

# ON THE CONTENT AND CONTRADICTIONS OF FINANCIALISED COMMERCIAL BANKING

Paulo L dos Santos

[ps45@soas.ac.uk](mailto:ps45@soas.ac.uk)

Department of Economics  
School of Oriental and African Studies

Draft- Draft - Draft - Draft

NOT TO BE QUOTED WITHOUT AUTHORISATION

Word Count: 9,808

May 2008

## 1. Introduction

By many historical measures the current financial crisis is without precedent. It has arisen from neither an industrial crisis nor an equity market crash. It was precipitated by the simple fact that increasing numbers of largely black, Latino and working-class white families in the US have been defaulting on their mortgages. That this caused Bear Sterns to collapse, bringing the entire financial system to the brink, and continues to generate losses for banking giants like Citibank and UBS, underscores the fundamental changes to the practices and social content of banking taking place over the past 25 years.

Banking has become increasingly dependent on lending to individuals, and the direct extraction of revenues from ordinary wage-earners. It has also become enmeshed with capital markets, in which banks mediate financial market transactions involving investment funds, bonds, equity, and derivative assets. And it increasingly relies on inference-based techniques for the estimation of risk of capital market instruments and banks' own financial position. The current financial crisis is in many ways a crisis of banking as it has emerged through these dramatic changes. Identifying the origins, content and contradictions of contemporary banking is consequently an important part of understanding the current crisis, as well as the broader character of contemporary capitalism.

Contemporary banking is very different from the traditional business of taking deposits from corporations and the general public, making loans to enterprises, and making profits from the difference in interest rates between them. It is also different from the "finance capital" described within the Marxist tradition by Hilferding (1910). Nevertheless, Marxist political economy has a unique and important contribution to make to the analysis of the the social and historical significance of contemporary banking and its distinctive relationship to accumulation. This paper seeks to make empirical and analytical contributions to this task.

Empirically, it considers macro-level data, centrally from the US, on banking and capital markets. It also considers in detail the operations of nine of the largest international commercial banks, based on their annual corporate disclosures.<sup>1</sup> These are leading US, European and Japanese banks which by the end of 2007 collectively controlled more than US\$ 16 trillion in assets across every region of the globe. Even in 2007, when most of them took considerable losses, the average return on equity was still a relatively high 14.87 percent.

Firm-level inquiry allows for very particular findings. It reveals how central lending to individuals has become for the world's largest banking organisations. It also reveals the relative importance of different financial market mediation activities, each of which embodies different social relations. Notably, revenues from fund management and profits on trading and proprietary accounts appear as highly important sources of bank profits, particularly for European banks.

---

<sup>1</sup> The banks examined are Citigroup, HSBC, Bank of America, RBS, Barclays, Santander, BNP Paribas, Dresdner Bank, and Sumitomo Mitsui Financial Group. The first two banks have the most prominent and extensive international operations. The list includes the top two US and top three British commercial banks. Santander is the top bank from Spain, with extensive international operations, notably in Latin America. Dresdner bank was chosen over Deutsche as a representative German bank as the latter is principally an investment bank. BNP Paribas and SMFG are leading French and Japanese banks. See appendix for details on extraction of data from corporate reports.

In order to characterise these activities the paper advances a series of analytical elements pertaining to the different major functions of contemporary banking, drawing on Marx (1894), Itoh and Lapavitsas (1999), and most directly from Hilferding (1910). Particular attention is given to the characterisation of financial market mediation functions. This includes advancing an alternative appreciation of “founder’s profit” to address the empirical and theoretical weaknesses with Hilferding’s (1910) own conclusions on the issue.

On these bases the paper argues that contemporary banking centres on one hand on mutually beneficial, arms-length relationships with corporations centred on investment banking services. At the same time, banks have developed historically new, *exploitative* modes of appropriation from the independently secured income of wage earners. This is possible because access to present and future consumption by individual wage earners increasingly requires them to access financial markets. Banks mediate access to housing, durable consumer goods, education, and increasingly health care, though insurance, mortgage and other individual loans, receiving payments that draw on wage income. As such, banks engage in the *direct exploitation* of wage income, as argued in Lapavitsas (2008).

The gradual privatisation of pension provision has also helped banks develop other avenues of appropriation founded on wage income. Unprecedented money inflows into capital markets, chiefly in the form of individual pension savings, have enhanced the scope for various corporate “financial engineering” measures in which banks play a central role. It has further led to the rise of mass pension, mutual and other investment funds. Banks earn various fees from such funds. In contrast with the relationship between corporations and banks, these activities bear the mark of the profound social inequality between wage earners seeking to secure future consumption and banks seeking to maximise profits, as glaring and arguably systematic disadvantages to the former.<sup>2</sup> It may thus also be usefully understood as exploitative.

The rest of the paper proceeds as follows. Section 2 lays out the broad changes to the composition and character of banking incomes and discusses the regulatory, technological and capital-market setting that has shaped them. Section 3 turns to the changes to conventional lending and money-dealing activities of banks. Section 4 takes some time to discuss all major financial market mediation functions, their significance, and their exploitative content. Section 5 offers a brief concluding discussion.

## 2. New Sources and Types of Bank Income

A number of studies have documented and discussed the changes in banking over the past three decades.<sup>3</sup> The broad empirical contours highlighted by those studies are clear. The income banks receive from interest-rate spreads has steadily diminished in importance. Households have shifted their assets away from bank deposits in favour of various investment funds, and the importance of bank lending to enterprises has fallen significantly. Banks have responded by developing new revenue streams in fees, commissions and other non-interest gains from a range of activities associated with “financial market mediation”. These involve

---

<sup>2</sup> As discussed below, this is most evident in the tendency of retail investors to engage in what mainstream economists term “behavioural” trading, in contrast to “rational”, profit-maximising trading.

<sup>3</sup> See Allen and Santomero (1997, 2001), Erturk and Solari (2007), Leyshon and Thrift (1999), Lapavitsas and dos Santos (2008), for instance.

facilitating the participation of non-financial agents in financial markets through investment banking services to corporations and, increasingly, through the management of investment, mutual, pension and insurance funds for retail investors. Banks have also increased lending to individuals as consumption loans and mortgages.

Macro-level data easily corroborates these observations for advanced economies.<sup>4</sup> Bank non-interest income has increased in significance throughout the OECD countries.

**Table 1 - Non-Interest Income as Percentage of Total Bank Revenues**

	1980	1985	1990	1995	2000	2005
United States	24.9	30.5	30.3	32.1	39.7	40.7
(West) Germany	20.4	20.6	26.8	21.0	35.8	34.2
Spain	14.9	15.6	18.2	23.1	35.8	33.2
France			22.6	45.5	60.9	62.2

Calculated from OECD Bank Income Statement and Balance Sheet Statistics

Bank lending has correspondingly declined in importance. It has also changed in composition. As highlighted in the paper above, lending has shifted towards individual consumption and mortgage loans. Lending to real sector enterprises, conversely, has fallen dramatically. In Germany, non-mortgage bank lending to non-banks declined from 68.2 percent of GDP in 1972 to 26.8 percent in 2003. In Britain, resident banks' lending to individuals rose from 11.6 to 40.7 percent of total lending between 1976 and 2006, with lending to financial intermediaries also rising from 20.3 to 32.4 percent. In the US, bank lending to commercial and industrial enterprises fell from 10.8 to 8.2 percent of GDP. Although belated, the corresponding fall in Japan has been sudden, with bank lending to non-financial enterprises moving from 61 percent of GDP at the end of 1997 to 39.2 percent in the autumn of 2007.<sup>5</sup>

Throughout these changes, banking profits have, with some volatility, increased in significance across the advanced economies.

<sup>4</sup> The observations here also broadly apply to the other OECD economies for which comparable data is available. See [www.oecd.org](http://www.oecd.org)

<sup>5</sup> Percentages calculated from Bank of England, US Flow of Funds, Financial Accounts for Germany, Bank of England and Bank of Japan data.

**Table 2 - Bank Profits as Percentage of GDP**

Country	1980	1988	2005
United States	0.72	0.74	1.62
(West) Germany	0.53	0.81	1.35
Spain	0.84	1.42	1.77
France		0.96	1.53

Calculated from OECD Bank Income Statement and Balance Sheet Statistics

### 2.1 Institutional Investors and Corporate Financial Behaviour

A number of interrelated processes and innovations have created the context for these changes over the past 25 years. Technical innovation has been instrumental in the orientation of banks to individual credit. Credit scoring methods have made mass retail lending possible by yielding, not unproblematically, hard, quantitative estimates of the creditworthiness of individual borrowers, and of large, securitised pools of loans to individuals. Technological change has also created new money-dealing services, such as ATMs and ebanking, whose costs banks appear to have passed on to retail depositors.<sup>6</sup>

State policy in favour of financial liberalisation and secular changes in the financial behaviour of corporations and households have been particularly important in creating opportunities for bank profits from financial market mediation. Most directly, the relaxation and eventual repeal of Glass-Steagall restrictions on investment banking activities by commercial banks and the increasing acceptance of bancassurance in Europe opened the way for increasing commercial bank intervention into capital markets.

More fundamentally, the gradual privatisation of pension provision has had a major impact on both sides of capital markets. On the demand side it has increased the volumes of money seeking to buy securities; on the supply side it has greatly increased the scope for capital gains from various “financial engineering” measures. Across both sides, the scope for fee and other income from financial market mediation has been greatly enhanced.

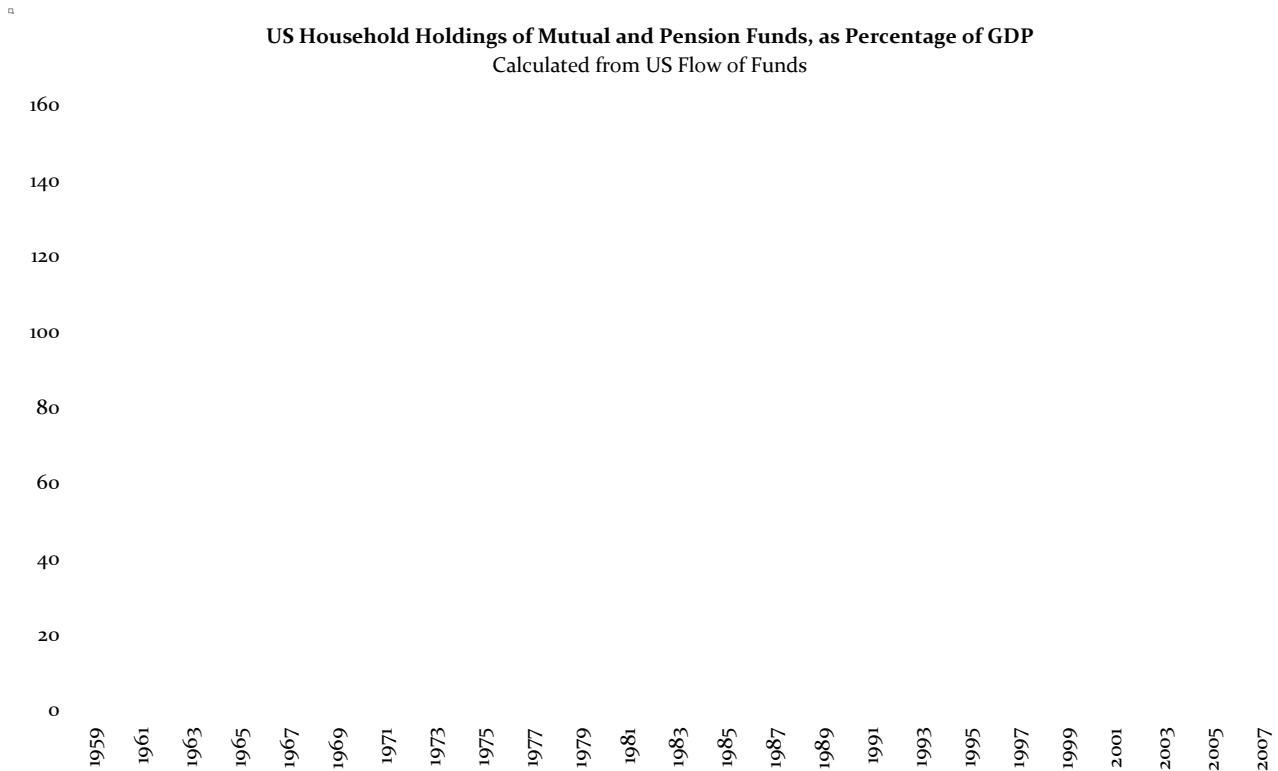
As state pensions have been eroded across the OECD countries, trillions of dollars entered capital markets in the form of various retirement-related investment funds.<sup>7</sup> The late 1970s and early 1980s saw a raft of measures that both degraded public pensions and encouraged private retirement savings in the US. Access to tax sheltered Individual Retirement Accounts was steadily broadened in the 1970s, and 401(k) plans were implemented in the early 1980s. The 1981-83 Greenspan Commission on Social Security endorsed these measures and led the charge against the quality of public pensions by imposing income tax on benefits over a

---

<sup>6</sup> See Lapavitsas and dos Santos (2008).

<sup>7</sup> As the OECD (2007) recently noted, “In nearly all OECD countries today’s workers will have to do more on their own to prepare for tomorrow’s retirement, even if they save throughout their entire career”, p 1.

very low level.<sup>8</sup> As a result, the holdings of pension and mutual funds by US households exploded, from a post-war average around 40 percent of GDP to the 120-140 percent average of the last ten years.



Japanese households also accumulated significant financial assets over the same period, including a high level of insurance reserves, which include pension savings.

**Table 3 - Japanese Household Mutual Funds and Insurance Reserves Holdings, Percentage of GDP**

1980	1985	1990	1995	2000	2005
21.8	36.2	54.6	72.3	83.5	88.3

Calculated from OECD Data

Similarly, across a range of OECD countries, total holdings of open- and close-end investment funds and insurance reserves rose from 41.9 to 73.4 percent of GDP between 1995 and 2005.<sup>9</sup> By 2006, these increases had helped take the worldwide total of assets in managed funds to a total of US\$63.8 trillion, more than twice the combined GDP of the US and EU for that year.<sup>10</sup>

<sup>8</sup> See Greenspan Commission (1983). For an overview of IRAs and 401(k) accounts, see Investment Company Institute (2006, 2007).

<sup>9</sup> Figures calculated from OECD data for Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Spain and the United Kingdom.

<sup>10</sup> Watson Wyatt (2007).

The rise of these institutional funds created new “buy-side” opportunities for banks able to supply investment banking services. Banks could earn fees from directly managing investment funds. In addition, they could earn fees from servicing the brokerage and derivative asset needs of independent insurance, hedge and other investment funds.

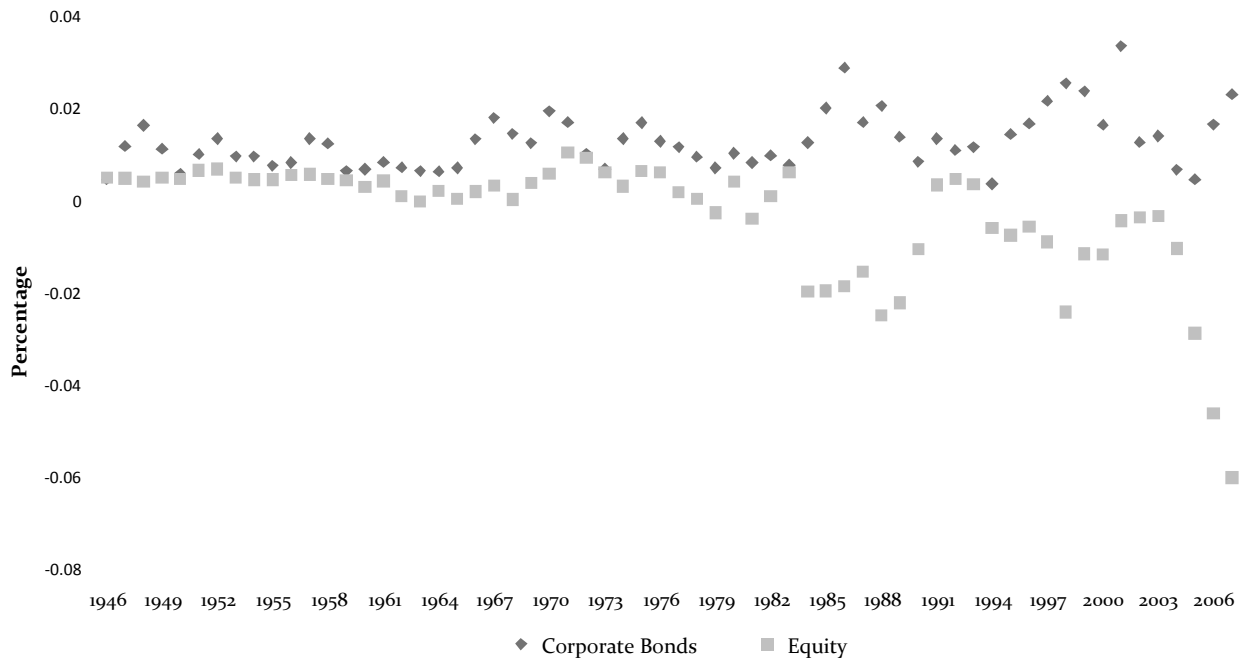
The new funds also helped create new “sell-side” opportunities for banks by fueling a tremendous increase in capital market issuance, particularly in the US. The issuance of US corporate liabilities, notably bonds, grew in tandem with new money inflows, rising from a post-war average of around four percent of GDP to well over 30 percent in 2001.



This increase in the issuance of corporate liabilities in the US signaled a fundamental change in the relationship between non-financial corporations and capital markets. Throughout the post-war period the total indebtedness of these corporations increased steadily, from 18.18 to 36.41 percent of GDP between 1946 and 2007. The large inflows of money since the early 1980s led to a dramatic change in the composition of this borrowing. Bank borrowing accounted for a relatively stable 27 to 37 percent of total borrowing by non-financial corporations between 1946 and 1982. From then on it fell precipitously to 13.4 percent in 2007. Bonds rose from 46.7 to 70.0 percent of total borrowing by these corporations between 1983 and 2007.

The relationship between bond issuance and the financial management of US non-financial firms also underwent a clear change in this period. In pure statistical terms, bond finance flows exhibited a clear positive correlation with equity finance flows between 1946 and 1983, suggesting a broad degree of complementarity between these two financing channels. Since 1983, not only has the correlation become negative, but equity flows have also been generally negative.

**US Corporate Liability Flows of Nonfarm, Nonfinancial Corporations to GDP**  
 Source: Flow of Funds of the United States, Board of Governors of the Federal Reserve System



Increased corporate bond borrowing in this period appears to be closely related to “financial engineering” operations involving the withdrawal of equity, like buybacks, private equity purchases and flips, mergers and acquisitions. As discussed in detail below, the potential capital gains made by such operations are greatly enhanced in a setting of increasing volumes of money entering capital markets. And commercial banks have developed significant revenue streams by managing, advising and underwriting these financial operations.

### 3. Economic Relations of Bank Lending and Money-Dealing

The changes in banking operations and social relations have included important changes in bank lending and money dealing functions. Marxist political economy has long offered compelling accounts of the nature and social content of these banking activities.<sup>11</sup> Those can be readily extended to offer insights into the particular forms these activities take in contemporary banking: lending to individuals, and rising banking and credit-card account fees paid by retail bank clients. Through both channels, banks have come to mediate increasing proportions of consumption, drawing revenue from the independently secured wage income of their clients. As such, they constitute historically novel avenues for the direct exploitation of wage earners.

#### 3.1 Lending to Enterprises

Classical Marxist analysis of bank lending is founded on the distinctive concept of interest-bearing (or loanable) capital. Interest-bearing capital is a peculiar type of capital that is distinct from industrial and commercial capital. It originates from idle pools of money capital that appear in the first instance over the

<sup>11</sup> Best developed in Hilferding (1910).

course of the circuit of industrial and merchant capital. Such pools are mobilised and transformed into loanable money capital by the credit system, which channels it back into circulation in the form of loans to capitalist enterprises.<sup>12</sup> Trading in interest-bearing capital involves credit relations, that is, the advance of value against a promise of repayment with interest. In this light, banks are capitalist enterprises that specialize in all aspects of dealing in interest-bearing capital, accruing revenues from the difference in the price paid for deposits and that paid on loans.

Loanable money capital receives not profits but repayments with interest. To Marx (1894), the level of the rate of interest is irrational: It is the price--or expression of value in money--of a future flow of money. It also reveals no underlying socio-economic relationship or inherent material aspect of social reproduction, not least because it is not the price of a produced commodity. The rate of return on loanable money capital is determined simply through the interaction of supply and demand. This relative detachment from the material realities of production makes relations defined over loanable money capital highly susceptible to the influence of broader patterns of socio-political power.<sup>13</sup>

In lending to capitalist enterprises, the payment of interest is a share of the profit generated by capital applied to production or circulation of commodities. At the broadest level, the systematic basis for the payment of interest in this context is the increased turnover of total capital achieved by the mobilisation of idle money and its application to functioning circuits of capital through lending. More concretely, individual firms will be able to increase the returns on their own capital by leveraging it through borrowing, so long as the return on applied capital exceeds the rate of interest. Finally, given that debt holders must be paid in order to avoid bankruptcy, high levels of debt may be used as a lever to keep enterprise costs down, most often by lowering or keeping down total wage payments.<sup>14</sup>

Under normal conditions, loanable money capital advanced to a capitalist enterprise will help generate the source of its own repayment with interest, by circulating in the borrower's circuit and expanding through the appropriation of surplus value. Finally, the relationship between capitalist lender and borrower is at this level of abstraction one between social equals. Among the many expressions of this equality is the hiring of financial officers by enterprises, whose very jobs are to ensure the firm secures outside finance on the most advantageous terms possible.

---

<sup>12</sup> See Itoh and Lapavitsas (1999).

<sup>13</sup> Lapavitsas (2003).

<sup>14</sup> This appears to be an increasingly common practice, particularly in firms controlled by private equity groups aiming for fairly quick gains in market capitalisation.

### 3.2 Lending to Individuals

Lending to individuals has become a major part of banks' overall lending activities. This is evident for the banks surveyed here, particularly the top two US banks.

**Table 4 - Loans to Individuals as Percentage of Total Loan Portfolio, Dec 2006**

HSBC	Citigroup	B of A	RBS	Barclays	Paribas	Dresdner	SMFG
40.5	77.7	76.3	24.0	44.0	33.0	20.1	26.8

Yet even these figures understate the importance of this type of lending for the world's largest financial groups. The very organisation of Citibank, HSBC and Bank of America reveals their orientation to individual credit. Citibank's "Global Consumer" business segment generated profits of US\$12.1 billion, or 56 percent of all profits, in 2006. Revenues from credit cards and consumer lending stood at US\$13.5 billion, or 31.6 percent of all revenues. That same year HSBC's "Personal Financial Services" segment, which overwhelmingly focuses on consumption and mortgage credit, generated US\$9.5 billion in profits, or 42.9 percent of the bank's profits, far ahead of commercial and investment banking divisions, which accounted for 27.3 and 26.3 percent of profits respectively. Central to this performance is HSBC's credit card network of over 120 million cards worldwide. Bank of America's "Global Consumer and Small Business" segment, which focuses centrally on consumption and mortgage credit and retail accounts, accounted for 65.6% of net interest income that year.

This type of lending has a distinctly *exploitative* social content. Money loaned out to individuals for consumption or mortgages does not ordinarily generate the value from which it is to be repaid with interest, as is evident from the high levels of collateral typically associated with this lending.<sup>15</sup> Interest payments are generally made from subsequent wage receipts by borrowers, representing an appropriation of value borrowers have secured independently of the loan. Recent innovations in consumer lending involving the international operations of banks like HSCB and Citibank offer a congealed expression of this direct appropriation. Along with other banks in Brazil and Mexico, these banks offer wage- and pension-linked loans that often include a legal agreement by the borrower's employer or the state to deduct loan repayments directly from payroll.

At least two concrete factors add to the exploitative character of lending to individuals. First, the relationship is profoundly unequal. It involves on one hand a specialist in managing money flows trying to maximise profits, on the other an ordinary wage earner trying to secure access to consumption. A range of "behavioural" patterns follow, including the tendency for consumers to continue using the first card they ever obtained, regardless of its comparative rates.<sup>16</sup> Also, lending rates are often ten to 20 percentage points above base rates. The high relative profitability of this type of credit suggests high rates of interest do not arise from lower repayment rates. HSBC, for instance, generated 42.8 percent of its profits from lending to individuals

<sup>15</sup> The obvious and partial exception to this relates to residential real estate bubbles, which open the possibility for temporary leveraged capital gains in housing assets for some households. The instability, inequity and destructive power of this type of bubble needs no motivation at this point.

<sup>16</sup> Gruber and McComb (1997) point to evidence of this for the US economy.

and related fees in 2006, while allocating only 29.4 percent of its total assets to such activities. Significant economies of scale in credit-scoring methods compound these effects by narrowing the scope for competition among suppliers.<sup>17</sup>

Second, the scope for exploitation through lending to individuals has increased in the past two decades. The privatisation of provision for a number of basic social necessities has increasingly forced ordinary individuals into debt, transferring growing shares of their incomes to banks and other financial enterprises. The most obvious example is housing, where provision for the working class and poor has become synonymous with facilitating private ownership through the development of mortgage securitisation markets.<sup>18</sup> As table 5 shows, mortgage lending accounts for a very high proportion of lending to individuals for leading banks.<sup>19</sup>

**Table 5 - Mortgage Lending as Percentage of Total Lending to Individuals, Dec 2006**

HSBC	Citigroup	B of A	RBS	Barclays	Paribas	Dresdner	SMFG
53.6	33.1	59.1	72.9	73.0	N/A	33.3	98.1

Another significant item is education, where costs have been gradually privatised on to individual students across a range of countries. This has opened yet another avenue for direct exploitation by banks. In 2006, Citibank reported US\$220 million in profits from its US student loans division alone.

Credit cards are another important component of this lending. And here banks in the US moved aggressively to concentrate the industry as it grew in the 1990s. In 1995 they held no more than 25 percent of credit card receivables in the US.<sup>20</sup> As late as 1999, the top ten US issuers controlled only 55 percent of the market, and many of them were independent credit card companies.<sup>21</sup> Since then large banks bought their way into dominant market share, acquiring Associates, Bank One, British-based MBNA, and Providian. After 2004, the top ten US issuers controlled over 90 percent of the market, and counted only one independent, non-bank enterprise.<sup>22</sup>

<sup>17</sup> For a discussion of economies of scale, see Mester (1997).

<sup>18</sup> The role of US housing agencies Freddie Mac and Fannie Mae in the US in developing the market for mortgage securitisation and in paving the way for the sub-prime mortgage crisis has been widely noted. Less noticed has been the role of the World Bank's International Finance Corporation in doing the same thing for dozens of developing countries. See IFC (2008).

<sup>19</sup> These figures include home equity withdrawals, which are particularly significant for US and British banks. Even during the peak of this activity in 2003 in Britain, however, new home equity withdrawals stood at around 20.67 percent of mortgages extended that year. Calculated from Bank of England data.

<sup>20</sup> Allen and Santomero (2001).

<sup>21</sup> Land, Mester, and Vermilyea (2007).

<sup>22</sup> JP Morgan, Citigroup, Bank of America, the independent Capital One, HSBC and Washington Mutual held the top seven spots at the time. See Akers et al (2005).

To conclude, lending to individuals become a major source of profits for banks. Through such lending, banks appropriate value independently secured, typically as wages. The broader significance of this direct exploitation cannot be overstated. In the US, against a background of stagnant real wages, the financial obligations of households increased from 15.36 to 19.35 percent of disposable income between 1980 and 2007.<sup>23</sup> Impressive as these figures are, they do not exhaust the direct appropriation of income by the banking system. They do not include fees associated with credit card and banking accounts, or those paid on investment funds.

### 3.3 Money Dealing Fees

Banks have always earned income from the plain handling of money, such as operating the payments system, transmitting money abroad and undertaking foreign exchange transactions. Banks are money-dealers, or commercial enterprises that specialize in managing money flows and hoards. In fact, as noted in Lapavitsas (2007), within a Marxist framework, banks can be treated as money-dealing enterprises that also have specialist skills in transacting interest-bearing capital.

Money dealing and account related fees are very important sources of income for contemporary banks. They have also generated considerable controversy, including in Britain, where the Office of Fair Trading has for a number of years been trying to curb overdraft and related bank fees widely perceived to be excessive and unfair. The figures for fee income from card and account services for the surveyed banks tell their own story, particularly for Bank of America and British banks.

**Table 6 - Card and Other Account Service Charges**

Bank	2006		2007	
	US\$ billion	Revenue Share	US\$ billion	Revenue Share
HSBC	9.00	12.8%	10.86	12.4%
Citigroup	6.78	7.6%	7.22	8.8%
Bank of America	22.51	30.5%	22.99	33.8%
RBS	9.096	17.7%	10.078	16.2%
Barclays	11.10	27.9%	12.73	27.6%
BNP Paribas	2.53	7.2%	3.07	7.2%
Dresdner	0.33	3.9%	0.35	4.7%
Santander	1.53	5.5%	1.95	5.7%
SMFG	1.58	9.6%	n/a	

<sup>23</sup> See Federal Reserve, Household Debt Service and Financial Obligations Ratio.

Bank of America charged its customers at total of US\$22.51 billion in 2006 in card and account fees, accounting for almost a third of its revenues for that year. Together, the two top US banks made out with almost US\$30 billion in fees from the provision of money-dealing services to individual accounts that year. In Britain, Barclays received 27.6 percent of operating revenues in 2007 from banking and credit fees, a slight decrease in significance in relation to 2006, when the British Office of Fair Trading implemented rules limiting late and overdraft fees.<sup>24</sup> Together with HSBC it made out with a total of US\$23.607 billion in fees from money-dealing activities in 2007.

An important part of these revenues relates to the expansion of credit to individuals. Overdraft charges, late payment fees, credit card annual charges, &c are all levied as fees but are part of consumer lending. Bank of America attributed the significant rise in its non-interest income between 2005 and 2006 to its purchase of British-based credit card issuer MBNA, which resulted in increases in excess servicing, cash advance, and late fees. Similarly, Furnace (2004) reports that total US late credit card fees rose from insignificant levels in 1990 to over US\$1 billion in 1996, and to almost US\$9 billion in 2003. As such, they should also be understood as direct exploitation.

Other account related fees relate to account management and other money-dealing services. Some of these are new and relate to new access services, such as ATMs, phone and internet banking facilities. Banks have incurred significant costs in establishing these new facilities, and their introduction is yet to translate into reductions in overhead costs. In fact, the high costs of new money-dealing technologies appears to have been passed on to clients, who have become heavy and frequent users particularly of ATMs and pay increasing volumes of fees for accessing their own accounts.<sup>25</sup> As such, banks have increased their participation in the basic access to consumption by ordinary depositors, extracting increasing volumes of exploitative fees in the process.

#### **4. Financial Market Mediation**

Facilitating access to capital markets by non-financial agents has emerged as an important activity for commercial banks over the past twenty years. This includes a range of fee-generating activities; from conventional investment banking functions of underwriting and corporate advisory services to new services in investment and insurance fund management and issuing and dealing in derivate assets. Associated with all these activities are the increasingly significant capital gains made by banks on their trading and own accounts. As table 7 shows for 2006, revenues from these activities accounts for a considerable share of revenues for the surveyed banks, particularly European ones. The nine banks grossed US\$13 billion on this account that year.

---

<sup>24</sup> Shareholders can be reassured that the ensuing losses in revenue were at least partially made up for with growth in Barclaycard international. See Barclays (2008), p 30.

<sup>25</sup> See Berger and Mester (2003) and Lapavitsas and dos Santos (2008).

**Table 7 - Revenues from Financial Market Mediation as Percent of Total Revenues, 2006**

HSBC	Citi	B of A	RBS	Barclays	Paribas	Sant'dr	Dresd'r	SMFG
19.5%	14.6%	16.6%	30.5%	37.8%	58.1%	19.0%	50.8%	6.6%

The increasing significance of these activities to capitalism in general and for commercial banks in particular poses a considerable analytical challenge for Marxist political economy. They are often complex, and many of them, like widespread mutual funds or derivative assets, are historically novel. Identifying the social content of these different activities requires development of Marxist theory. The seminal work of Hilferding (1910) offers invaluable insights on the basic workings of capital markets, and is used as a foundation for much of the discussion below.

A central consequence of Hilferding's insights is the concept of founder's profit: a peculiar capital gain realised by a corporation's founders when equity is issued because buyers of the equity demand an expected rate of return that is lower than the rate of profit generated by the enterprise's operations. Characterising founder's profits and capital gains more broadly is central to the theorisation of the relationship between corporations and the investment banks managing the issue of their securities to capital markets. As such it is also central to broader analysis of other financial market mediation activities that rest on the basic underwriting and advisory functions of investment banks.

Hilferding's insistence in connection with founder's profits that equity returns tend to converge downwards to the basic rate of interest is highly problematic in this regard. It has proven to be empirically wrong. More importantly, it makes it impossible to pursue the social content of the relationship between investment banks and corporations.<sup>26</sup> It also makes it difficult to identify differences between that relationship and that between the growing mass of retail investors and banks and other intermediaries mediating their access to capital markets.

This section aims to make a modest contribution on this account by documenting the significance for large commercial banks of the various market mediation activities, and by offering a number of analytical elements for a Marxist theorisation of these functions and their social foundations. The discussion is founded on a distinctive application of Hilferding's approach to capital markets. As tangentially suggested by Hilferding,<sup>27</sup> it proposes that the return on a capital market security is determined with no direct relationship to underlying realities of production, on the basis of the overall balance of supply and demand for loanable money capital and investors' perceptions of its relative riskiness.

The expected return on equity (or 'fictitious') capital is understood as a different social relationship from the rate of profit on circulating capital. It is determined not through the production and circulation of commodities, but through pure competition between buyers and sellers of securities in capital markets. Under

---

<sup>26</sup> Hilferding's own take on this relationship was rather simple. Banks fused with and controlled industrial capital and appropriated the totality of founder's profits.

<sup>27</sup> Hilferding (1910), p 108.

ordinary conditions, this competition tends to keep the expected rate of return somewhere between the rate of interest for the corporation's debt and its rate of profit. Founder's profit, traditional and new investment banking functions are grounded on these realities, and their content and importance for contemporary banks are discussed in turn.

Through these functions banks appropriate fractions of existing loanable money capital ultimately owned by corporations and individual households. As with ordinary lending, the social character of the relationship between banks and clients is fundamentally different between corporate clients and individual retail investors. There is wide scope for systematic mutual gains in the investment banking relationship with corporations. Those are funded by flows of loanable money capital owned by the mass of investors, who are increasingly ordinary savers. In contrast, evidence is presented that suggests that the relationship between banks and average retail investors is exploitative, centrally through the financialisation of future retirement consumption.

#### 4.1 Marxist Theory and Investment Banking

Revenues from traditional underwriting and advisory investment banking functions are moderately important for the banks in the survey. The figures actually understate the importance of these activities, which, as discussed below, form the basis for the far more significant gains made on trading and proprietary accounts.

**Table 8 - Incomes from underwriting, advisory and other investment banking functions**

Bank	2006		2007	
	US\$ billion	Revenue Share	US\$ billion	Revenue Share
HSBC	1.90	2.7%	2.79	3.2%
Citigroup	6.55	7.4%	7.94	9.7%
Bank of America	3.42	4.7%	3.45	5.0%
RBS	4.27	8.3%	5.58	8.9%
Barclays	5.71	9.5%	1.91	4.1%
BNP Paribas	6.77	19.3%	7.70	18.1%
Dresdner	0.36	4.2%	0.49	6.6%
Santander	0.40	1.4%	0.73	2.1%
UBS	13.02	39.3%	16.79	52.5%
Goldman Sachs	5.63	14.9%	7.56	16.4%

The broad approaches taken in Hilferding (1910) and Marx (1894) are invaluable in grappling with the content of these activities and understanding why world's largest corporations hand over tens of billions of

dollars to banks in the form of investment banking fees every year. Capital markets are markets for rights to different future cash flows paid by corporations. Loanable money capital enters capital markets seeking self-expansion through the purchase of securities or titles to such flows. Two broad types of securities are traded, bonds and equity. Bonds are debt claims and holders are entitled to the payment of interest. Equity represents a claim on residual profits of enterprise in the form of dividends; it may also legally represent voting rights at corporate meetings.

Capital markets effect a socialisation *sui generis* of debt and of capital itself, with potential benefits for the capitalist class as a whole. Under capitalist conditions, this process will of necessity be contradictory, as it takes place in a setting of individual appropriation among competing capitalists. The noxious problems of creditworthiness, trust and confidence that arise as a result are the broadest foundations of a socially necessary role for investment banking services.

In the purchase of any non-marketable enterprise liability, the value advanced by the buyer loses the flexibility it had when it was loanable money capital. Loanable money capital entering in the form of a loan or a new partner's investment becomes commodities in the enterprise's circuit of capital. This loss of liquidity can be overcome through developed capital markets. Liquid markets for corporate securities allow liability holders readily to realise their value as money, the most flexible, independent and socially recognised embodiment of value. This will generally reduce the cost of outside finance for enterprises as larger volumes of money will seek liquid securities. As such, capital markets offer potential advantages to both buyers and sellers of loanable money capital.

But in the context of general capital market competition, the liquidity of a newly issued security cannot be guaranteed a priori. It requires the establishment of its acceptability in exchange for money, which is not only self-reinforcing but related to the generalised acceptance of the security's creditworthiness. Investment banks help create or enhance the liquidity of securities through underwriting. They commit to buy the new security at a particular price, assuring buyers of its ready reconversion into money and signaling the bank's confidence in its value.

As argued and historically illustrated by Morrison and Wilhelm (2007), investment banks are in a position to do this given their relationships with groups of sellers and buyers. On the security selling side, the banks are responsible for 'due diligence' on the issuer's conditions, making use of their specialisation in credit enhancement. On the buying side the bank engages in ongoing consultations with a network of close private and institutional investors, gathering knowledge of prices those buyers would pay for the issue, and any aspects of the issue and issuer they may wish to see changed. Banks thus also advise issuers on a range of issue-related and broader corporate-finance matters that may increase the liquidity and improve the terms of the bond issue. This often includes selling derivative assets to its corporate clients to reduce potential security buyers' perceptions of risk associated with the issuer.

All parties generally gain as a result of these activities. The buyers, who are clients of the bank or, increasingly, institutional funds managed by the bank, get a first shot at buying securities that, if the bank has

done its job well, will likely appreciate in the short run. The issuer faces a lower cost of debt. And the bank receives fees, typically in the form of a discounted price on the issued security in relation to the offer price.<sup>28</sup>

The very character of the commodities being traded in capital markets conditions the need for investment banking activities. Ownership of bonds and equities entitles holders to future money flows that are *uncertain*. More fundamentally, as with bank loans, the price of these future money flows is irrational and reflects no direct relationship to fundamental realities of production. In such setting, the determinants of supply and demand behaviour at more concrete levels acquire increased analytical significance.

Three important related results follow. First, as laid out but not developed by Hilferding (1910),<sup>29</sup> the riskiness of a security as perceived by holders of loanable money capital becomes particularly important. The higher the risks perceived to be associated with a particular security, *ceteris paribus*, the smaller the volumes of loanable money capital seeking to buy it and the resulting price. The expected cash flow associated with the security will thus represent a higher rate of return on the original purchase. Second, prices will fluctuate unanchored along with the ebbs and flows of the overall supply and demand of loanable money capital. The larger demand for securities is in relation to supply, the lower returns on all securities will be, *ceteris paribus*. As a result, and third, capital market securities are natural instruments for speculation and manipulation, as expectations of rises or falls in price may often be self-fulfilling.

Capital market competition, however, does generate certain regularities and tendencies on capital market prices and returns. It is useful to consider separately bonds and equity in this regard. Bonds embody credit relations, not fundamentally different from those created by bank loans. Their rate of return is a rate of interest, which is a sharing of profits. Its level will depend on the quantity and characteristics of other bonds, the relative perceived risk of the individual bond, and the amount of loanable money capital seeking self-expansion in bond markets. Private bonds ordinarily pay higher interest yields than state paper generally regarded as safe. Bond rates are typically measured as premia above returns on state bonds.<sup>30</sup> The expected rate of return on a bond effectively demanded by buyers may account for expected capital gains on the bond. Those could arise as the relative riskiness of the corporation's debt falls, or as overall demand for bonds increases. These are unlikely to be systematic as the management of corporations generally will not aim for gains by outsider debt holders.

Equity possesses a distinct relationship to the process of accumulation, dividend payments in the first instance, taken here to amount to total corporate profits for simplicity of exposition. Equity capital exists at one remove from capital engaged in production and circulation of commodities. It does not represent an aliquot of circulating capital, but a pro-rata claim on future streams of dividends equal to the profits generated by the circulation of capital. This is clear from the divergence of a corporation's market capitalisation and net

---

<sup>28</sup> Chen and Ritter (2000) report this discount is usually around seven percent of the listed price.

<sup>29</sup> See chapter seven.

<sup>30</sup> The existence of a large, liquid market for securities generally deemed as risk-free is an important factor in the development of liquid bond markets. The rise in volumes of private marketable debt since the early 1980s was accompanied by an equally impressive rise in the volume of outstanding marketable US Treasury bonds, notes and bills. Those rose from just over 20 percent of GDP in 1980, to almost 45 percent by 1997.

asset values. Capital engaged in industrial or merchant circuits appreciates through the *rate of profit*, established through mediations involving struggles at the point of production, the composition of capital, and competition in input and output markets. Equity (or 'fictitious') capital appreciates according to the *rate of return*, established through competition in capital markets. Each of these rates represents fundamentally different social relations.

The expected rate of return on a corporation's issued equity will generally be higher than the rate of interest on its bonds. Debt repayment is generally more secure than gains on equity. In this important regard the position articulated here differs from that offered by Hilferding (1910), who argued that competition among buyers of equity would take returns on equity down to the rate of interest. Hilferding understood quite well the existence of risk premia. Yet he did not formulate their presence in the pricing of equity securities, possibly because he underestimated the systematic additional risk associated with equity in relation to debt securities.

Competition in capital markets also tends to ensure that the rate of return expected by buyers of a corporation's equity is no higher, and typically be *lower* than the rate of profit. If the expected rate of return effectively demanded by capital markets is higher than the expected rate of profit, the corporation will not likely issue and sell equity. In such a setting, the market price of equity will be lower than the market price of the corresponding real assets, and the firm can in principle realise more money by liquidating. More significantly, holders of loanable money capital will generally accept expected returns lower than the rate of profit because those returns can only be realised by applying their capital to found a new enterprise--a possibility that is not generally open to them. Even if such opportunities were available, engaging in such a project would expose investors to the loss of liquidity mentioned above as well as to the additional entrepreneurial risks associated with a new enterprise.

As a result, the expected rate of return on purchased equity will tend to lie between the rate of interest for the corporation's debt securities and its expected rate of profit. Where exactly it lies will depend on the relative riskiness of the corporation's future cash flows perceived by investors, and the volumes of available loanable money capital in relation to available capital market securities. The difference between the rate of profit and the expected rate of return on equity is the foundation of founder's profits, which may be enhanced through the services of an investment bank. A simple numerical example can illustrate these points.

Consider a new corporation making its initial public offering, through which its founders will sell out completely to equity buyers. Suppose the founders have put \$80,000,000 in real assets into the enterprise, that these are expected to generate the average net rate of profit of 12.5 percent, and that all resulting profits are paid out in dividends of \$10,000,000 per annum. Competition among investors and sellers of liabilities will determine the new corporation's initial market capitalisation. Supposing safe government bonds are yielding five percent returns, we know investors will pay less than \$200,000,000 for the corporation, a price that would transform future dividend payments into a five percent return. Similarly, the founders will not accept selling for less than the \$80,000,000 already sunk into the enterprise. If capital markets are not accepting a price higher than that, the founders will do better by either waiting until conditions change, or liquidating.

Suppose that with the help of an investment bank, the founders achieved a market capitalisation on offer of \$100,000,000. In this case, buyers of the equity are expecting a ten percent rate of return. Competition requires that this will only be the case if under current market conditions, securities perceived as bearing more risk than this equity are yielding more than ten percent and those bearing less risk are yielding less than that.

The founders together with the investment bank have made a founder's profit of \$20,000,000 on an initial investment of \$80,000,000. This represents a return of 25 percent over the period between founding and IPO. This profit represents an appropriation of existing loanable money capital, paid on sale by investors demanding a rate of return lower than that being realised by the corporation on its originally acquired real assets.

The actual magnitude of this profit depends on general capital market conditions, but also on the extent to which the investment bank is able to improve the perceived liquidity and creditworthiness of the securities. As a result, the bank may lay a claim on part of the founder's profit realised through the IPO in the form of underwriting and promotion fees. The exact sharing reflects no reality of accumulation, and will depend on the free interaction of demand and supply for investment banking services and capital market conditions.

Expected capital gains may be included in the analysis above. They may be added to the dividend returns expected by buyers, and to the expected returns of issuers and sellers of equity, without changing the exposition and conclusions above. Capital gains may arise through increased profitability, lower relative perceived risk for the corporation's liabilities, or greater volumes of money entering capital markets. Capital gains on equity are systematic both because enterprises retain earnings for investment in new projects, and because the owners of equity who would benefit from such gains have some say on the actual running of the enterprise.

Particularly given that they may arise simply from increases in demand for equity, they naturally lend themselves to self-fulfilling market movements and concomitant bubbles and busts. Even then, in themselves, neither founder's profits nor capital gains are swindles. They arise from the competitive operation of capital markets. Underwriting, promotion and 'financial engineering' can increase the size of these gains, particularly under favourable market conditions. Conditions have indeed been favourable since the early 1980s as increasing volumes of loanable money capital has entered capital markets in the form of institutional funds. The class content of those investments appears to have made a peculiar type of exploitation possible, involving fund management, proprietary gains, and often outright market manipulation. As the next two sections show, commercial banks have taken full advantage of such opportunities.

#### **4.2 Fund Management**

As already mentioned, managed funds held a total of US\$63.8 trillion in assets at the end of 2006. Even small management fees on such volumes of money can lead to appropriations of very large volumes of loanable money capital. In the US alone, mutual fund management fees have grown considerably since 1980.

**Table 9 - Total Mutual Fund Fees Paid by Holders in US, US\$ billion**

1980	1985	1990	2000	2001	2002	2003	2004	2005	2006
0.0	0.2	1.1	3.4	11.0	8.9	9.1	10.3	10.6	11.8

Source: Investment Company Institute

In the US, investment banks and brokerage houses were the first firms to profit from the new mass retail investment funds. In 1980, the top ten New York investment banks earned less than one percent of their revenues from asset management fees. By 2004, top investment banks earned 7.5 percent of their revenues from such fees.<sup>31</sup> After the 1988 partial relaxation of Glass Steagall restrictions, US commercial banks were offering mutual fund shares to customer, albeit selling them for an “administrative fee” and not an “underwriting commission” or “brokerage fee”.<sup>32</sup> In 1989, commercial banks already had 7 percent of US mutual fund assets under their management. By 1995 this had risen to 15 percent.<sup>33</sup> Worldwide, the nine banks surveyed and their financial group partners controlled at least 10.2 percent of the entire managed fund market in 2006, a share on par with the combined total for investment banks UBS, Credit Suisse, JP Morgan, Goldman Sachs, and Deutsche.<sup>34</sup> The importance of these activities is evident in the banks’ revenue figures.

**Table 10 - Fund Management Commissions and Fees**

Bank	2006		2007	
	US\$ billion	Revenue Share	US\$ billion	Revenue Share
HSBC	2.98	4.2%	2.59	3.1%
Citigroup	1.44	1.6%	1.97	2.4%
Bank of America	4.21	5.7%	3.38	5.0%
RBS	9.096	17.7%	10.078	16.2%
Barclays	2.83	7.1%	3.58	7.8%
BNP Paribas	2.37	6.8%	2.91	6.8%
Dresdner	0.42	4.9%	0.45	6.1%
Santander	2.24	8.0%	2.59	7.6%

<sup>31</sup> See Morrison and Wilhelm (2007)

<sup>32</sup> McGrath (1989).

<sup>33</sup> Neely (1995).

<sup>34</sup> Insurance companies and independent intermediaries controlled 50 percent at the end of that year. Calculated from Watson Wyatt (2007).

The revenue share is broadly higher for banks operating in Europe, where banks and insurance companies overwhelmingly control the market. Independent funds still maintain a significant market share in the US.<sup>35</sup>

Mutual fund holdings, at least in the US, are widespread among middle-class professionals as well as ordinary working-class wage earners. As of 2006, 53 percent of households owning mutual fund shares had a total annual income below US\$75,000; 28 percent earned less than the median of approximately US\$50,000.<sup>36</sup> The attraction of mutual funds for small holders of loanable money capital, for whom direct access to capital markets is too costly, time-consuming, or complicated, is access to rates of return higher than those available through commercial bank deposits or mostly safe government securities. Yet the social realities of the relationship cannot be escaped. Retail investors are various types of wage earners approaching it on the basis of securing future (typically retirement) consumption. Fund managers are well connected financial professionals seeking to maximise profits.

The results are startling. The *Economist* (1 March) recently reported on research by top US fund management firm Vanguard showing that between 1980 and 2005 the S&P 500 share index returned 12.3 percent per year on average. Over the same period, the average equity mutual fund yielded only 10 percent. The average investor gained only 7.3 percent on average per year, largely due to the strong “behavioural” tendency of retail investors to buy high and sell low. This return realised by the average equity mutual fund investor is not much higher than rates available for long-term savings deposits. Over the same period, US six-month T-bills yielded an average 6.00 percent, while US municipal and local government 20-year bonds yielded an average 6.92 percent.<sup>37</sup>

The significance of these differences can be illustrated by considering a hypothetical investment of \$100 made in 1980. If it was invested in safe T-bills,<sup>38</sup> the invested money would have grown to \$454.94 by 2005. If it was invested in the S&P index, it would have grown to \$2041.14. The total premium for investing in equity over T-bills over this period stood, thus, at \$1559.20. Consider a wage earner hoping to save for retirement who tried to take advantage of those potential gains by investing \$100 in an equity mutual fund in 1980. Earning only the average return received by equity mutual fund investors over this period, her investment would have only grown to \$624.59 by 2005. This represents a gain over the safe T-bill investment of \$169.65, or a mere 10.9 percent of the total potential gains from equity investment!

The remaining 89.1 percent were appropriated by fund managers and other financial market firms. This includes appropriation through commissions and fees on investment funds as well as the trading and proprietary gains discussed below. Unsurprisingly fund management is remarkably profitable. In an

---

<sup>35</sup> See BCG (2003).

<sup>36</sup> Investment Company Institute (2007). For reference, in May 2007, a household with a full-time assembly line worker and a full-time teaching assistant had an average income of US\$ 49,300. See Bureau of Labour Statistics, [www.bls.gov](http://www.bls.gov).

<sup>37</sup> Calculated with monthly data from Federal Reserve’s Selected Interest Rates.

<sup>38</sup> Assuming each instrument paid its average annual return over the period every year.

international survey of money fund managers' performance in the lean year of 2002,<sup>39</sup> Boston Consulting Group (2003) found that 64 percent of the funds reported pre-tax profit margins above 20 percent. A full 42 percent of the funds reported profit margins higher than 30 percent. Funds targeting retail investors were reportedly the most profitable.

Although the thought experiment pursued here is no substitute for more comprehensive empirical study, its results strongly suggest these activities have a strong exploitative element, particularly given the high profitability of fund management. By providing pension savings services that used to be provided by the state, fund managers mediate future consumption and appropriate loanable money capital originating in the wages of ordinary retail investors.

### 4.3 Proprietary Trading

Commissions and fees from fund management are only one of the ways in which banks performing investment banking and fund management services can profit at the expense of investors, particularly retail ones. Investment banking and fund management activities naturally pose opportunities for banks to make capital gains on securities. Underwriting requires banks to make investment in the securities being issued.

Brokers often stand in as counterparty for client transactions with volumes that could alter market prices, in which case banks charge clients a margin on the security's current price. And banks increasingly invest in the companies they advise, on which they have intimate knowledge.<sup>40</sup> Finally, when retail investors buy high and sell low, the counterparty to the transaction is the bank's trading account. To the extent that the bank possesses better knowledge about capital markets, avoids "behavioural" trading, and has the financial clout to withstand downturns, it will profit handsomely from such transactions.

This is a controversial issue, as it is rightly perceived to pose potential conflicts of interest between the bank and its clients, and to be fertile ground for the manipulation of markets at the expense of other investors.<sup>41</sup> Banks are generally reluctant to report which transactions are carried out for clients and which are carried on a principal basis. Further complicating matters, this type of gain can accrue not only on listed own investment, but also on securities held for trading as part of brokerage services for both institutional and retail clients. The combined figures for gains on those accounts gives a good sense of the importance of this type of revenue for commercial banks.

---

<sup>39</sup> Including seven of the top ten fund managers by asset, plus another 33 who collectively controlled over one-fifth of the world market.

<sup>40</sup> See Morrison and Wilhelm (2007).

<sup>41</sup> See, for instance, Blackburn (2006) for accounts of a number of instances of market manipulation.

**Table 11 - Own and Trading Account Gains**

Bank	2006		2007	
	US\$ billion	Revenue Share	US\$ billion	Revenue Share
HSBC	8.86	12.6%	13.89	15.9%
Citigroup	5.76	6.4%	-8.00	
Bank of America	5.57	7.5%	-3.92	
RBS	11.48	22.2%	12.39	19.9%
Barclays	8.42	21.2%	9.96	21.6%
BNP Paribas	11.22	32.0%	14.17	33.4%
Dresdner	3.57	41.7%	-0.66	
Santander	2.70	9.6%	4.10	12.1%
SMFG	1.08	6.6%	n/a	
UBS	10.97	33.2%	-6.96	
Goldman Sachs	25.56	67.9%	31.23	67.9%

Collectively, the nine banks surveyed made profits of US\$58 billion in 2006 from such gains. For its part, Goldman Sachs made over US\$25 billion on this account that year, more than enough to cover the employee compensation bill of just over US\$16 billion.<sup>42</sup>

The sub-prime crisis also highlighted the importance of these activities. While some of the surveyed banks suffered losses in outright mortgage and other consumer loans, centrally in US markets, the main impact on these banks took place through their trading-account holdings of sub-prime mortgage CDOs. The 2007 trading account losses in credit or structured products for Citigroup, Bank of America and Dresdner stood at US\$ 21.806 billion, 5.176 billion, and 468 million, respectively. While posting net overall trading account gains, RBS, Barclays, and HSBC registered net trading losses in credit instruments amounting to US\$2.861 billion, 823 million, and 419 million. Some of these losses were associated with holdings for trading, as these banks mediated purchases by many hedge funds investing in sub-prime mortgage CDOs.<sup>43</sup> But the sheer volume of losses shows that these holdings were to a significant extent proprietary in that they were motivated by the hope of returns on holding these assets.

<sup>42</sup> For an average of just under US\$622,000 per employee.

<sup>43</sup> Dodd (2007).

#### 4.4 Derivatives

Investment and commercial banks have engaged heavily in issuing, trading, and market-making for derivative assets. Markets for over-the-counter interest-rate and foreign exchange derivatives have grown tremendously in the past twenty years, reaching almost US\$400 trillion in notional amounts outstanding in June of 2007, according to the Bank for International Settlements. Although insignificant as recently as the end of last century, the volume of credit default swaps have also increased dramatically in the past seven years.

**Table 12 - Credit Default Swaps, Notional Amounts outstanding at year-end, US\$ Trillion<sup>44</sup>**

2001	2002	2003	2004	2005	2006	2007
0.919	2.192	3.779	8.422	17.096	34.423	42.58

Sources: International Swaps and Derivatives Association Market Survey, BIS

Banks were naturally placed to lead the way as derivative markets developed. They were the first enterprises affected by the increased risks posed by interest- and exchange-rate liberalisation starting in 1973. They became pioneers in deploying hedging techniques with interest rate and foreign exchange derivative contracts as part of their own risk management. It is difficult to identify the revenues banks raise from issuing these assets and gains they make on their trading accounts as they are not reported separately. What is clear is that six of the nine commercial banks surveyed have prominent market positions. According to Emm and Gay (2005), Citigroup, Bank of America, BNP Paribas and RBS have been recently among the top seven dealers of derivative assets worldwide. HSBC and Barclays also have a solid presence in US markets.

**Table 13 - Selected OTC derivatives Dealers in United States by Market Share, June 2007**

Bank	US, 2007	Ranking
JP Morgan	51.3%	1
Citigroup	20.7%	2
Bank of America	19.5%	3
HSBC	2.9%	4
Wachovia	2.7%	5
ABN Amro	0.8%	13
Barclays	0.4%	19

US Office of the Comptroller of the Currency, Quarterly Report on Bank Derivatives Activities, 2007 Q2

<sup>44</sup> Except in 2007, for which the end of June figure is given.

The investment banking functions of these banks naturally placed them in a position to sell derivative contracts to corporate clients. Those assets may help improve capital-market perceptions of a corporation's security, thus lowering their cost of capital, and creating the basis for the payment of issuance fees. Despite the fact that non-financial corporations make heavy use of these assets,<sup>45</sup> financial intermediaries themselves account for the bulk of the markets, particularly for credit default swaps.

**Table 14 - OTC Derivative Contracts With Financial Intermediaries, Percent of Total, June 2007**

Foreign Exchange	Interest Rate	Credit Default Swaps
78.8%	86.9%	97.9%

Source: Calculated from BIS Semiannual OTC derivatives statistics, end of June 2007

As with corporations, financial intermediaries may alter capital market perceptions of their prospects through the use of widely recognised derivative assets. Banks acquire derivatives to manage their risk positions. They increasingly use credit default swaps, which lower the regulatory capital cost of holding debt securities under Basle II capital adequacy conventions.<sup>46</sup> Insurance companies, investment and hedge funds regularly acquire derivative assets from dealers in order to conform their positions with the expectations and requirements of customers and regulators. As such, derivative assets may help improve the market acceptability of the liabilities on those intermediaries, including regulatory capital reserves. Gains made from these improvements provide the foundation for payments of fees for obtaining derivative contracts. It should be noted here that the most important function of a derivative asset in this connection is not necessarily to change the prospects of the buyer, but to change the *perception* of those prospects by other capital market players.<sup>47</sup>

Whether bought for hedging or pure speculation, derivative assets yield fees to issuing banks. Like good bookies, banks generally maintain a neutral position to either side of all markets. Issuance fees represent various appropriations of existing loanable money capital, centrally from institutional investors drawing funds from the mass of retail investors. As such, bank profits from this issuance also contain an exploitative character.

<sup>45</sup> The International Swaps and Derivatives Association reports well over 90 percent of the world's top 500 corporations regularly use over-the-counter derivatives.

<sup>46</sup> By reducing the measured risk of an asset holding and, thus, lowering the corresponding risk-weighted capital reserves.

<sup>47</sup> Millo and MacKenzie (2007) eloquently emphasises this aspect of derivative markets, particularly in relation to the prevalence of pricing models based on the basic models of Black and Scholes (1973) and Merton (1973) whose mathematical foundations yield easily authoritative prices, regardless of their empirical purchase on reality.

## 5. Some Concluding Observations

A number of secular, policy and technological developments have fundamentally changed banking and its relationship to accumulation. Banks have developed new sources of income through credit to individuals and various financial market mediation activities. As a result they have been able to appropriate growing fractions of the income of wage earners, through interest payments, various investment fund fees, and from capital gains made at least partly at the expense of ordinary savers. The privatisation of the provision of a growing number of social necessities has been central to this process, as it has forced wage earners into financial markets to secure access to increasing proportions of current and future consumption. The relationships banks establish with them in this regard are exploitative. In contrast, the relationship of banks with corporations is increasingly centered on investment banking services which are provided on a detached, arms-length basis, and appears to be mutually beneficial.

The current financial crisis may be usefully understood as a crisis of this type of banking. Put most plainly, the sub-prime mortgage lending boom represented attempts by banks and other intermediaries to extract sections of income from layers of the US population with little to no incomes. The collateralisation of credit card debt may yet add to the system's problems. Hubris about the power of new, inference-based estimations of risk, and positivism, played an important part in this, as capital market players came to believe that derivative assets and their inference-based pricing formulas could actually describe and account for all market eventualities. More importantly, competition among intermediaries ensured that even though many of them knew sub-prime mortgage lending was going to lead to losses, they could hardly afford to miss out on the boom.<sup>48</sup> To borrow from former Citigroup boss Chuck Prince III, when the music stopped, most banks were caught dancing.

Contemporary banking created the current financial crisis and is responsible for the consequent devastation of the lives of millions of people. It is also central to contemporary capitalism. Whatever happens over the next period, it is unlikely that bank appropriation of value at the expense of ordinary wage earners will collapse by the power of its own contradictions. The revenues are far too significant, and the beneficiaries far too central to the socio-political fabric of the different advanced capitalist economies. The weakening of trade union and of broader social organisations of ordinary people over the past thirty years facilitated the growing intrusion of the financial system into the everyday lives of ordinary wage earners. It is the reawakening of those organisations that can once again place on the agenda the social provision for housing, retirement, education, health and other necessities, and the broader desirability of conscious, democratic economic planning.

---

<sup>48</sup> HSBC (2007), p 8, noted in March 2007 that much of its US sub-prime mortgage portfolio had “evidenced much higher delinquency than had been built into the pricing of these products”. Despite promises to shareholders of “restructuring this business to avoid any repetition of the risk concentration that built up”, the bank reported losses of US\$ 1.8 billion in consumer lending and US\$1.2 billion in investment banking for the US operations one year later.

## References

- Akers, D, J Golter, B Lamm and M Solt (2005), "Overview of Recent Developments in the Credit Card Industry", *FDIC Banking Review*, 17(3), 23-35.
- Allen, F and A Santomero (1997), "The theory of financial intermediation", *Journal of Banking and Finance*, 21(11-12), 1461 – 85.
- \_\_\_\_\_ (2001), "What do financial intermediaries do?", *Journal of Banking and Finance*, 25(2), 271 – 94.
- Barclays (2008), *Annual Report 2007*, London: Barclays plc.
- Berger, A and L Mester (2003), "Explaining the dramatic changes in performance of U.S. banks: technological change, deregulation, and dynamic changes in competition", *Journal of Financial Intermediation*, 12(1), 57 – 95.
- Boston Consulting Group (2003), *Navigating the Maze, Asset Management 2003*, Boston: Boston Consulting Group.
- Black, F and M Scholes (1973), "The pricing of options and corporate liabilities", *Journal of Political Economy*, 81(May/June), 637 – 59.
- Blackburn, R (2006), "Finance and the Fourth Dimension", *New Left Review*, May/June, 39-70.
- Chen, H and J Ritter (2000), "The Seven Percent Solution", *Journal of Finance*, 55(3), 1105-31.
- Dodd, R (2007), "Subprime: Tentacles of a Crisis", *IMF Finance and Development*, 44(4), 15-19.
- Emm, E and G Gay (2005), "The Global Market for OTC Derivatives: An Analysis of Dealer Holdings", *The Journal of Futures Markets*, 25(1), 39-77.
- Erturk, I and S Solari (2007), "Banks as continuous reinvention", *New Political Economy*, 12(3), 369 – 88.
- Furnace, D (2004), "Why Overdraft Income is Growing for Financial Institutions?", *Kentucky Banker Magazine*, March 2004, Louisville: Kentucky Bankers Association.
- Greenspan Commission (1983), "Report of the National Commission on Social Security Reform", Washington, DC: Social Security Administration.

Gruben, W and R McComb (1997), "Liberalization, Privatization, And Crash: Mexico's Banking System in the 1990s", *Federal Reserve Bank of Dallas Economic Review*, First Quarter, 21-30.

Hilferding, R (1910, 1981) *Finance Capital*, London: Routledge & Kegan Paul.

Itoh, M and C Lapavitsas (1999) *Political Economy of Money and Finance*, London: Macmillan.

HSBC (2007), *Annual Report 2006*, London: HSBC Holdings plc.

International Finance Corporation (2008), *Annual Report 2007*, Washington, DC: World Bank Group.

Investment Company Institute (2006), "401(k) Plan Asset Allocation, Account Balances and Loan Activity in 2005", *Research Perspective*, 12(1), 1-20.

\_\_\_\_\_ (2007), *2007 Investment Company Fact Book, 47th Edition*, [www.icifactbook.org](http://www.icifactbook.org).

Lang, W, L Mester and T Vermilyea (2007), "Competitive Effects of Basel II on U.S. Bank Credit Card Lending", *Federal Reserve Bank of Philadelphia Working Paper*, 07-9, Philadelphia: Federal Reserve Bank of Philadelphia.

Lapavitsas, C (2003), *Social foundations of markets, money, and credit*, London: Routledge.

\_\_\_\_\_ (2007), "Information and trust as social aspects of credit", *Economics and Society*, 36(3), 416 – 36.

\_\_\_\_\_ (2008), "Financialised Capitalism: Direct Exploitation and Periodic Bubbles", unpublished manuscript.

Lapavitsas, C and P dos Santos (2008), "Globalization and Contemporary Banking: On the Impact of New Technology", *Contributions to Political Economy*, 27(1), Forthcoming.

Leyshon, A and N Thrift (1997), *Money/Space*, London, Routledge.

Marx, K (1894, 1909), *Capital*, Volume III, Chicago: Charles H. Kerr & Company.

McGrath, K (1989), "Legislative and Regulatory Update: Banks and Mutual Funds", speech given to 1989 American Bankers Association by SEC Director of Investment Management, 6 February 1989, Washington, DC: Securities and Exchange Commission.

Merton, R (1973), "Theory of rational option pricing", *Bell Journal of Economics and Management Science*, 4 (Spring), 141 – 83.

Mester, L (1997), "What is the point of credit scoring?", *Federal Reserve Bank of Philadelphia Business Review*, September – October, 3 – 16.

Millo, Y and D MacKenzie (2007), "Building a Boundary Object: The Evolution of Financial Risk Management", unpublished manuscript.

Morrison, A and W Wilhelm (2007), *Investment Banking, Institutions, Politics, and Law*, New York: Oxford University Press.

Neely, M (1995), "Will the Mutual Fund Boom be a Bust for Banks?", *Federal Reserve Bank of St Louis Regional Economist*, October, St Louis: Federal Reserve Bank of St Louis.

Organization for Economic Cooperation and Development (2007), *Closing the Pensions Gap: The Role of Private Pensions*, Paris: OECD.

Watson and Wyatt (2007), "The World's 500 Largest Asset Managers", [www.watsonwyatt.com/research/deliverpdf.asp?catalog=PI\\_500\\_Analysis\\_2007](http://www.watsonwyatt.com/research/deliverpdf.asp?catalog=PI_500_Analysis_2007).

## **Appendix on Bank Corporate Reports**

Unless otherwise noted, all information concerning individual banks was obtained from their respective Annual Reports for 2006 and 2007. The only exception is SMFC, for which the report for fiscal 2006-07 was used. Given the significant accounting conventions across national regulators and individual institutions, it is necessary to specify the sources for particular data reported above. This is done by reported area of activity in the explanations below, which also include pertinent caveats and difficulties.

### **Credit card and Account Service Charges**

For all banks, these are fees from credit and banking cards, and account services. For RBS, total non-interest income from retail operations is provided, which includes fund management fees. For BNP Paribas net commission income not measured at fair value is given, which is a residual estimate of money-dealing commission and fees.

### **Financial Market Mediation**

The percentages are an understatement for SMFG and RBS, neither of which reported separate fund management revenues. SMFG does not report narrow investment banking revenues either. The figure given is exclusively for gains on own and trading account.

### **Investment Banking Fees**

For HSBC the figures are the sum of net income from brokering, corporate finance fees and underwriting. Citigroup's and Bank of America's figures are net income from investment banking plus underwriting and investment banking trade related fees. The RBS figures are the sum of net fees and commissions from Global and UK operations of its Global Banking and Markets segment. Fee income from Barclays Capital provides the figure for Barclays. UBS figures are the sum of all underwriting, brokerage, M&A and corporate finance fees. The figures given for Dresdener are net incomes from M&A and underwriting. Santander's "Banca Inversiones" entry from its "Banca Mayorista" segment is given. Goldman Sachs gives its revenues for investment banking activities.

### **Fund Management and Related Commission Fees**

The figures relate to net fees and or commissions on management of investment, pension, mutual and other funds. The exceptions are Citigroup, for which net income of Smith Barney and Private Banking divisions is given, and RBS for which fees earned at retail level are given, which also include money-dealing fees.

### **Own and Trading Account Gains**

For HSBC the figures are the sum of “Net trading income and Net income from financial instruments”. For Citibank, they relate to “Principal transactions” total revenue (the reported loss for credit instrument tallied at US\$ 21.8 billion). For Bank of America and SMFG, they correspond to “Trading account profits” plus equity investment income and gains on sales of debt securities. The bank’s trading account loss for 2007 stood at US\$ 5.13 billion. The figures for RBS include net gains from trading plus gains from investments, asset-backed activities, and rental. The figures for Barclays are from “Principal transactions” and include net trading and investment incomes. Santander’s “resultados netos de operaciones financieras” are reported. Paribas reports prominently on its net gains on financial instruments at fair value and on available-for-sale financial assets. The figures for UBS and Goldman Sachs are, respectively, for net trading income and trading and principal investments income.