these banks could put a severe effect on the economy. Many countries faced a recession when their investment bank faced bankruptcy.
	3. Though investment banks generate lots of capital but they take a huge amount of risk with their investment causing stress in the financial sector.
	4. Salary varies from time to time and employee to employee resulting in a lot of dissatisfaction and unrest amongst employees.

**1.15 Capital Gearing**: Capital gearing is a British term that refers to the amount of debt a company has relative to its equity. In the United States, capital gearing is known as "financial leverage." Companies with high levels of capital gearing will have a larger amount of debt relative to their equity value.

**What is a Gearing Ratio:** Capital gearing means maintaining desirable and a proper proportions between various types of securities in the capital structure of the Company. While gearing ratios represent a group of financial metric that is used by a company to compare the shareholders' equity to the debt that it carries in the Financial Statement. This becomes the basis of evaluating the risk that the company carries. In this sense it denotes various ways to assess the company's amount of leverage and its financial stability. Gearing is measures of how much of a company’s operations are funded using debt versus the funding received from shareholders as equity.

Capital gearing ratio is the ratio between total equity i.e., shareholders’ funds and total debt i.e., borrowings of the entity; This is a specifically an important metric used by the analyst who is trying to invest in a company and wants to compare whether the company is holding the right capital structure. A gearing ratio lower than 25% is typically considered as a low-risk by both investors and lenders. A gearing ratio between 25% and 50% is typically considered optimal or normal for well-established companies. It strengthens the qualitative aspect of the capital structure. Capital gearing provides a rational balance to the capital structure. As a result, the investor, creditors and enterprise, all get benefits. Capital risks may be reduced by capital gearing and profit earning capacity of the entity is increased. There are many types of gearing ratios, but a common one to use is the debt-to-equity ratio. To calculate it, you add up the long-term and short-term debt and divide it by the shareholder equity. Gear ratios can be boiled down to a single statement: Higher ratios (with a lower numerical value) give better torque/acceleration and lower ratios allow for higher top speeds and better fuel economy. Higher ratios mean the engine has to run faster to achieve a given speed. Is it better to have a higher or lower gear ratio? A **high geared ratio** is good when you need more acceleration to cruise your vehicle, whereas a lower gear ratio provides more torque to get the vehicle moving from a resting position.**Low geared ratio** refers to a ratio of vehicle speed to engine speed. One can activate the low gear in a number of ways, depending on your car's make and model: Manual Transmission: Downshift into a lower gear before you encounter an obstacle. It is also referred to as financial gearing or financial leverage. A company is said to have a high capital gearing if the company has a large debt as compared to its equity.

Perhaps the most common method to calculate the gearing ratio of a business is by using the debt to equity measure. Simply put, it is the business's debt divided by company equity. The debt to equity ratio can be converted into a percentage by multiplying the fraction by 100. How can the gearing ratio be evaluated? A business with a gearing ratio of more than 50% is traditionally said to be highly geared carrying phenomenal risk for the entity as lenders are fair weather friends. They are with the company till the going is smooth. As soon as the going gets tough they start demanding their amount back, which the company may not be able to return causing financial trouble for the company. Thus, something between 25% - 50% would be considered normal for a well-established business which is happy to finance its activities using debt.

**In simple words**, deciding the ratio of capital to be made available by various sources, in the total capitalization is known as capital gearing. Thus, the relationship between equity share capital, preference share capital and debt capital is termed as Capital Gearing.

The term capital gearing is used to describe the ratio between the ordinary share capital and fixed interest-bearing securities of a company.

**1.16 Types of Capital Gearing:**

Let us understand the two concept in detail.

### 1. High Gearing:

* When the amount of equity share capital in the company is less than the debt capital and preference share capital, that situation is said to be high gearing. Here, when in any company ordinary share capital is less than other fixed interest-bearing securities, then it’s known as high gearing. This is a high risk situation for the company. For example, if a company is said to have a capital gearing of 3.0, it means that the company has debt thrice as much as its equity. Here the car is travelling at the 4th or 5th gear and is at high speed which increases the risk involved. This

represents high risk as if there is an obstacle and the driver applies the brake, the car will not stop immediately and may turn turtle or meet with an accident. In this sense we need to understand the implication and risk involved in capital gearing.

In this strategy

* Potentially pay less income tax
* Interest and other costs of gearing may be tax deductible, and could potentially reduce taxable income.

### 2. Low Gearing:

* When the amount of equity share capital is more than the amount of debt capital and preference share capital, then it is known as low gearing.
* **In other words**, in the situation when the ratio of equity shares capital is more than fixed cost bearing securities, it is known as low gearing.
* This is a low risk situation for example: When the engine is moving hard and the wheels are moving slower, one is travelling in low gear, say 1st or 2nd gear. Here the speed is slow so the risk involved is less.
* In case one applies the brake the vehicle would stop immediately and comfortably.
	1. **Importance of Capital Gearing:**

The following points highlight the importance of capital gearing:

1. By assessing the capital gearing, the entity may obtain capital at the low cost.
2. The financial position of the institution can be strengthened with the help of capital gearing and proper gearing of capital may be done for ensuring the operations are efficient
3. Any institution may determine the ratios of its capital sources through capital gearing, using this information it can then decide to make the best utilization of funds.
4. It can help in arriving at the most balanced mix of various securities by the company
5. Fluctuation in profit earnings can be regulated.
6. A regular adherence to it can help strengthen the qualitative aspect of the capital structure.
7. Capital gearing provides a rational balance to the capital structure. **As a result,** the investor, creditors and enterprise, all get benefits.
8. Capital risks may be reduced by capital gearing and profit earning capacity of the company can be increased.

## Effects of Capital Gearing in Trade Cycles:

##

## A trade cycle refers to cyclical fluctuations in economic activities especially in employment, output, income, prices, profits etc. They have a very wide impact and therefore effect the entire population. The four important features of Trade Cycle are (i) Recovery, (ii) Boom, (iii) Recession, and (iv) Depression. The trades cycle or business cycle are cyclical fluctuations of an economy and keep occurring at regular intervals The enterprise may be safeguarded against the ill effects of trade cycles boom and depression, by way of proper gearing. If the market has the conditions of depression, the profits of the enterprise become uncertain.**In such a situation**, it is better to depend on equity capital alone, because by being less dependent on fixed cost capital, the management can save the financial position of the enterprise, from getting spoiled and under stress and strain.The time from one economic peak to the next, or one recessive trough to the next, is considered a business cycle. From the year 1945 to the year 2009, the NBER defined eleven cycles, with the average cycle lasting a bit over 5-1/2 years.

## Types of Business Cycle:

## The different types of cycles include:

**(i) Recovery:** Economic recovery is the business cycle stage following a recession that is characterized by a sustained period of improving business activity. Normally, during an economic recovery, gross domestic product (GDP) grows, incomes rise, and unemployment falls as the economy rebound and spreads an environment of optimism in the country. After the trough, the economy moves to the stage of recovery. In this phase, there is a turnaround in the economy, and it begins to recover from the negative growth rate. The four stages of the cycle are expansion, peak, contraction, and trough. Factors such as GDP, interest rates, total employment, and consumer spending, can help determine the current stage of the economic cycle. Insight into economic cycles can be very useful for businesses and investors.

**(ii) Boom:** A boom is a period of strong economic expansion where many businesses are operating at full capacity or above capacity, and the unemployment rate is very low. Income and production are at very high levels. This can lead to rapid growth in prices. Three forces combine to cause the boom cycle. They are the law of supply and demand, the availability of financial capital, and future expectations. These three forces work together to cause each phase of the cycle. In the boom phase, strong consumer demand is the leading force. The other factors are:

* Loose Monetary Policy. If monetary policy is too loose, it means real interest rates are too low given the state of the economy, e.g. UK economy in late 1980s
* Loose Fiscal Policy
* Boom and Bust in Asset Prices
* Bank Lending
* Multiplier/accelerator effect.

On the contrary, if the market has conditions of Boom, then the business earns a good profit. **Hence**, fixed cost capital like preference shares and debentures can be increased. Because in this phase the enterprise can carry this burden conveniently due to increasing profits. As a result, the shareholders also get adequately benefited from higher profits, which will also raise the Goodwill of the enterprise. **Hence**, it is clear that successful financial managers should go on changing capital gearing of his business/company/institution, according to the movements of trade cycles, to save the enterprise from the ill effects of business boom and depression. In the beginning, when an enterprise is established.

Two steps should be taken to fulfill the financial requirements of the entity:

* To issue securities with variable costs.
* To collect capital in the beginning by equity shares.

**(iii) Recession:** Recessions can be caused by an overheated economy, in which demand outstrips supply, expanding past full employment and the maximum capacity of the nation's resources. Overheating can be sustained temporarily, but eventually spending will fall in order for supply to catch up to demand. The NBER defines a recession as a period between a peak and a trough in the business cycle where there is a significant decline in economic activity spread across the economy that can last from a few months to more than a year. The working definition of a recession is two consecutive quarters of negative economic growth as measured by a country's gross domestic product (GDP), although the National Bureau of Economic Research (NBER) does not necessarily need to see this occur to call a recession, and uses more frequently reported monthly data.

**(iv) Depression:** Depression, in economics, represents a major downturn in the business cycle characterized by sharp and sustained declines in economic activity impacting the overall performance of the economy. It results in: high rates of unemployment, poverty, and homelessness; increased rates of personal and business bankruptcy; massive declines in stock markets; and great reductions in international trade. A recession is a normal part of the business cycle that generally occurs when GDP contracts for at least two quarters. A depression, on the other hand, is an extreme fall in economic activity that lasts for years, rather than just several quarters. An economic depression is primarily caused by worsening consumer confidence that leads to a decrease in demand, eventually resulting in companies going out of business. When consumers stop buying products and paying for services, companies need to make budget cuts, including employing fewer workers.

## Business Cycle - The 6 Different Stages of a Business Cycle

These two steps are in the interest of the enterprise. But as the enterprise progresses and certainty of income goes on increasing fixed cost capital may be increased for with stability in income the enterprise can manage the financial burden easily. This process is known as capital gearing as discussed above.

**1.18 What are the advantages and disadvantages of gearing?**

Companies have low gearing when most of their capital comes from equity. They are considered financially stable.

**1.18.1 Advantages of a Low Geared Enterprise:**

* **Low financial risk**: The extent of financial risk faced by an entity is low. As such it can take more risk related to business.
* **Companies are less vulnerable to default and bankruptcy risk.** During periods of low profit and high-interest rates, companies are less vulnerable to default and bankruptcy risk since the profits earned are healthy, making it possible to pay all the dues on time.
* **Burden of loan and interest payments are reduced**: During a low geared phase the burden of loan and interest payments are reduced since the entity is operating in a very conducive environment and is able to earn high profits and there is little possibility of default. Since the profits are high there is no need to borrow. The entity is in a position to plough back its profits.
* **Safety for investors is assured:** The entity can use this financial strategy in times of recession when interest rates are low
* **Investors use gearing ratios:** The investors use gearing ratios **to** determine whether a business is a viable investment or otherwise.
* **Companies cab attract investors**: Since the business environment is conducive and the company’s balance sheet is strong and accompanied with low gearing ratios, it can easily attract investors. Thus raising funds from the market is not difficult.

**1.18.2 Disadvantage of High Gearing Level:**

1. **High Default Rate**

The risk of default increases at high level of gearing. Company may not be able to pay the interest, the high interest payment may reduce the profit drastically and company has higher chances of liquidation as compared to low gearing companies.

1. **Tax Exhaustion**

Debt finance results in tax saving but this benefit limited to the profitability of the business, if the business profit convert into business loss due to high interest payment then the tax benefit associated with the interest is no more available.

1. **Borrowing Capacity Reduces**

The borrowing capacity reduces at high level of gearing due to default risk. The debt holder is no more interested to borrow the high geared company due to high default risk. The debt holder is interested in regular interest payment on their debt which is at risk in high geared company.

1. **Low Investor Confidence**

The investor has low confidence on high geared company because financial risk if mainly born by the equity holder and therefore the equity holder avoid investment in high geared company. The high geared company may not be able to pay the regular dividend due to high interest payment.

|  |
| --- |
| **Example 1.** A company has provided the following balance Sheet as on 31March 2020: |
| Particulars |
| Equity Capital of Re. 1 each |
| Reserves and Surplus |
| 12% Redeemable Preference Shares of Rs100 each  |
| 7% Convertible Debentures of Rs.100 each |
| 9% Loan |
| EBIT |
| The redeemable Preference Shares are duly redeemed using the reserves. Convertible debentures are duly converted. Calculated the EPS and Diluted EPS. |
| **Solution:** |

|  |  |  |
| --- | --- | --- |
| **Particulars** | **Actual EPS** | **Diluted EPS** |
| EBIT | 900,000 | 900,000 |
| Less: Debenture Interest | 87500 | 0 |
| Less: Interest on Loan | 54000 | 54,000 |
| EBT | 758,500 | 846,000 |
| Less: Ignore Tax | 0 | 0 |
| Less Preference Dividend | 174000 | 0 |
| Profit for Equity Shareholders | 584,500 | 846,000 |
| Number of Shares | 1,500,000 | 2,750,000 |
| EPS | 0.39 | 0.31 |

**Comments:**

The Actual EPS is Re. 0.39. and the diluted EPS takes into consideration only the debentures as they are converted without using the Reserves. The number of Equity Shares increase to 27,50,000. So the EPS stands at 0.31.the Eps falls in case of Diluted EPS since the number of shares increase.

**Example 2:**Neyveli Corporation has 10,000 shares of common stock outstanding and net income of Rs. 1,000,000. Tax rate is 40%. If there are 2,000 convertible bonds outstanding each at Rs. 1,000 face amount paying 5% interest annually. What would the diluted EPS be if each bond is convertible into two shares of common stock?

**Solution:**

|  |  |
| --- | --- |
| **Particulars**  | **Details** |
| Bonds (2,000\*$1,000)  | Rs.2,000,000 |
| After tax cost of interest (2,000,000\*5%\*(1-40%) (A)  | Rs. 60,000 |
| Net income (B)  | Rs.1,000,000 |
| Common stock (C)  | 10000 |
| Additional shares if bonds are converted (2000\*2) (D) | 4,000 |
| Diluted EPS (A+B)/(C+D)  | **Rs. 75.71** |

The Diluted EPS = Rs. 75.71. Diluted EPS means the earnings per share, which was calculated considering that the convertible securities were converted. These convertible securities are convertible debentures, preferred shares, stock options, etc.

**Example:** Hit and Run Limited provides the following information:

|  |  |
| --- | --- |
| The Net Profit for the year ending 2017 | Rs.4,50,000 |
| The Preference Dividend paid in 2017 | Rs.30,000 |

The common Shares at the beginning of the year 2017 was 50,000 shares. The company issued another 40,000 shares in the middle of the year. Ascertain the EPS of Hit and Run Limited.

**Solution:**

Weighted Average of Common Shares = (50000 \* 1) + (40000\*0.5) =70,000 Shares

EPS = (Net Profit – Preference Shares) / Weighted Average Number of Common Shares

EPS = 4,50,000-30,000 / 70,000

EPS = 4,20,000 / 70,000 = Rs.6 per Share

**1.19 Trading on Equity:** Trading on equity happens when a company incurs new debt using bonds, loans, bonds or preferred stock. The company then uses these funds to gain assets which will create returns which are larger than the interest of the new debt. Alternatively, trading on equity called financial leverage.

Trading on equity is a financial process in which debt produces gain for shareholders of a company. Trading on equity happens when a company incurs new debt using bonds, loans, bonds or preferred stock. The company then uses these funds to gain assets which will create returns which are larger than the interest of the new debt. If it helps the company to generate profit and results in a higher return for the shareholders on their investment, it is considered a success. Companies usually go this way to boost earnings per share.

‘Trading on equity’ is called so because the company gets its loan amount from the creditors based on its equity strength. Companies usually borrow funds at favourable terms by taking advantage of their equity. If the amount borrowed is large as compared to the company’s equity, it is categorised as ‘trading on thin equity.’ When the borrowed amount is modest, the company is ‘trading on thick equity.’

## ****1.19.1 Advantages of Trading On Equity****

Trading on equity offers a company two advantages

* **Enhanced earnings:** By borrowing the funds necessary, the company creates for itself more avenues of earning revenue by obtaining new assets.
* **Tax treatment is favorable**– The borrowed funds have an interest expense that is tax deductible. So, the borrowing company has to pay lower tax. So, basically, the new debt results in a reduction of the total cost for the borrower.

**1.19.2 The Disadvantages:** Trading on equity has its own set of risk factors:

* **May Further Losses:** It may result in further losses if the interest expense cannot be paid off by the business. You should note that such borrowings can cause high-risk situations for a business, which is depending on the borrowed amount to finance its operations.
* **Changes in interest Rates:** If there is an unexpected rise in the interest rates, it can cause losses because the financial burden of the interest would increase for the company. So, while trading on equity holds the promise of potential increased returns, there is also a real risk of bankruptcy you must take into account.

**1.19.3 When Trading on Equity can be Considered a Success?**

Trading on equity is likely to be profitable in the following cases-

* When a company that is well-established resorts to such means financing
* The nature of the company’s business is not speculative
* the company has profits and sales that are both regular and relatively stable.
	+ 1. **Capital Gearing Ratio**:

The capital gearing ratio divides the amount of Shareholders’ equity by the fixed cost (interest or dividend) bearing funds. Common Stockholders’ Equity is equity less preferred stock. Fixed Cost Bearing Funds include long-term loans, bonds, debentures, and preferred stock. It is called financial leverage and is typically a measure of the company’s financial strength. If a company is said to be highly geared, it means that it has more debt than its own funds in its capital structure. It is based on subjective valuation, and thus there is no optimum capital gearing ratio. It varies from industry to industry. The ratio is calculated using the formula

**Capital Gearing Ratio = Common Stockholder’s Equity / Fixed Cost Bearing Funds.**

It is a simple ratio that includes the above-given items in order to find out the gearing and capital strength of the company.

Borrowed funds are a cheaper means of financing for companies since the rate is low and also the amount payment of interests, preference dividends, and interest on bonds and debentures is a tax deductible amount. They in fact directly reduce the amount of divisible profits. This leads to a significant decrease in the dividend paid to the shareholders. A highly geared company usually has a lower dividend pay-out ratio for this very reason. Thus investors looking to increase their earnings will prefer a low geared company. This ratio will be useful in this analysis.

One must understand that not all debt is bad debt. Subjectively, some companies have to be low geared while others high geared. Others may be able to strike the ideal balance. For a chance of sound investment, an investor must do a complete evaluation. Management must consider many other factors for evaluating a company, and the capital gearing ratio is just one of them.

**Example:**

The following information have been taken from the balance sheet of PQR limited:

**Year 2020:**

* Common stockholders’ equity: Rs. 35,00,000
* Preferred stock – 9%: Rs. 14,00,000
* Bonds payable – 6%: Rs. 16,00,000

**Year 2021:**

* Common stockholders’ equity: Rs.28,00,000
* Preferred stock – 9%: Rs.18,00,000
* Bonds payable – 6%: Rs.14,00,000

**Solution:** We can compute the capital gearing ratio for the years 2020 and 2021 from the above information as follows:

**For the year 2020:**

Capital gearing ratio = 3,500,000/3,000,000
= 7:  6 (Low geared)

**For the year 2021:**

Capital gearing ratio = 2,800,000/3,200,000
= 7: 8 (Highly geared)

The company has a low geared capital structure in 2020 and highly geared capital structure in 2021.

You may notice that the gearing is inverse to the common stockholders’ equity.

* Highly geared - Less common stockholders’ equity
* Low geared - More common stockholders’ equity

**References:**

1. https://mergersandinquisitions.com

**\*\*\*\*\*\*\***

**ASSESSING THE LEARNINGS:**

Q1. What is Investment Banking? Highlight its basic features?

Q2. Analyze the core functions of Investment Banking.

Q3. State and explain in brief the different types of Investment Banking:

Q4. State the core Investment Banking Activities and explain the same in brief?

Q5. Write a note on Evolution of Investment Banking:

Q6. Write a note on Gramm-Leach-Bliley Act (GLBA)

A7 What are the steps involved in M& A Process?

Q8. Who are the clients advised b Investment Banks?

Q9. State and explain the Stakeholders in an Investment Bank.

Q10. What are the advantages and Disadvantages of Investment Banks?

Q11. Explain the concept of Capital Gearing. What is a gearing ratio?

**Q12.Write Short Notes on:**

(a) Types of Capital Gearing:

(b) Importance of Capital Gearing:

(c) Effects of Capital Gearing in Trade Cycles:

## (d) Types of Business Cycle

## (e) Capital Gearing Ratio

## (f) Trading on Equity

## (g) Measuring success of Trading on Equity

Q13. What are the key advantages of a low geared Enterprise?

Q14. What are the key Disadvantages of High Gearing Level?

**Q15. Questions for Practice:**

* 1. Company Blue Mist has provided the following particulars for 2015 and 2016:

|  |  |
| --- | --- |
| **Particulars** | **Amount** |
| **Details for year 2015:**  |  |
| Total Equity | Rs. 5,000,000 |
| 12% Preferred Stock | Rs. 1,500,000 |
| Common Shareholders’ Equity (Total Equity less Preferred Stock) | Rs. 3,500,000 |
| Bonds | Rs. 1,500,000 |
| **Details for year 2016:** |  |
| Total Equity | Rs. 5,000,000 |
| 12% Preferred Stock | Rs 1,500,000 |
| Common Shareholders’ Equity (Total Equity less Preferred Stock) | Rs. 3,500,000 |
| Bonds(additional bonds of Rs1,000,000 were issued for the financial year) | Rs. 4,500,000 |
| **From the details ascertain the Capital Gearing Ratio for 2015 and 2016** |  |

* 1. Calculate capital gearing ratio from the following data provided by All Happiness Limited. Comment on the results too:

|  |  |  |
| --- | --- | --- |
| **Particulars** | **2021-22** | **2022-23** |
| Equity Share Capital  | 5,00,000 | 4,00,000 |
| Reserves and Surplus | 3,00,000 | 2,00,000 |
| 8% Long Term Loans | 2,50,000 | 3,00,000 |
| 6% Debentures | 2,50,000 | 4,00,000 |

* 1. From the details Provided by Laughing Gas Limited, ascertain the Capital Gearing Ratio. Comment on the results too:

|  |  |  |
| --- | --- | --- |
| **Particulars** | **2021-22** | **2022-23** |
| Equity Share Capital  | 5,00,000 | 20,00,000 |
| Reserves and Surplus | 7,50,000 | 8,50,000 |
| 8% Long Term Loans | 9,00,000 | 11,00,000 |
| 6% Debentures | 4,50,000 | 5,50,000 |

(d) Maxwell Corp. had the following information related to common and preferred shares during the year.

|  |  |
| --- | --- |
| **Particulars** | **Amount** |
| Common shares outstanding | 700,000 |
| Common shares repurchased | 20,000 |
| Conversion of preferred shares | 40,000 |
| Common shares repurchased | 36,000 |
| Maxwell reported a net income of $2,000,000 at December 31. What amount of shares should Maxwell use as the denominator in the computation of basic earnings per share |

**(e)** The following information is available for Barone Corporation:

|  |  |  |
| --- | --- | --- |
| January 1, 2015 | Shares Outstanding | 2,000 |
| April 1,2015 | Shares Issued | 3,20,000 |
| July1,2015 | Treasury Shares purchased | 1,20,000 |
| October1,2015 | Shares issued in a 100% stock Dividend |  |

 Compute the earnings per common share for 2015.

**(f)** Coal India Limited has 10,000 shares of common stock outstanding and net income of Rs. 1,000,000. Tax rate is 40%. If there are 2,000 convertible bonds outstanding each at Rs. 1,000 face amount paying 5% interest annually. What would be the basic and diluted EPS be if each bond is convertible into two shares of common stock?

**(g)**On December 31, 2010, Pinestock Limited had 200,000 shares of common stock and 5,000 shares of 10%, Rs.50 par value cumulative preferred stock outstanding. No dividends were declared on either the preferred or common stock in 2010 or 2011. On February 10, 2012, prior to the issuance of its financial statements for the year ended December 31, 2011, Pinestock declared a 100% stock split on its common stock. Net income for 2011 was Rs. 900,000. In its 2011 financial statements, Pine's 2011 earnings per common share.

**Case Discussion on The Glass Steagall Act**

In June 1933, America passed one of the most widely debated legislative initiatives before being signed into law by President Franklin Roosevelt. It was known as the Glass-Steagall Actor Banking Act of 1933.This act effectively separated commercial banking from investment banking and created the Federal Deposit Insurance Corporation, among other things. This Act prohibited bankers from using depositors' money to pursue high-risk investments. But the act was effectively undercut by looser restrictions in the deregulatory environment of the 1980s and 1990s.

Many experts argued that allowing the banks to diversify their activities allowed the banking industry the potential to reduce risk it faced in the industry. They argued that the restrictions of the Glass-Steagall Act could actually have an adverse effect, making the banking industry riskier rather than safer as was being contemplated. Glass-Steagall sought to permanently end bank runs and the dangerous bank practices that created them in the process. Congress passed Glass-Steagall to reform a system that allowed the failure of a mammoth 4,000 banks during the Great Depression.

Lawrence White and Jerry Markham rejected these claims and argued that products linked to the financial crisis were not regulated by Glass–Steagall or were available from commercial banks or their affiliates before the GLBA repealed Glass–Steagall sections 20 and 32.

It can help them to know that their money is safe, and their loans fraud-free, in another rebuilding era. It also will help them keep banking, accounting, investing, and loan processing activities secure and separate. The Glass-Steagall Act was what kept banks, brokers, and investors in line in the past

The short answer is no, not directly because Glass-Steagall's four provisions did not directly address the economic causes of the recession. However, it is plausible that its absence led to the De- prioritization of customers, an unhealthy risk-taking culture, and distorted underwriting mortgage standards.

The seeds of the financial crisis were planted during years of rock-bottom interest rates and loose lending standards that fuelled a housing price bubble in the U.S. and elsewhere. It began, as usual, with good intentions.

The Congress passed the Depository Institutions Deregulation and Monetary Control Act in 1980, which served to deregulate financial institutions that accept deposits while strengthening the Fed's control over monetary policy.

The Glass-Steagall Banking Reform Act was a law that led to the creation of the Federal Deposit Insurance Corporation. This creation ended the idea of unstable banking that was so far possible although not desirable. The Act ensured that banking could be fair and it would prevent future crashes like the Great Depression.

Some argue that the repeal of the Glass-Steagall Act of 1933 caused the financial crisis because banks were no longer prevented from operating as both commercial and investment banks, and the repeal allowed banks to become substantially larger or "too big to fail."

The Biggest Culprit: were The Lenders**.** Most of the blame is on the mortgage originators or the lenders. That's because they were responsible for creating these problems. After all, the lenders were the ones who advanced loans to people with poor credit and a high risk of default.

List of the Cons of the Glass-Steagall Banking Act of 1933. It eliminated interest on checking accounts for consumers. The Glass-Steagall Banking Act of 1933 introduced a provision that would become called Regulation Q in the future.

**Questions:**

1. What was the key issue dealt I Glass Steagall Act of 1933?
2. What were the impact of repealing of the Act?
3. Did the Act cause Financial crisis as was believed?

**References:**

1. www.financeinstitute.com/blog /the-history-of-investment-banking
2. www.ftc.gov/business-guidance/privacy-security/gramm-leach-bliley-act
3. www.angelone.in/knowledge-center/
4. ttps://www.cqf.com
5. https://corporatefinanceinstitute.com/ deregulation
6. https://www.wallstreetmojo.com/