

# *Comparison of Investment Banking Models in the US and China*

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**Abstract:** Investment banks in the United States first emerged in the early 19th century, with a focus on securities underwriting. Compared with other countries, the United States investment banks were established earlier, and after the subprime crisis, the United States investment banks, through their own exposure to business problems, improved so that they have a more perfect regulatory system and a more advanced business model. As a result, in the process of developing its own business, China's investment banks should take the essence and discard the dross in order to find a suitable development direction for themselves, gaining recognition in the capital market construction and promoting the further improvement of China's international status. This paper uses literature analysis and comparative analysis to explore the differences between the operating models of investment banks in China and the US, and to provide insights and suggestions for the development of Chinese investment banks. The study finds that investment banks in China should expand the attribution model, thereby increasing the concentration of capital. At the same time, the proportion of securities brokerage business should be adjusted and the leverage ratio in the industry should be strictly controlled to avoid excessive internal consumption.

**Keywords:** investment banks, development models, comparison between the US and China, subprime crisis, financial intermediation

## 1. Introduction

The revenue sources of US investment banks are dominated by innovative and induced businesses, with traditional businesses supplementing them. On the contrary, Chinese investment banks China's investment banks were established late and have insufficient experience in business development and management, and currently suffer from small asset size and limited revenue streams [1]. Some studies found that the subprime mortgage crisis brought certain negative effects to the U.S. economy, such as recession and changes in the regulatory system. Faced with such unfavorable situation, U.S. investment banks overcame this economic crisis in a short period of time by reducing the types of proprietary business, shifting business focus, focusing on traditional investment banking, and adjusting leverage ratios and a series of other measures to reduce risks [2]. However, few researchers have compared investment banks in China and the United States to objectively and specifically analyze the differences in their business approaches. In this paper, through literature analysis and comparative analysis, we study the differences between the operating models of investment banks in

China and the United States, and make suggestions for the development of Chinese investment banks. This is conducive to Chinese investment banks finding a suitable direction for their development, so as to gain recognition in capital market construction and promote further improvement of China's international status.

## **2. Business Model and Characteristics of Investment Banks in the US**

US investment banks were founded later than European investment banks, but have reached a leading position today due to their accelerating growth. After the lifting of commission restrictions on US stockbrokers in the mid-1970s, there was a constant restructuring of the business and mergers and acquisitions in the industry. By the 1990s, US investment banks had established a professional and distinctive business model. At the same time, their international competitiveness could not be ignored. US investment banks have always adhered to the concept of diversification in the course of their development [3]. The following are the three main business models of US investment banks.

### **2.1. The First Model the Independent Investment Bank Model that Focuses on Diversification**

The famous American investment banks Morgan Stanley, Merrill Lynch, Goldman Sachs, Bear Stearns and Lehman all belong to this model, but the above five investment banks have gone through transformation or bankruptcy after the sub-prime crisis. The characteristics of this model include the following: firstly, the investment bank changed its management system from a partnership system to a publicly listed shareholding system. Secondly, in order to seek a larger market for their business, the investment banks increased their leverage in order to obtain larger profits and thus to increase their market share. Furthermore, in order to diversify their assets in the face of some long-term assets, US investment banks frequently choose to invest in structured short-term funds. At the same time, the value of stocks and their returns in this model are always unstable and the systemic risk in the market is extremely high [4]. Finally, the trading business is separated from the traditional ancillary client business and becomes a new business, which includes account trading as well as portfolio trading.

### **2.2. The Second Model the Independent Investment Banking Model that Maintains the Roots of the Traditional Business**

This business model is practised by many US investment banks such as K B Wood, R James, Jefferies, Green and P Jaffe. The characteristics of this model include the following: firstly, the business is mostly profit-oriented, with only a small number of proprietary accounts traded. Secondly, the model is focused on developing its own distinctive features and is dedicated to the subdivision of the market business. Its main objective is to develop its existing business in depth rather than to expand. At the same time, the leverage ratios of the five largest investment banks in the US are out of reach for the investment banks implementing this model, and in some cases are below those of most commercial banks. In addition, the low leverage allows them to take on less systemic risk and to achieve relatively stable returns and equity values [5].

### **2.3. The Third Model Has Evolved into a more Generalist Banking Model for Financial Holding Companies**

In the case of Citi, for example, some financial holding companies have followed the Financial Services Modernization Act and evolved into a full-service banking model, incorporating traditional independent investment banks that were previously ineffective or on the verge of bankruptcy into

their own subsidiaries, forcing them to transform their systems [6]. This model includes the following features: firstly, the bank is a financial holding company, where the head office is responsible only for the overall layout and strategic planning of the company, and its business does not include specialised financial services; at the same time, its subsidiaries are able to ensure their own operational and management independence, thus avoiding much of the friction and competition brought about by cooperation. Secondly, this model of investment banking offers a more complete and systematic approach to financial services, simplifying the process for investors and eliminating the need for complex procedures. In addition, the supervision of investment banks under this model is mostly done under the umbrella of the main supervisory model, where different institutions are responsible for the supervision of different types of business. Insurance business is supervised by the State Insurance Supervision Office, securities business is mainly supervised by the Securities and Exchange Commission and banking business is managed by the existing banking regulators.

### **3. Current Status and Main Problems of Investment Banking in China**

China's investment banking is tentatively in the exploration stage; in only thirty years, there are still more or less problems in various types of business. These problems will need to be addressed over time, improved, and progressed in practice in order to catch up as quickly as possible with the countries that were early movers in the investment banking industry and thus move forward in tandem with them [7]. At the same time, the public's perception of investment banking in China is not sufficiently advanced and remains superficial. Most people believe that the main business of investment banking is securities underwriting and that its role is to provide effective assistance to listed companies in going public. However, this perception is incomplete and there are serious misunderstandings. The root cause of this phenomenon is that the general economic environment in China does not provide good opportunities and ways for people to understand and learn the essence and connotation of investment banking. In fact, the types of businesses of investment banks in China are not only limited to securities underwriting but also include mergers and acquisitions, fund management, financial advisory, financial innovation, venture capital, and other businesses; only the perfection and depth of these businesses are still beyond the reach of other pioneering countries.

#### **3.1. Single Business Category, with Certain Operational Risks and Debt Crisis**

China's existing investment banking business categories are relatively single and, at this stage, suspended in the narrow sense of the investment banking stage due to a lack of innovation capacity. Compared with other pioneering countries, the United States, for example, its investment banking business involved in a broader range. In the United States investment banking all business, self-dealing, brokerage and underwriting business accounted for about 40% of the total revenue of all business, of which international business income accounted for about 37% of the average income (in order to JP Morgan 26.2%, Goldman Sachs 45.9%, Lehman Brothers 36.8%, Merrill Lynch 34.8% as representatives). However, by studying the distribution of investment banking revenue in China in recent years, we found that proprietary and brokerage revenue accounted for approximately 80% of total revenue, with proprietary revenue accounting for approximately 32.18% [8]. These figures show that the main source of income of China's investment banks is self-dealing business, which reflects the existence of serious operational risks and debt crisis of China's investment banks, which will also become a major hidden problem in the long-term development of China's investment banks, and thus affect the development of investment banks.

### **3.2. Weak Capital Base of China's Investment Banks, Prone to Serious Losses in Case of Crisis**

By the end of 2020, China's investment banking business continued to be favourable and the performance of brokerage firms continued to grow. CITIC Securities topped the list with revenue of RMB6.882 billion, while Haitong Securities, CITIC Construction Investment, CICC, Guotai Junan, and Huatai Securities ranked between 2nd and 6th with revenue of over RMB3 billion. The top 100 securities companies achieved a total revenue of RMB 82.027 billion, an increase of 37.15% year-on-year [9]. Although the current registered capital is still able to sustain the normal operations of China's investment banks, it is still the tip of the iceberg compared to US investment banks. Because of the small size of our investment banks' capital assets, they are inevitably severely damaged in the face of temporary crises, resulting in serious losses such as mergers and reorganisations, bankruptcies, and closures. There are many precedents for this in China, such as the failure of the "327 bond" in 1996, which forced a merger between Wanguo Securities and Shenyin Securities, and in 2020, when the global economy was depressed under the impact of the epidemic, investment banks were also affected and their development slowed down. A strong capital base is therefore particularly important when risks come into play.

### **3.3. China's Investment Banking Management System is not Standardised and Prone to Breaches of Regulations**

Due to the lack of strict governance within China's investment industry, there are some responsible persons in the industry who violate the rules and regulations and overstep their authority to operate or trade and thus seek their own interests. Such behaviour not only disrupts the order of the industry, but also seriously harms the interests of clients, making them unable to receive the protection of their property in the course of trading, or even causing losses. A number of brokerages such as Liaoning Securities, Wuzhou Securities, Hantang Securities, Minfa Securities, Dapeng Securities and Nanfang Securities were forced to merge or restructure, and some even faced bankruptcy, as a result of line crossing practices in the industry many years ago. These violations of the industry order have become a major obstacle to the development of investment banking in China.

### **3.4. Lack of Innovation and Weak Core Competitiveness**

By the end of 2020, there were hundreds of investment banks in operation in China. However, among the many investment banks, most of the business types tend to be the same, and there is no innovation. Compared with foreign investment banks, China's investment banking business is still stuck in the traditional sense and lacks the ability to innovate. In contrast, some US investment banks, such as Merrill Lynch and Goldman Sachs, have their own distinctive businesses. Since joining the WTO, Chinese investment banks have gradually revealed the problem of weak core competitiveness, which will play a negative role in the future development of the world investment banking sector [10].

## **4. Inspiration from US Investment Banks to China's Investment Banks**

The United States investment bank was established earlier, and after experiencing the subprime crisis, and the adjustment of business, the management system is also more perfect. Therefore, China's investment banks have gained many inspirations from the development of the United States investment banks.

#### **4.1. Expand the Scale and Increase the Concentration of Capital**

At this stage, China's investment banks are still in the exploratory stage of development, and their scale has not yet reached the desired target. However, due to insufficient scale, when unexpected risks come, it will be difficult for China's investment banks to cope with them or cause serious losses. At the same time, the small scale will also become an obstacle to improving the returns of our investment banks. The fragmentation of capital has led to a decline in the competitiveness of investment banks and a reduction in the efficiency of the industry. The US Wall Street oligopoly model is ample proof that adopting a competitive model of eliminating the best and the worst among securities firms is conducive to the overall development of the investment banking industry in order to better compete with other countries.

#### **4.2. Adjusting the Proportion of Securities Brokerage Type Business and Grasping the Opportunity of Intermediary Transformation**

Although there are a large number of investment banks in China, most of them lack their own business characteristics, and their businesses tend to be similar, with no outstanding features. At the same time, each investment bank is competing on the basis of the amount of commission, which has led to a steady decline in the amount of commission in the past few years. In the US, however, the share of securities economics business is low, at 10%. In the 1970s, the US abolished fixed commissions, and although the US investment banks once used compressed commissions to compete with each other, resulting in a restricted development situation, with the transformation of the traditional US industry, the prevalence of capital intermediation led to an adjustment in the technical structure of the US investment banks, which in turn provided room for the development of the financing business of the real economy. By the same token, if China's investment banks can learn from the precedent of the transformation of the real economy in the United States, grasp the opportunity of intermediary transformation, so that traditional industries can be upgraded, then China's investment banks will step up to a higher ladder of development.

#### **4.3. Strictly Control the Leverage Ratio of the Industry to Avoid Excessive Internal Consumption**

Compared with US investment banks, the NAV of China's securities industry is comparable and even surpassed that of US investment banks in 2017. The high leverage ratio is a factor that cannot be ignored as to why US investment banks are consistently ahead of other countries. High leverage has two sides to it, it can create high profits as well as many risks. Therefore, it is important for China to find the right leverage ratio for itself, strictly control the risks, upgrade its business strategy, find its own strengths and be consistent.

In the face of the differences between China's investment banks and the United States, we should take the essence and remove the dross, not just follow suit but find a development model suitable for our economic market so that China's investment banks can get the most effective reference to help.

### **5. Conclusion**

By comparing the operating models of investment banks in China and the US, this study finds that Chinese investment banks should consider increasing their size to improve capital concentration, while adjusting the share of stockbroking and thus looking for opportunities to transform their intermediation. In addition, strict control of leverage in the industry is necessary to avoid excessive internal consumption. This study only provides a categorical overview of the operating model of investment banks in the US, with less research on their current status. In future research, the current

situation and development history of investment banks in the US can be studied in detail, and more insights can be gained from it to make more effective recommendations for Chinese investment banks.

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