What is... CORPORATE banking?

BANKTrack

Corporate banking typically refers to financial services offered to large clients ('wholesale clients'). Although many wholesale clients are large corporations, they may also include other institutions like pension funds, governments and other (semi-) public entities. Corporate banking is a very profitable division for banks, far more profitable than retail banking, which is aimed towards households and small and medium enterprises (SME's).

The services offered

The services offered by corporate divisions of banks include (a) general **commercial banking** activities, and (b) services particularly tailored to large clients such as multinational companies.

(a): Commercial banking activities include traditional banking services like deposit taking, lending, lines of credit, and facilitation of various kinds of financial transactions (e-banking, credit cards, etc.).

Households and small and medium enterprises (SME's) also rely on this range of services for their financial needs.

(b): For wholesale clients, however, many additional financial services are available, such as:

- **International transactions.** International banking services include trade financing and foreign exchange transactions. Banks also offer services to protect firms against currency and price fluctuations.
- **Investment banking.** Large corporations and public institutions are financed not only through loans, but through the sale of securities (stocks and bonds) to the public. The services related to the issuing of securities are called 'investment banking', a business that used to be completely separated from traditional commercial banking. In recent decades, the distinction between traditional commercial and investment banks has become blurred, and nowadays many banks offer both types of services. Investment banks perform underwriting, that is they assist companies in issuing bonds or shares, and buy the initial offers at a fixed price. Investment banking also includes providing advice and financing for mergers and acquisitions (M&A's).
- **Project finance.** For large infrastructure and other projects, banks offer specific loans which are repaid based on the revenue generated by that project. For some large and potentially risky projects, the bank can arrange a banking **syndicate**, wherein a group of banks each lend a client a portion of a large loan. Project finance can also include the sale of project-specific bonds.
- **Insurance.** Banks may also sell insurance products, although insurance is traditionally not a banking activity. Again, consolidation in the financial services industry has brought together many different financial services. These services allow corporate clients to access many different services within a single financial institution. While banks may also offer retail insurance products to individuals, corporate insurance may cover company activities, staff and management.
- **Advisory services.** Wholesale banking activities also include financial advising for all kinds of corporate and financial activities, such as mergers and acquisitions, asset management, and taxation (e.g. the use of tax havens)
- **Shareholding.** Banks can **participate in the management of**, and **own shares in**, companies. A bank can, for example, buy a company's shares to help to provide the company with some extra liquidity, if the company is in financial distress.

Trends & Critical Issues

- **Speculative finance / "Ponzi finance".** Recently, there has been a trend towards more speculative methods of financing. Previously, clients used to pay back both the principal and the interest on loans through their cash flows; nowadays many companies' cash flows are only sufficient to service their debt -- that is, cover their interest payments. Adverse circumstances, like small rises in interest rates or declining company incomes, can result in the company not being able to service their debt at all. This situation can lead to "Ponzi finance," where a company constantly raises new funds, often through hidden or innovative systems, in order to pay other creditors. This practice is often facilitated by banks and other financial firms that seek to make profits from increasingly complex finance mechanisms. Obviously, an economy dominated by such speculative 'Ponzi finance' may be fragile and susceptible to crisis, as it becomes dependent on continuing asset price inflation and larger amounts of debt. Increasingly, there are cases of companies that get into trouble as a result of using Ponzi finance, and may go bankrupt. Authorities can intervene, but such intervention may only encourage more 'Ponzi finance' to a point where the excessive amount of debt is beyond salvation.

- **Conflict of interests.** As mentioned above, banks offer an increasingly broad scope of financial services to their corporate clients. One could argue this leads to a more comprehensive provision of financial services. On the other hand, however, the danger for conflicts of interest to occur also increases, as banks and companies become more and more intertwined. For instance, if banks underwrite bonds for a certain company at a specific price, they may be tempted to sell these bonds to investors who seek the bank's advice in their asset management decisions. Another risk that became apparent in recent years stems from the use of the above-mentioned Ponzi schemes. When a company is accumulating debt, and is not able to meet its interest obligations, financial firms may help develop all kinds of 'creative' mechanisms to channel funds to the company, and hide the company's debt. Banks may become increasingly involved in fraudulent practices, especially if bank representatives also have a seat in the company's board or own its shares. This occurred in the collapse of Parmalat, the Italian dairy producer.

CSR Initiatives

Of course, protecting investors from the practices described above is not really a matter of Corporate Social Responsibility. The practices described, like false prospectuses and misleading advices, are simply illegal. Following the corporate scandals in United States and Europe, governments have taken some steps to reduce these conflicts, but critics argue that the reforms have not gone far enough.

More traditional sustainability issues are also critical for the corporate banking sector. Given its role in facilitating all kinds of corporate practices, banks have a great role and responsibility in advancing sustainability. Currently, CSR initiatives directed to corporate banking mainly cover only a small part of company financing by banks. The Equator Principles, for example, offers clear indicators to what environmental and social conditions projects have to fulfil to be financed. Several other banks have adopted other environmental standards around forestry, oil & gas, and mining.

However, corporate banks have a long way to go in addressing sustainability. For example, most investment banks still do not perform environmental and social screening on the companies for which they raise funds. Also, the practice of assisting clients with the use of tax havens and other offshore markets is very dubious. Since September 11, governments have paid more attention how these offshore centres can be linked to all kinds of illegal and unsustainable activities. Although some steps have been made to prevent money laundering, efforts to combat tax havens have been limited.

More info:

Factsheet commercial banking;
Factsheet project finance;
Factsheet investment banking;