On the Content of Banking in Contemporary Capitalism

Paulo L dos Santos
Department of Economics, School of Oriental and African Studies

15 February 2009

Research on Money and Finance Discussion Papers

RMF invites discussion papers that may be in political economy, heterodox economics, and economic sociology. We welcome theoretical and empirical analysis without preference for particular topics. Our aim is to accumulate a body of work that provides insight into the development of contemporary capitalism. We also welcome literature reviews and critical analyses of mainstream economics provided they have a bearing on economic and social development.

Submissions are refereed by a panel of three. Publication in the RMF series does not preclude submission to journals. However, authors are encouraged independently to check journal policy.
Paulo L dos Santos, Address: Department of Economics, Soas, Thornhaugh Street, Russell Square, London, WC1H 0XG, Britain. Email: ps45@soas.ac.uk. The author would like to thank the participants of the International Workshop on the Political Economy of Financialisation at Kadir Has University in Istanbul in March 2008, and the participants of the Crisis of Financialisation Conference at Soas in May 2008. A special acknowledgement is owed to Professor Makoto Itoh for his detailed and prescient comments on an earlier draft. All remaining errors and one-sidedness are the author’s.

Research on Money and Finance is a network of political economists that have a track record in researching money and finance. It aims to generate analytical work on the development of the monetary and the financial system in recent years. A further aim is to produce synthetic work on the transformation of the capitalist economy, the rise of financialisation and the resulting intensification of crises. RMF carries research on both developed and developing countries and welcomes contributions that draw on all currents of political economy.

Research on Money and Finance
Department of Economics, SOAS
Thornhaugh Street, Russell Square
London, WC1H 0XG
Britain

www.soas.ac.uk/rmf
Abstract

This paper considers the character and social content of banking in contemporary capitalism. Based on a survey of the operations of nine leading international banks, it documents the marked differences between contemporary banking and the traditional business of taking, making loans to enterprises, and making profits from the difference in interest rates between them. Notably, the operations of the world’s top banking organisations are shown to centre on various forms of credit to individual wage earners and on mediating access to financial markets by corporations and, increasingly, individuals. In order to characterise the social content of such activities the paper seeks to apply, and where necessary extend, existing Marxist analyses of banking, capital markets, and their relationship to capitalist accumulation. This includes advancing a number of elements of a distinctive Marxist interpretation of capital-market operations to theorise financial market mediation relations between banks, corporations, and the mass of retail savers. The analysis pursued helps identify the distinctive and exploitative content of the relations banks maintain with ordinary wage earners through consumer and mortgage lending, as well as through the provision of pension-related saving services.
1. Introduction

By many historical measures the current financial crisis is without precedent. It originated 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 and Lehman Brothers 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, class and social content of banking taking place over the past 25 years.

Banking has become heavily dependent on lending to individuals, and the direct extraction of revenues from ordinary wage earners. It has also become enmeshed with capital markets, where banks mediate financial market transactions involving bonds, equity, and derivative assets, and where they increasingly obtain funding. 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 in 1981. Nevertheless, Marxist political economy has a unique and important contribution to make to the analysis of the social and historical significance of contemporary banking and its 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. 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, their average return on equity was still a relatively high 14.87 percent.

Firm-level inquiry 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 important sources of bank profits, particularly for European banks.

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 1909, Itoh and Lapavitsas 1999, and most directly from Hilferding 1981. Particular attention is given to the characterisation of financial market mediation functions. This

---

1 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.
includes advancing a distinctive appreciation of the social content of capital markets and investment banking, building critically on Hilferding’s 1910 analysis.

On these bases the paper argues that contemporary banking centres on one hand on mutually beneficial, arms-length relationships with corporations based 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. Those have developed in the political climate created by significant class-struggle defeats suffered by the working-class movement, in which the provision of a growing share of necessary goods and services became of remained private.

Private provision of education, housing, and health make access to money a growing requirement for present and future consumption. Against a setting of stagnant real wages and rising income inequality, this has pushed wage earners onto financial markets as an integral part of their basic reproduction. Banks mediate access to housing, durable consumer goods, education, and increasingly health care, though insurance, mortgage and other individual loans, drawing profits from wage income that are increasingly central to their operations.

The gradual privatisation of pension provision has also helped banks develop other avenues of appropriation founded on wage income. Pension and other investment funds have generated rising fee incomes for banks. The associated unprecedented money inflows into capital markets have also enhanced the scope for various corporate “financial engineering” measures in which banks play a central role. In contrast to 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. It may be usefully understood as possessing an exploitative content.

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. Sections 4 and 5 consider the significance and social content of financial market mediation functions performed by banks. Section 4 focuses on fund management, derivative assets and proprietary gains. Section 5 offers distinctive Marxist analytical elements for an approach to the social content of capital markets and traditional investment banking functions. Section 6 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. 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 activities associated with “financial market mediation”. These involve facilitating the participation of others in financial markets through investment

---


Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism
banking services to corporations, brokerage and, increasingly, through the management of investment, mutual, pension and insurance funds for retail investors. Banks have also increased lending to individuals through consumption loans and mortgages.

These trends are evident in macro-level data for advanced economies. Bank non-interest income has increased in significance throughout the OECD countries.

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

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>24.9</td>
<td>30.5</td>
<td>30.3</td>
<td>32.1</td>
<td>39.7</td>
<td>40.7</td>
</tr>
<tr>
<td>(West) Germany</td>
<td>20.4</td>
<td>20.6</td>
<td>26.8</td>
<td>21.0</td>
<td>35.8</td>
<td>34.2</td>
</tr>
<tr>
<td>Spain</td>
<td>14.9</td>
<td>15.6</td>
<td>18.2</td>
<td>23.1</td>
<td>35.8</td>
<td>33.2</td>
</tr>
<tr>
<td>France</td>
<td>22.6</td>
<td>45.5</td>
<td>60.9</td>
<td>62.2</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Calculated from OECD Bank Income Statement and Balance Sheet Statistics

Bank lending has correspondingly declined in importance. It has also changed in composition, shifting from lending to real sector firms towards individual consumption and mortgage loans. 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.

2.1 The Rise of the Institutional Investor

A number of interrelated processes and innovations have created the context for these changes. Technical innovation has been instrumental in the orientation of banks to individual credit. Credit scoring methods have made mass retail lending possible by yielding quantitative (and problematic) 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 been passed on to retail depositors.

State policy in favour of financial liberalization, and secular changes in the financial behaviour of corporations and households, have been particularly important. Most directly, the relaxation and repeal of Glass-Steagall restrictions in the US, and the acceptance of the

---

3 The observations here also broadly apply to the other OECD economies for which comparable data is available. See www.oecd.org


provision of various insurance services by banks in Europe have widened the scope for commercial bank intervention into capital markets.

More fundamentally, the rising importance of corporations’ own retained earnings, and the gradual privatisation of pension provision have had a major impact on both sides of capital markets. On the demand side, increased volumes of money have sought to buy securities. On the supply side, the scope for capital gains generated from various “financial engineering” measures has increased. And 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. 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 very low level. 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.

Figure 1 - US Household Holdings of Mutual and Pension Funds to GDP, 1959 - 2007

![Figure 1 - US Household Holdings of Mutual and Pension Funds to GDP, 1959 - 2007](image)

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

---


Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism
Table 2
Japanese Household Mutual Fund Holdings and Insurance Reserves, percent of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Calculated from OECD Data

Similarly, across a range of OECD countries, total holdings of open- and closed-end investment funds and insurance reserves rose from 41.9 to 73.4 percent of GDP between 1995 and 2005. 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.

The rise of these institutional funds created new “buy-side” opportunities for banks. They could earn fees from directly managing investment funds. In addition, they could earn fees by assisting independent insurance, hedge and other investment funds in their securities transactions.

2.2 Changes in Corporate Financial Behaviour

The new funds also helped create new “sell-side” revenues 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.

Figure 2 - US Corporate Capital Raised to GDP, 1960 - 2001

Calculated from Securities Industry Association Factbook

---

5 Figures calculated from OECD data for Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Spain and the United Kingdom.
6 Watson Wyatt 2007.

Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism

Evidence for US non-financial corporations suggests this increase in the issuance of marketable corporate liabilities signaled fundamental changes in their relationship with capital markets. Since the early 1970s, their net fixed investment has tended to fall, with cyclical fluctuations, in relation to profits. In the 25 years to the end of 1984, the net fixed investment of US non-financial corporations averaged 23.7 percent of their actual profits. In the 25 years that followed, they averaged 17.7 percent, despite the dot.com investment boom of 1995 to 2000. In this context, the increase in corporate security issuance was not associated with increased productive investment, which could increasingly be funded with internal funds.

Instead, it was associated with a dramatic increase in “financial engineering” operations aimed to secure capital gains. As bond issuance grew in importance for non-financial corporations, its relationship with net equity flows underwent a fundamental structural change. In pure statistical terms, bond finance flows displayed a clear positive correlation with equity finance flows between 1946 and 1983, suggesting they were alternative sources of funds. Since 1983, the correlation become negative, as did net equity flows.

**Figure 3 - US Nonfinancial Corporations’ Liability Flows to GDP, 1952Q1 - 2008Q4**

Calculated from Flow of Funds of the United States, Board of Governors of the Federal Reserve System

In words, the increased corporate bond borrowing over this period appears to be closely related to the withdrawal of equity, which typically takes the form of “financial engineering” operations like share buybacks, private equity purchases, mergers and acquisitions. These operations have become increasingly important to the relationship of non-financial corporations and financial markets, at least in the US. As discussed in detail below, the potential capital gains achieved by such operations are greatly enhanced in a setting of increasing volumes of money entering capital markets. Commercial banks have

---

9 Rising from 46.7 percent of their borrowing in 1983 to 70 percent by 2007.

*Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism*
developed significant revenue streams by managing, advising, underwriting and financing these financial operations.

Through all these changes, banks have been able not only to maintain, but actually to increase the significance of their profits in the advanced economies.

Table 3
Bank Profits as Percentage of GDP

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>0.72</td>
<td>0.74</td>
<td>1.62</td>
</tr>
<tr>
<td>(West) Germany</td>
<td>0.53</td>
<td>0.81</td>
<td>1.35</td>
</tr>
<tr>
<td>Spain</td>
<td>0.84</td>
<td>1.42</td>
<td>1.77</td>
</tr>
<tr>
<td>France</td>
<td>0.96</td>
<td>1.53</td>
<td></td>
</tr>
</tbody>
</table>

Calculated from OECD Bank Income and Balance Sheet Statistics

3. Economic Relations of Bank Lending and Money-Dealing

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. 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 financial expropriation of wage earners. This section tackles these changes in bank behaviour, offering an empirical and analytical discussion of the importance and distinct social content of these new channels of appropriation.

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 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. 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.

---

10 Best developed in Hilferding 1981.
Loanable money capital receives not profits but repayments with interest. To Marx 1894, the level of the rate of interest contains an element of irrationality: 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. To Marx, competition between buyers and sellers, however, tends to maintain the rate of interest between zero and the rate of profit during ordinary periods. Their 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.\(^{13}\)

In lending to capitalist enterprises, the payment of interest is generally 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.\(^{14}\)

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 who both enter the transaction on the basis of a profit-maximising calculus. An important expression of this equality is the hiring of financial officers, whose very jobs are to ensure the firm secures outside finance on the most advantageous terms possible. The social relations defined by lending to individuals are fundamentally different in most of these regards.

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>
<thead>
<tr>
<th></th>
<th>HSBC</th>
<th>Citigroup</th>
<th>B of A</th>
<th>RBS</th>
<th>Barclays</th>
<th>Paribas</th>
<th>Dresdner</th>
<th>SMFG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans</td>
<td>40.5</td>
<td>77.7</td>
<td>76.3</td>
<td>24.0</td>
<td>44.0</td>
<td>33.0</td>
<td>20.1</td>
<td>26.8</td>
</tr>
</tbody>
</table>

\(^{12}\) See part V.

\(^{13}\) Lapavitsas 2003.

\(^{14}\) This appears to be an increasingly common practice, particularly in firms controlled by private equity groups aiming for fairly quick gains in market capitalisation.

Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism
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 focuses on consumption and mortgage credit, generated US$9.5 billion in profits, 42.9 percent of the total, 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. 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 HSBC and Citibank offer a congealed expression of this direct appropriation. Along with other banks across Latin America, 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 condition 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 patterns deemed ‘irrational’ by mainstream economic analysis follow, including the tendency for consumers to continue using the first card they ever obtained, regardless of its comparative rates. 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 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, reducing the scope for competition.

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. As table 5...
shows, mortgage lending accounts for a very high fraction of lending to individuals for these banks.\textsuperscript{18}

\begin{table}
\centering
\caption{Mortgage Loans to Total Loans to Individuals, December 2006}
\begin{tabular}{ccccccc}
\hline
 & HSBC & Citigroup & B of A & RBS & Barclays & Paribas & Dresdner & SMFG \\
\hline
 & 53.6 & 33.1 & 59.1 & 72.9 & 73.0 & N/A & 33.3 & 98.1 \\
\hline
\end{tabular}
\end{table}

Another significant item is education, where growing costs have increasingly fallen directly on individual students and their families 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 part of this lending. And here banks in the US moved aggressively to concentrate the industry as it grew in size and profitability in the 1990s. In 1995 they held no more than 25 percent of credit card receivables in the US.\textsuperscript{19} As late as 1999, the top ten US issuers controlled 55 percent of the market; many of them were independent credit card companies.\textsuperscript{20} 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.\textsuperscript{21}

The broader significance of this orientation to individual lending cannot be overstated. In the US, against a background of stagnant real wages, the financial obligations of households is estimated to have increased from 15.36 to 19.35 percent of disposable income between 1980 and 2007.\textsuperscript{22} The volume of transfers from households to the financial sector on this account is unprecedented. And as the current financial crisis shows, this lending has introduced a distinct, new source of instability to financial markets.

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.\textsuperscript{23} 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

\textsuperscript{18} These figures include home equity withdrawals, which are best understood as consumer credit. Even in Britain, where such withdrawals were exceptionally high, they never amounted to more than 20 percent of mortgage credit.

\textsuperscript{19} Allen and Santomero 2001.

\textsuperscript{20} Land, Mester, and Vermilyea 2007.

\textsuperscript{21} 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.

\textsuperscript{22} See Federal Reserve, Household Debt Service and Financial Obligations Ratio.

\textsuperscript{23} See Lapavitsas 2007.
number of years been trying to curb overdraft and related bank fees widely perceived to be excessive and opaque. 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, 2006**

<table>
<thead>
<tr>
<th>Bank</th>
<th>2006 US$ billion</th>
<th>Revenue Share</th>
<th>2007 US$ billion</th>
<th>Revenue Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>HSBC</td>
<td>9.00</td>
<td>12.80%</td>
<td>10.86</td>
<td>12.40%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>6.78</td>
<td>7.66%</td>
<td>7.22</td>
<td>8.80%</td>
</tr>
<tr>
<td>Bank of America</td>
<td>22.51</td>
<td>30.50%</td>
<td>22.99</td>
<td>33.80%</td>
</tr>
<tr>
<td>RBS</td>
<td>9.10</td>
<td>17.70%</td>
<td>10.08</td>
<td>16.20%</td>
</tr>
<tr>
<td>Barclays</td>
<td>11.10</td>
<td>27.90%</td>
<td>12.73</td>
<td>27.60%</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>2.53</td>
<td>7.20%</td>
<td>3.07</td>
<td>7.20%</td>
</tr>
<tr>
<td>Dresdner</td>
<td>0.33</td>
<td>3.90%</td>
<td>0.35</td>
<td>4.70%</td>
</tr>
<tr>
<td>Santander</td>
<td>1.53</td>
<td>5.50%</td>
<td>1.95</td>
<td>5.70%</td>
</tr>
<tr>
<td>SMFG</td>
<td>1.58</td>
<td>9.60%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Bank of America and Citigroup together received almost US$30 billion in fees from money-dealing services to individual accounts in 2007. In Britain, Barclays received more than a quarter of its 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. 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 credit to individuals. Overdraft charges, late payment fees, credit card charges, &c are 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 exploitative.

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 fixed costs in establishing these

---

24 See appendix for explanation of categories used in different corporate reports to obtain all data reported in this section. The figure given in this table for RBS also includes retail fee revenues not associated with money dealing.

25 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.
new facilities, and their introduction is yet to translate into reductions in overhead costs. Bank clients have become heavy users of the new technologies, increasingly using cards and making frequent ATM withdrawals to access consumption.\textsuperscript{26} Growing money-dealing fees, thus, may in part amount to payments by ultimate users of new, expensive, technologies. But their persistence and opacity, the magnitudes involved, and their intrusion into the very process of consumption suggest the presence of exploitative elements in them.

While further research is necessary on this particular account, it is clear that in both lending and money-dealing services banks have reoriented to private wage income as a source of revenues. The resulting relations contain important exploitative elements. Significant as the resulting profits are, they do not exhaust the current scope for bank appropriation of wage earnings. The growing scope of financial market mediation activities have afforded banks additional avenues for bank profits grounded on wages. The next two sections turn to those activities and the social content of contemporary capital markets.

4. Financial Market Mediation

Facilitating access to capital markets has emerged as an important activity for commercial banks over the past twenty years. As table 7 shows for 2006, revenues from these activities are very important for the surveyed banks, particularly European ones. The nine banks grossed US$113 billion on this account that year.

<table>
<thead>
<tr>
<th>HSBC</th>
<th>Citi</th>
<th>B of A</th>
<th>RBS</th>
<th>Barclays</th>
<th>Paribas</th>
<th>Sant’dr</th>
<th>Dresd’r</th>
<th>SMFG</th>
</tr>
</thead>
<tbody>
<tr>
<td>19.50%</td>
<td>14.6%</td>
<td>16.6%</td>
<td>30.5%</td>
<td>37.8%</td>
<td>58.1%</td>
<td>19.0%</td>
<td>50.8%</td>
<td>6.6%</td>
</tr>
</tbody>
</table>

These revenues arise from a range of activities, from conventional investment banking functions of underwriting, brokerage and corporate advisory services to investment and insurance fund management and the issuance 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.

The view motivated in the next two sections is that, through these functions, banks appropriate fractions of existing loanable money capital ultimately owned by the mass of all investors. As with ordinary lending, the social character of the relationship banks have with capitalist clients is fundamentally different from that of their relationship with retail savers. In the current setting, there is scope for systematic mutual gains in arms-length relationships between investment banks and corporations and other financial intermediaries. Those gains are ultimately funded by flows of loanable money capital owned by the mass of investors, who are increasingly ordinary savers. In contrast, the relationship between banks and average retail investors appears in the present context as exploitative, as banks systematically appropriate value by mediating future retirement consumption.

In order to establish these points it is necessary to characterise the functioning of capital markets and the intervention in them by banks. This requires the extension of

\textsuperscript{26} See Berger and Mester 2003 and Lapavitsas and dos Santos 2008.

*Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism*
existing Marxist theory. No significant Marxist contribution has been made to this analysis in the hundred years since Hilferding’s 1910 seminal work. And despite its many insights, Finance Capital presents problems in its approach to the concept of founder’s profit as well as in the contemporary relevance of its core concept of finance capital, both of which lie at the heart of Hilferding’s conceptualisation of the integration of corporations, capital markets and investment banks.

Section five below offers initial analytical elements of a Marxist approach to the contemporary form of those social relations. Before that, this section documents the relative importance of revenues from fund management, proprietary gains, and derivatives trading for top international banks.

4.1 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 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>
<thead>
<tr>
<th>Year</th>
<th>Fees (US$ billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>0.0</td>
</tr>
<tr>
<td>1985</td>
<td>0.2</td>
</tr>
<tr>
<td>1990</td>
<td>1.1</td>
</tr>
<tr>
<td>2000</td>
<td>3.4</td>
</tr>
<tr>
<td>2001</td>
<td>11.0</td>
</tr>
<tr>
<td>2002</td>
<td>8.9</td>
</tr>
<tr>
<td>2003</td>
<td>9.1</td>
</tr>
<tr>
<td>2004</td>
<td>10.3</td>
</tr>
<tr>
<td>2005</td>
<td>10.6</td>
</tr>
<tr>
<td>2006</td>
<td>11.8</td>
</tr>
</tbody>
</table>

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. After the 1988 partial relaxation of Glass Steagall restrictions, US commercial banks were offering mutual fund shares, albeit selling them for an “administrative fee” and not an “underwriting commission” or “brokerage fee”. In 1989, commercial banks already had 7 percent of US mutual fund assets under their management. By 1995 this had risen to 15 percent. 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. The importance of these activities is evident in the banks’ revenue figures.

---

27 See Morrison and Wilhelm 2007.
29 Neely 1995.
30 Insurance companies and independent intermediaries controlled 50 percent at the end of that year. Calculated from Watson Wyatt 2007.
### Table 9
**Fund Management and Commission Fees**

<table>
<thead>
<tr>
<th>Bank</th>
<th>2006</th>
<th></th>
<th>2007</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>US$ billion</td>
<td>Revenue Share</td>
<td>US$ billion</td>
<td>Revenue Share</td>
</tr>
<tr>
<td>HSBC</td>
<td>2.98</td>
<td>4.20%</td>
<td>2.59</td>
<td>3.10%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>1.44</td>
<td>1.60%</td>
<td>1.97</td>
<td>2.40%</td>
</tr>
<tr>
<td>Bank of America</td>
<td>4.21</td>
<td>5.70%</td>
<td>3.38</td>
<td>5.00%</td>
</tr>
<tr>
<td>RBS</td>
<td>9.10</td>
<td>17.70%</td>
<td>10.08</td>
<td>16.20%</td>
</tr>
<tr>
<td>Barclays</td>
<td>2.83</td>
<td>7.10%</td>
<td>3.58</td>
<td>7.80%</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>2.37</td>
<td>6.80%</td>
<td>2.91</td>
<td>6.80%</td>
</tr>
<tr>
<td>Dresdner</td>
<td>0.42</td>
<td>4.90%</td>
<td>0.45</td>
<td>6.10%</td>
</tr>
<tr>
<td>Santander</td>
<td>2.24</td>
<td>8.00%</td>
<td>2.59</td>
<td>7.60%</td>
</tr>
</tbody>
</table>

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.³¹

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$50,000.³² 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, 2008) has 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 tendency of retail investors to buy high and sell low. The 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.\footnote{Calculated with monthly data from Federal Reserve’s Selected Interest Rates.}

The significance of these differences can be illustrated by considering a hypothetical investment of $100 made in 1980.\footnote{Assuming each instrument paid its average annual return over the period every year.} If it were invested in safe T-bills, by 2005 the investor would hold $454.94. In contrast, had it been invested in S&P index securities, 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. Now 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 international survey of money fund managers’ performance in the lean year of 2002,\footnote{Including seven of the top ten fund managers by asset, plus another 33 who collectively controlled over one-fifth of the world market.} 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.\footnote{Morrison and Wilhelm 2007 discuss extensively the significant economies of scale present in retail investment fund management.}

Although the thought experiment pursued here is no substitute for more comprehensive empirical study, its results 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. As discussed in section 5 below, the bases for these systematic flows of value arising in the sphere of exchange in capital markets ultimately lie in the fundamental class differences between retail investors on one hand, and banks and corporate managers on another.

4.2 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 investments 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

---

\footnote{Calculated with monthly data from Federal Reserve’s Selected Interest Rates.}

\footnote{Assuming each instrument paid its average annual return over the period every year.}

\footnote{Including seven of the top ten fund managers by asset, plus another 33 who collectively controlled over one-fifth of the world market.}

\footnote{Morrison and Wilhelm 2007 discuss extensively the significant economies of scale present in retail investment fund management.}
knowledge. 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 and has the financial clout to withstand and take advantage of even moderate 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. 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.

Table 10
Own and Trading Account Gains

<table>
<thead>
<tr>
<th>Bank</th>
<th>2006 US$ billion</th>
<th>Revenue Share</th>
<th>2007 US$ billion</th>
<th>Revenue Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>HSBC</td>
<td>8.86</td>
<td>12.60%</td>
<td>13.89</td>
<td>15.90%</td>
</tr>
<tr>
<td>Citigroup</td>
<td>5.76</td>
<td>6.40%</td>
<td>-8.00</td>
<td></td>
</tr>
<tr>
<td>Bank of America</td>
<td>5.57</td>
<td>7.50%</td>
<td>-3.92</td>
<td></td>
</tr>
<tr>
<td>RBS</td>
<td>11.48</td>
<td>22.20%</td>
<td>12.39</td>
<td>19.90%</td>
</tr>
<tr>
<td>Barclays</td>
<td>8.42</td>
<td>21.20%</td>
<td>9.96</td>
<td>21.60%</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>11.22</td>
<td>32.00%</td>
<td>14.17</td>
<td>33.40%</td>
</tr>
<tr>
<td>Dresdner</td>
<td>3.57</td>
<td>41.70%</td>
<td>-0.66</td>
<td></td>
</tr>
<tr>
<td>Santander</td>
<td>2.70</td>
<td>9.60%</td>
<td>4.10</td>
<td>12.10%</td>
</tr>
<tr>
<td>SMFG</td>
<td>1.08</td>
<td>6.60%</td>
<td>n/a</td>
<td></td>
</tr>
<tr>
<td>UBS</td>
<td>10.97</td>
<td>33.20%</td>
<td>-6.96</td>
<td></td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>25.56</td>
<td>67.90%</td>
<td>31.23</td>
<td>0.68</td>
</tr>
</tbody>
</table>

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.

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,

---

37 See Morrison and Wilhelm 2007.
38 See, for instance, Blackburn 2006 for accounts of a number of instances of market manipulation.
39 For an average of just under US$622,000 per employee.
centrally in US markets, the main impact on these banks took place through their trading-account holdings of sub-prime mortgage CDOs. The 2007 trading account losses in credit or structured products for Citigroup, Bank of America and Dresdner stood at US$ 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. But the sheer volume of losses suggests these holdings were to a significant extent proprietary in that they were motivated by the hope of returns on holding these assets.

4.3 Derivatives

Investment and commercial banks have engaged heavily in issuing, trading, and market-making for derivative assets. Markets for over-the-counter (OTC) 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 has also increased dramatically in the past seven years.

<table>
<thead>
<tr>
<th>Table 11</th>
<th>Credit Default Swaps, Notional Amounts Outstanding at Year-End, US$ Trillion</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>2002</td>
</tr>
<tr>
<td>----------</td>
<td>-----------------</td>
</tr>
<tr>
<td>0.92</td>
<td>2.19</td>
</tr>
</tbody>
</table>

Source: 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.

---

40 Dodd 2007.
41 Except in 2007, for which the end of June figure is given.

Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism 20
Table 12
Selected OTC Derivatives Dealers in US by Market Share, June 2007

<table>
<thead>
<tr>
<th>Bank</th>
<th>Market Share</th>
<th>Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>JP Morgan</td>
<td>51.30%</td>
<td>1.00</td>
</tr>
<tr>
<td>Citigroup</td>
<td>20.70%</td>
<td>2.00</td>
</tr>
<tr>
<td>Bank of America</td>
<td>19.50%</td>
<td>3.00</td>
</tr>
<tr>
<td>HSBC</td>
<td>2.90%</td>
<td>4.00</td>
</tr>
<tr>
<td>Wachovia</td>
<td>2.70%</td>
<td>5.00</td>
</tr>
<tr>
<td>ABN Amro</td>
<td>0.80%</td>
<td>13.00</td>
</tr>
<tr>
<td>Barclays</td>
<td>0.40%</td>
<td>19.00</td>
</tr>
</tbody>
</table>

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

The investment banking functions of these banks naturally placed them in a position to sell derivative contracts to corporate clients. As discussed below, those assets may help improve capital-market perceptions of a corporation’s liabilities, 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, financial intermediaries account for the bulk of OTC markets, particularly for credit default swaps.

Table 13
OTC Derivative Contracts with Financial Firms, Percent of Total, June 2007

<table>
<thead>
<tr>
<th>Foreign Exchange</th>
<th>Interest Rate</th>
<th>Credit Default Swaps</th>
</tr>
</thead>
<tbody>
<tr>
<td>78.80%</td>
<td>86.90%</td>
<td>97.90%</td>
</tr>
</tbody>
</table>

Calculated from BIS Semiannual OTC derivatives statistics

As with corporations, financial intermediaries may acquire derivative assets to improve market perceptions of their position and liabilities. Banks increasingly use credit default swaps, as part of holding and dealing in structured debt products like CDOs, as well as to lower the regulatory capital cost of holding debt securities under Basle II capital adequacy conventions. 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. 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

---

42 The International Swaps and Derivatives Association reports well over 90 percent of the world’s top 500 corporations regularly use over-the-counter derivatives.

43 By reducing the measured risk of an asset holding and, thus, lowering the corresponding risk-weighted capital reserves.

Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism
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.  

Whether bought for hedging or pure speculation, derivative assets yield fees to issuing banks. Like good bookies, issuers 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 represent systematic transfers of value from the mass of retail investors to the financial sector.

5. Capital Markets, Investment Banking and Marxist Theory

The increasing significance of financial market mediation to capitalism in general and for commercial banks in particular poses a considerable analytical challenge for Marxist political economy. These activities can be highly complex, and many of them are historically novel. Identifying their social content requires development and extension of Marxist theory.

Building on Marx 1909, Hilferding 1981 offers the best developed Marxist approach to capital markets. Yet despite its important insights, the book’s approach to the integration of corporations, banks and capital markets is defined by the concepts of finance capital and founder’s profit. Subsequent developments in capitalism have pointed to empirical and analytical weaknesses in both concepts. As the discussion above suggests, contemporary capitalism is not characterised by the merger of banking and industrial capital.

The concept of founder’s profit, as formulated by Hilferding, also poses difficulties. It refers to a peculiar capital gain realised by a corporation’s founders when equity is issued and sold because buyers expect and receive only the basic rate of interest as a return on their investment. In this he followed very closely on the steps of Marx, for whom the rate of interest represented the general mode of appropriation for all holders of money capital, regardless of the instruments employed.

Yet historically, expected and realised equity returns have exceeded returns on bills and bonds over long periods of time. More importantly, this view makes it impossible to characterise the social content of relations defined by investment banking activities. Put most simply, if corporations can directly raise capital at the rate of interest, there is no reason for them to engage the costly services of investment banks and little content to financial market mediation.

Starting from these appreciations, and the most general and compelling foundations of Hilferding’s approach to capital markets, this section aims to make a modest and preliminary contribution to a Marxist theorisation of capital markets, investment banking and financial market mediation. The discussion affords a general characterisation of the

44 Millo and MacKenzie 2007 eloquently emphasise 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.

45 A wide literature documents the superior returns on equity over bonds in the US throughout the twentieth century. In the post-war period, US equity returns have yielded an average excess return of 5.5 percent over bills (DeLong and Magin, 2007). Besser 1999 also presents evidence from Germany between 1870 to 1995 showing that equity returns, while highly volatile, have been consistently higher than bond returns over long investment horizons.

46 In Hilferding these relationships are rather simple. Banks fused with and controlled industrial capital and the resulting finance capital appropriated the totality of founder’s profits, and increasingly dominated economic, social and political life within rival national imperialist blocs.
social necessity and inherent contradictions of capital markets and investment banking in capitalism, as well as an elucidation of their parasitic class content in the concrete historical setting prevalent since the early 1980s.

5.1 Capital Markets, Risk and Investment Banking

Capital markets are markets for securities: rights to different future cash flows paid by corporations. In the first instance, corporations enter capital markets to raise funds for investment. Loanable money capital enters capital markets seeking self-expansion through the future cash flows associated with securities and possible capital gains. 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 gains may be realised on any security when a holder sells it for a price higher than its purchase price.

Capital markets effect a socialisation sui generis of debt and of capital itself, with potential benefits for the capitalist class as a whole. In the purchase of any non-marketable enterprise liability, the value advanced by the buyer loses the flexibility and general acceptability it had when it was in the form of loanable money capital. Loanable money capital is transformed into commodities in the enterprise’s circuit of capital, and its transformation into more value hinges on the vicissitudes of that circuit over time. This loss of liquidity can be ameliorated through developed capital markets. Liquid markets for corporate securities allow security holders readily to realise value into money, which is not only the most flexible, independent and socially recognised embodiment of value, but the very purpose of the advance of loanable money capital. Increased liquidity will attract larger volumes of money seeking a security, generally reducing the cost of outside finance.

Bonds and equity give holders rights to uncertain future flows of money. As with ordinary loans, their prices are irrational from the perspective of Marxist political economy in that they are money expressions of the value of future money. Prices are determined unanchored, through the competitive interaction of supply and demand. In the capitalist setting of competitive individual appropriation, this relative detachment poses a range of difficulties, including problems of trust and confidence between parties in a setting of anarchic uncertainty about the economic future.

It is in relation to these difficulties that corporate ‘financial engineering’ and investment banking acquire social significance by possibly assisting a corporation to reduce its financing costs or generate capital gains. In general, all developments that increase the profitability of an enterprise will also increase equity prices—higher rates of exploitation, leadership in the installation of new techniques of production, increased control of markets, &c.

But the detachment of capital-market prices from underlying realities of accumulation creates other potential sources of capital gains (or losses) that have no direct relationship to underlying real investments or profitability. A generalised expectation of future security price rises will often in itself increase demand, leading to further price rises that for some time yield considerable profits and appear to validate expectations. Sheer manipulation, including by investment banks, has often been an integral part of such
processes. Capital markets and investment banking inherently create the possibility of such speculative bubbles and their devastating consequences.47

Yet capital markets also create a systematic foundation for investment banking functions and profits that does not by itself involve swindles, bubbles or manipulation: potential improvements to the social perceptions of the risks associated with the self-expansion of value through a particular corporate security. These may lower the cost of raising capital and generate capital gains that sustain investment-banking fees and profits.

As generally noted by Hilferding,48 investors’ perceptions of risks associated with security returns play a defining role in the demand for securities. Specifically, security buyers will try to assess the potential problems posed by its future cash flows and its reconversion into money. Thus the perceived creditworthiness and liquidity of a security are central determinants of demand.

The less creditworthy or liquid a security is perceived to be, ceteris paribus, the smaller demand for it will be. Resulting security prices will be lower, and the expected future cash flows accruing to holders will represent a higher yield on initial investment. Similarly, two securities with different expected potential future cash flows, but with the same perceived creditworthiness and liquidity, will see their present prices move until both yield the same expected return. As a result, systematic ‘risk premia’ arise in capital markets: a general positive association between expected returns on a security and the perceived risks to the self expansion of loanable money capital it poses.

The potential benefits of investment banking operations in this regard are most clear when considering the issue of a new corporate security. Neither its liquidity nor its creditworthiness can be guaranteed a priori. Investment banks help redress this situation in the first instance 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 creditworthiness.

As argued and historically illustrated by Morrison and Wilhelm 2007, investment banks are able to do this given their position and relations within social and business networks of corporate managers, individual investors, and managers of institutional funds. 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. Buyers agree to discuss these issues with the bank on the understanding they will be offered preferential access to the resulting security issue. Banks also advise corporations on a range of issue-related and broader corporate-finance matters that may improve market perceptions of a corporation’s securities. This often includes advising on the management of total security supply, or selling derivative assets to reduce perceptions of risks associated with the issuer.

All insiders generally gain as a result of these activities. The initial buyers, who are individual or institutional clients of the bank, get a first shot at buying securities that, if the bank has done its job well, will likely appreciate significantly in the short run. The issuer

---

47 Effects are often compounded by leveraging of investments made on the basis of such self-fulfilling expectations. Returns may be astronomical while the bubble lasts, making not jumping into it very difficult in the context of general competition in capital markets. See Kindleberger and Aliber 2005 for a good historical account of such crises.

faces a lower cost of capital. And the bank receives fees, typically in the form of a discounted price on the issued security in relation to the offer price.49

Corporate managers and investment banks may also try to generate capital gains on old issues of equity by employing similar methods. Whether the securities are new or old, all such gains are funded from the loanable money capital of outside buyers. Those buyers accept higher security prices because they come to perceive better prospects or fewer risks associated with ownership of the security in question.

The uncertainty, competitiveness and relative detachment of capital-market operations ensure they are directly shaped by historically concrete social conventions and sustained practices among market participants.50 This includes perceptions about securities, which may be generally shared and sustain transactions even while at considerable variance from the realities underpinning the value of securities.51 This gives rise not only to potential instability, but also to possible systematic advantages to market participants better able to shape and apply capital-market conventions and practices.

5.2 Bonds, Equity, and Capital-Market Returns

Capital market competition imposes general constraints to potential gains from these activities, as well as certain tendencies in the quantitative relationship between capital-market and real-accumulation rates of return. 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 regarded as safe. Bond rates are typically measured as premia above returns on state bonds.52 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 will not generally try specifically to increase the price of outstanding bonds.

Equity possesses a distinct relationship to the process of accumulation, returns realised through dividend payments and capital gains. Equity capital (in Marx’s words, ‘fictitious capital’) does not represent an aliquot of real circulating capital. It entitles the holder to a pro-rata claim on future streams of dividends drawing on the profits generated by the circulation of capital. This is clear from the divergence of a corporation’s market capitalisation and net asset values. Capital engaged in industrial or merchant circuits

49 Chen and Ritter 2000 report this discount is usually around seven percent of the listed price.

50 See MacKenzie 2003, for instance.

51 The current crisis has exposed a range of such cases in the credit-scoring models used in mortgage lending, and in the estimation of future cash flows associated with mortgage-backed CDOs. The methods used were adequate for convincing successive layers of security buyers, but not for actually describing the objective characteristics of the security. See Lapavitsas and dos Santos 2008.

52 The existence of a large, liquid market for state securities generally deemed as risk-free is an important underpinning in the development of liquid private 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.
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 capital appreciates according to the rate of return, established through competition in capital markets. While related, each of these rates represents fundamentally different social relations.

At purchase, the expected rate of return on a corporation’s equity will generally be higher than the rate of interest on its bonds. Debt repayment is generally more secure than residual gains on equity. In this important regard the position articulated here differs from that offered by Hilferding, 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 across different securities. But in his approach to capital market securities he followed closely on Marx’s own exposition in Chapter 23 of Volume III of Capital on the returns to loanable money capital. And while Marx’s exposition on the matter elucidates the objective foundation of interest payments in the generation of profits by real capital, it also advances the rate of interest as the general return on all loanable money capital, regardless of the financial and social relationship between the buyer and the seller or the type of security in question. It is impossible to approach risk premia, which inherently involve individual securities and their returns, on such a basis.

The rate of return expected by new buyers of equity will depend on their perceptions of present profitability, their confidence in the security, as well as on their expectations of the future evolution of these factors. Investment banking and ‘financial engineering’ operations can affect these perceptions and expectations, reducing the expected rate of return demanded by new equity buyers, and thus generating price rises and capital gains for incumbent owners.

The scope for gains from such activities will generally depend on the evolution of demand for securities in relation to supply, and on the capacity of corporate managers and investment bankers to devise ways to increase the confidence in the security by potential buyers. This will hinge on historically specific practices and conventions that have acquired general acceptance in shaping capital-market perceptions, as well as on the specific composition of investors seeking to make gains from securities.

The steady privatisation of pension provision and other necessities since the early 1980s created a unique setting in capital markets. It not only greatly increased demand for securities, but also added a growing mass of ordinary savers onto capital markets. The class implications have been dramatic. On one side we have seen corporate managers and investment bankers nestled in extensive social and business networks of capitalist investors and managers, organised professionally with the explicit purpose of maximising returns by shaping market perceptions. On the other side, we have seen atomised individual savers whose engagement with capital markets is primarily dictated by trying to access consumption—retirement, a child’s education, a down payment on a house, &c.

I owe this important observation on the origins of Hilferding’s approach to Makoto Itoh.

Earlier versions of this article considered the simple case of equity issued by a corporation not expected to experience capital gains and paying out all profits as dividends. In that case, expected returns on equity will not normally be higher than the corporation’s rate of profit. Otherwise, market capitalisation would typically be much lower than the price of the corporation’s assets. Eventually, either the corporation will buy back cheap equity, or it will be bought up and reorganised or liquidated. Either way, the situation is unlikely to last very long.

Such as derivative assets. See Milo and MacKenzie 2007.

Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism
It should not be surprising that the results of this encounter have proven systematically unfavourable to retail savers. The relative detachment of capital-market operations from underlying realities of production, and their susceptibility to perceptions, conventions and—more recently—highly technical practices, tend to favour the well-connected capitalist relative to retail savers. The dramatically different outcomes of capital-market trading for retail investors and for financial intermediaries are not usefully understood as the product of the ‘irrationality’ of retail investors. After all, financial intermediaries have amply proven their own capacity for ‘irrationality’. Systematic uneven capital-market outcomes are simply an expression of the class content of contemporary capital markets.

While more analytical and empirical work are needed in this regard, it is clear that the foundation of the recent astronomical profits associated with investment banking activities have ultimately been funded from the investments of ordinary savers. In a setting where these activities have not been generally associated with securing increased real investment—which could lead to general increases in productivity, wages, and standards of living—in investment banking during this period appears as monumental and crystallised class parasitism.

6. Some Concluding Observations

A number of secular, policy and technological developments have fundamentally changed banking and its relationship to accumulation. Particularly in the US, non-financial corporations have become less reliant on outside finance in general and bank loans in particular for their operational investments. Their relationship with capital markets has consequently changed, and to a significant extent consists of “financial engineering” operations aimed at capital gains and involving the withdrawal of equity and bond borrowings. The privatisation of pensions provision has facilitated this change by triggering unprecedented inflows of loanable money capital into capital markets in the form of retirement savings. Banks have placed themselves at the heart of these processes, offering mutually beneficial, arms-length investment-banking services to corporations. They have also pursued the provision of various investment fund instruments to ordinary savers, who systematically receive very unfavourable terms in those services.

The steady privatisation of the provision of a growing number of social necessities has also made access to money a precondition for the basic reproduction of ordinary wage earners. Particularly in a setting of stagnant real wages and rising social inequality, this has forced wage earners onto financial markets to secure mortgage, education and consumer credit as well as private insurance services. The relationships banks establish with them through those activities involve large and systematic appropriations of value drawing on individual income. As such, they are exploitative. While these changes are most clearly pronounced in the US and Britain, the micro-level evidence discussed in this paper suggests the new banking practices are spreading, distinctively, to other advanced capitalist economies.

The current financial crisis may be usefully understood as a crisis of this type of banking and attendant financial activities. Regulatory arbitrage and rising degrees of leveraging of financial intermediaries have played important roles in the crisis. Positivist hubris about the power of new, inference-based estimations of risk also played their part, 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. And
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.\textsuperscript{56} To borrow from former Citigroup boss Chuck Prince III, when the music stopped, most banks were caught dancing.

Yet underpinning all of these factors was the drive by banks and broader financial system to increase the scope for financial expropriation. Unsurprisingly, problems arose as this expansion started to include historically oppressed layers of the US population with very low and insecure wage incomes. The unfolding economic depression is adding to the system’s problems as increasing volumes of ‘prime’ mortgages and other consumer debt go bad.

It was 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 have been 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 necessaries, as well as the broader desirability of conscious, democratic economic planning.

\textsuperscript{56} 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


Paulo L dos Santos - On the Content of Banking in Contemporary Capitalism


Neely, M 1995, ‘Will the Mutual Fund Boom be a Bust for Banks?’, Federal Reserve Bank of St Louis Regional Economist, October.


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.

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.