

# Considerations regarding the Direct Involvement of Banks in Capital Markets

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## Abstract

*Intensification of financial instability has led to a diversification of banks' activities. They have been involved not only in financial innovation activity, but also in capital market operations, mainly by issuing shares and bonds. We also remark the emergence of new financial instruments created by banks, such as structured products that are listed on stock exchanges and offer investors new opportunities to build portfolios.*

**Key words:** banks, capital market, securities

**JEL Classification:** G21, G24

## Introduction

The initial function of commercial banks - the mobilization and allocation of financial resources by crediting the economy - retains the largest share of total bank operations, the latter representing the leading providers of financial funds for various businesses.

However, banks have entered on capital markets, becoming real competitors for brokerage companies, pension funds, mutual funds or insurance companies, developing new products and services and using tools and techniques specific for these new markets. The transactions run by banks on capital markets have proved to be profitable, and the fees earned represent significant revenues.

The involvement of banks in capital markets has various forms: banks participate directly in the market by issuing shares and bonds, some of which are quoted on a regulated capital market, or they act as investors (qualified investors) or market makers, providing market's liquidity.

In addition, banks indirectly activate on capital markets, providing financial investment services and doing such financial operations on behalf of their clients. It has also been noticed the active participation of banks in the process of innovation in capital markets; some of the transactions carried out on stock exchanges in developed countries are initially traded on banking market. In some cases, transactions are completed on the banking market, but their settlement takes place in the capital market (at stock exchanges), thus being eliminated the counterpart risk, exchanges ensuring all contracts settled via their electronic trading and settlement system.

## **The Direct Involvement of Banks in Capital Markets**

The direct involvement of banks in capital markets requires their direct participation as issuers of securities (shares and bonds), which subsequently can be listed on a regulated capital market, but also as direct investors and market makers.

### **Banks as Issuers of Shares and Bonds**

Like companies from other sectors (industry, commerce etc.), banks issue shares and/or bonds in order to attract financial funds, and some of the securities issued by banks are listed for trading on a regulated capital market. The registration of securities on stock exchanges requires the fulfillment and the assumption of some obligations that differ from one exchange to another.

Given the advantages of issuing shares and bonds and their listing on a regulated market, benefits like reputation (the permanent and implicit advertising in business circles), raising capital (access to financial resources through a wide range of stock products) and financial consolidation (the separation of long-term investors of the minority or short term investors), many banks have chosen issuing shares and listing them on stock exchanges as a way of raising funds. This is the case of international banking companies such as Bank of America, JP Morgan, Citigroup, Barclays, UniCredit, Intesa Sanpaolo, Groupe Societe Generale, Erste Group Bank AG or local banks such as Transilvania Bank or Carpathian Commercial Bank.

For example, Citigroup's ordinary shares are traded on NYSE (New York Stock Exchange), on the Tokyo Stock Exchange and the Mexican Stock Exchange. Citigroup has also issued preference shares series T, F and AA that are listed on the NYSE (New York Stock Exchange).

In addition, common shares issued by UniCredit are listed and traded on three regulated capital markets: Milan, Frankfurt and Warsaw. Since November 2005, UniCredit SpA shares are listed and admitted to trading on the Frankfurt Stock Exchange, the largest stock exchange in Germany and since December 2007, UniCredit shares have been listed on the Warsaw Stock Exchange, the latter being the undisputed leader stock exchange in Central and Eastern Europe. Furthermore, UniCredit shares traded in Italy were included in the composition of the reference stock index, the FTSE MIB<sup>1</sup> (S & P / MIB until June 2009). The FTSE MIB index is a result of the merger between Borsa Italiana and the London Stock Exchange and it includes a number of the 40 most liquid and largest market capitalization shares traded on the Italian Stock Exchange. To be included in the composition of this index, the issuing companies must meet the following requirements:

- the companies must be financially viable;
- companies must be representative for the sector in which they operate and their shares are among the most liquid;
- 30% of company's shares are publicly traded;
- the holdings greater than 5% of total shares (long-term shareholders) are included in the iShares Russell 1000 Index (IWF).

Currently, the capital of UniCredit Spa is worth about 9.649 billion euros, divided into a number of 19,297,581,923 shares with a nominal value of 0.5 euros. The most recent capital increase was registered in March 2010, being worth 476,721 euros. From the UniCredit's listing date until now, there have been a series of capital increases, the most significant being presented in the next table.

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<sup>1</sup> [www.unicreditgroup.eu/it/Investors/Other\\_presentations.htm](http://www.unicreditgroup.eu/it/Investors/Other_presentations.htm)

**Table 1.** The most important capital increases from UniCredit Spa

Date	Social Capital	Shares` number	Ordinary shares` number	Preferred shares` number
31.03.2010	9.648.790.961,50	19.297.581.923	19.273.342,940	24.238.983
	The increase of capital with euro 476,721.00			
24.02.2010	9,648,314,240.50	19,296,628,481	19,272,389,498	24.238.983
	The increase of capital with euro 1,258,444,726.50			
18.05.2009	8,389,215,286.50	16,778,430,573	16,754,191,590	24.238.983
	The increase of capital with euro 1,218,815,136.50 according with the Shareholders Meeting Decision from 29.04.2009			
25.02.2009	7,170,400,150.00	14,340,800,300	14,319,093,748	21.706.552
	The increase of capital with euro 483,789,092.00			
30.06.2006	5,218,299,719.50	10,436,599,439	10,414,892,887	21,706.552
	The increase of capital with euro 3,225,776.50			
31.01.2006	5,213,388,513.00	10,426,777,026	10,405,070,474	21,706,552
	The increase of capital with euro 1,988,437.00			
16.01.2006	5,211,400,076.00	10,422,800,152	10,401,093,600	21,706,552
	The increase of capital with euro 4,334,692.00			
02.01.2006	5,205,592,384.00	10,411,184,768	10,389,478,216	21,706,552
	The increase of capital with euro 10,315,031.00.			
29.11.2005	5,195,277,353.00	10,390,554,706	10,368,848,154	21,706,552
	The increase of capital with euro 254,964,974.00			
18.11.2005	4,940,312,379.00	9,880,624,758	9,858,918,206	21,706,552
	The increase of capital with euro 254,964,974.00 after the selling of HVB` s shares			

Source: <http://www.unicreditgroup.eu>

It should be noted that, special indices were calculated for banking sector shares, such as Euro Stoxx Banks index, which can be subsequently used as underlying asset for futures and options contracts. The Euro Stoxx Banks Index is calculated as a cap weighted average price shares` issued by a number of 25 banking companies operating in Europe. The index on May 31, 2010 is presented in Table 2.

**Table 2.** The portfolio of Shares Euro Stoxx Banks index

Company	Weight	Capitalization (mil. Euro)	Weighting factor
BCO SANTANDER	20.11	67.90	1.00
BNP PARIBAS	13.52	45.65	0.83
BCO BILBAO VIZCAYA ARGENTARIA	9.46	31.93	1.00
UNICREDIT	9.43	31.85	0.95
DEUTSCHE BANK	8.90	30.05	1.00
GRP SOCIETE GENERALE	7.68	25.93	1.00
INTESA SANPAOLO	6.20	20.92	0.81
CREDIT AGRICOLE F	2.78	9.38	0.46
NATIONAL BANK OF GREECE	1.80	6.08	1.00
ERSTE GROUP BANK	1.79	6.06	0.55
UBI BCA	1.39	4.70	1.00
KBC GRP	1.38	4.67	0.41
COMMERZBANK	1.28	4.31	0.63
BCO POPULAR ESPANOL	1.06	3.57	0.64
BCO SABADELL	0.97	3.29	0.79
NATIXIS	0.89	3.02	0.29
MEDIOBANCA	0.86	2.92	0.54
BCO POPOLARE	0.85	2.88	1.00

Table 2 (cont.)

BCA MONTE DEI PASCHI DI SIENA	0.81	2.72	0.54
BANK OF IRELAND	0.72	2.42	0.64
BCO COMERCIAL PORTUGUES	0.69	2.32	0.77
BCA POPOLARE EMILIA ROMAGNA	0.66	2.22	1.00
ALPHA BANK	0.65	2.21	0.91
BCA POPOLARE DI SONDRIO	0.61	2.05	1.00
DEXIA	0.58	1.96	0.31

Source: [www.stoxx.com](http://www.stoxx.com)

In Romania, the Bucharest Stock Exchange's (BSE's) banking sector is represented by Transilvania Bank (TLV), BRD - Groupe Societe Generale (BRD), Carpathian Commercial Bank (BCC) and Erste Bank AG (EBS). The first bank listed and admitted to trading on the Bucharest Stock Exchange was Transilvania Bank. The trade of banking shares on BSE began at 15<sup>th</sup> October 1997 with Transilvania Bank, followed in January 2001 by BRD, respectively, in June 2004 by Carpathian Commercial Bank<sup>2</sup>.

The most recent listing of a banking company in the Romanian capital market was held on 14<sup>th</sup> February 2008 and was the listing and admission to trading of Austrian banking group Erste Bank shares. There has been a number of 316,288,945 shares of Erste Bank (EBS) listed on the Bucharest Stock Exchange using the procedure of "passporting" – the European passport for shares listed on several markets in the European Union (EU), which allows the free transfer of shares from one market to another. Erste Bank is the first foreign company which is listed on the domestic capital market, the shares of this company being also traded on the Vienna Stock Exchange, and the Prague Stock Exchange since 2002.

The Romanian bond market has developed slowly, state institutions playing an important role by supporting the primary market as issuers. Thus, after 2001, more and more municipalities have decided to fund local development projects by issuing municipal bonds, and many of these issues were listed on the Bucharest Stock Exchange. Currently, the Romanian bond market is dominated by government bonds that have been listed on the local stock exchange since 2008.

Since 2004, the bonds issued by various banks have had a modest impact on bond market in Romania. The bonds issued by banks like Romanian Development Bank, Finansbank, Raiffeisen Bank, Transilvania Bank, Procredit Bank, Romanian Commercial Bank and Carpathian Bank were characterized by low maturities of 3-4 years, variable interest rate and low values of loan - typically ranging between 35 and 200 million lei. Usually, these loans were denominated in local currency and the bonds have been listed on the Bucharest Stock Exchange. Transilvania Bank has launched a bond issue characterized as follows: the bonds were denominated in American dollars and were primarily designed for the International Financial Corporation as the main investor and they were convertible in shares.

With regard to bonds issued by banks in Romania, concerning the value and impact on the local capital market, we remark the bonds issued by international banking institutions such as the International Bank for Reconstruction and Development (IBRD), European Bank for Reconstruction and Development (EBRD) and European Investment Bank (EIB), some of which being listed on the Bucharest Stock Exchange (BSE). For example, the first bond issue of an international institution denominated in Romanian lei (RON) was launched by the International Bank for Reconstruction and Development in 2006. The bond issue was worth 525 million RON, the bonds' maturity was in 2009, with a coupon rate of 6.5% payable semi-annually, an issue price equal to face value and an AAA rating.

The next international institution, which launched a bond issue in Romania, was the European Investment Bank (EIB), which is the second international institution to launch a bond issue in

<sup>2</sup> [www.bvb.ro](http://www.bvb.ro)

our country. The program was launched in April 2007, and the results were the sale of a total of 1.5 million bonds with a nominal value of 100 RON. The details of this issue are presented in Table. 3.

**Table 3.** Details of EIB's bond issue

<b>Characteristics</b>	<b>Value</b>
Number of bonds offer for selling	1.500.000
Face value	100 RON
Selling price	100,25 RON
Notional value of issue	150 mil RON
Selling value	150.375 mil RON
Subscription period	26.04.2007 – 04.05.2007
Intermediary	ABN Amro Securities SA
Maturity	7 years
Interest rate	7%
Interest's payment	Annual
First coupon	7%
Anticipated redemption	n/a
Redemption at maturity	At face value
Funds` destinations	The finance of general operations
Guarantees	Unguaranteed
Convertibility	n/a
Distribution	ABN Amro Bank (România) SA
Listing	BSE

Source: [www.intercapital.ro](http://www.intercapital.ro)

The first bond issue of the European Bank for Reconstruction and Development on the Romanian market was launched in 2009, while being the first bond issue which has been simultaneously launched on the Romanian market and also on international markets. The amount of bonds issued by the EBRD was EUR 115 million with a maturity of 10 years, an interest rate of 11.25% and an issue price of 100%. Societe Generale was appointed as the lead manager and the bond trading was conducted through Clearstream, Euroclear and the Central Depository of Romania. The bonds were listed on both the Bucharest Stock Exchange, as well as the London Stock Exchange.

Banks' permanent concern for innovation and sustainable development determined the emergence of new categories of bonds. It is the case of "green bonds" issued by the World Bank to finance eligible projects<sup>3</sup> that help reduce climate change or seek to help people to adapt to climate change<sup>4</sup>. The green bonds were developed by the World Bank<sup>5</sup> in partnership with Bank Skandinaviska Enskilda Banken (SEB), they are rated AAA/Aaa and offer an alternative investment to fixed income assets for investors. These securities address to the requirements of institutional investors concerned about climate change in recent years and want to make social responsible investment. The repayment of bond loan is not correlated with the level of performance achieved by funded projects, and investors do not assume any risks associated with the projects financed by the specific green bond issues. Another important feature of these bonds is that investors benefit from the expertise of the World Bank regarding the identification and monitoring of investment projects for which funding bonds are issued.

<sup>3</sup> Examples of eligible projects: solar equipment utilization, funding new technologies that significantly reduce emissions of greenhouse gases, increasing efficiency in transportation, including the replacement of traditional transport fuels, reducing carbon emissions through afforestation and avoided deforestation, support for building efficient in terms of energy consumption.

<sup>4</sup> Examples of eligible projects aimed at adaptation to climate change: flood protection, sustainable management of forested areas and avoid deforestation.

<sup>5</sup> <http://treasury.worldbank.org/cmd/htm/WorldBankGreenBonds.html>

The green bonds issued by the International Bank for Reconstruction and Development (World Bank Group institution) were launched in November 2008, were denominated in Swedish kronor (SEK), with a total value of the issue of SEK 2.325 billion, a maturity of six years and a coupon of 3.5% per year. Since their launch until now, the Bank has issued bonds worth about \$ 1.5 billion, denominated in 15 currencies and through 20 transactions. The features of green bonds are presented in the table below.

**Table 4.** Total issues of green bonds

<b>Date</b>	<b>Volume</b>	<b>Coupon</b>	<b>Maturity</b>
24 April 2009	300 millions USD	Variable	2012
4 December 2009	180 millions USD	2%	2013
12 november2008	2,85 milliard SEK	3.5%	2014
8 June 2010	40 millions MXN	6.15%	2015
2 February 2010	150 millions NZD	5.23%	2015
8 June 2010	25 millions ZAR	7.2%	2015
5 March2010	150 millions AUD	6%	2017
2 March 2010	40 millions BRL	9.5%	2017
5 March 2010	2 millions EUR	2.5%	2017
10 March 2010	2.5 milliard HUF	5.5%	2017
2 March 2010	400 millions NOK	3.75%	2017
3 March 2010	50 millions NZD	5.625%	2017
2 March 2010	750 millions RUB	7.50%	2017
22 February 2010	700 millions SEK	3.25%	2017
4 March 2010	50 millions TRY	10.0%	2017
5 March 2010	100 millions ZAR	8.75%	2017
12 April 2010	150 millions ZAR	8.75%	2017
2 March 2010	25 millions COP	8%	2020
9 March 2010	125 millions JPY	8.75%	2020
5 March 2010	200 millions MXN	7.5%	2020

Source: <http://treasury.worldbank.org>

The green bonds issued by the World Bank are an integrated part of a strategic program of Bank Group institutions to support members and countries facing climate change, the program being adopted at the annual meetings in October 2008 and entitled Development and Climate Change: A Strategic Framework for the World Bank Group.

### **Banks and Structured Products Listed and Traded on Stock Exchanges**

Generally associated with financial innovation, structured products became known in the United States during the 1980's and came into Europe in the middle of 1990's. There is a wide terminology used to identify these products: *structured securities*, *derivative notes/securities*, *securitised derivatives*, all these terms suggesting the derivative component of structured products.

The international banking groups and commercial banks operating in the local market have had an important contribution to the creation and development of structured products market segment at the Bucharest Stock Exchange (BSE). As a result of collaboration between institutions of the capital market from Romania, on the one hand, and Erste Bank AG and the Romanian Commercial Bank, on the other hand, since July 8, 2010, the Bucharest Stock Exchange has launched a special market for structured products, the trading of these products being a premiere for the Romanian capital market.

The structured products are financial instruments that certify an obligation of the issuer (“debt”), including a derivative component that influences the risk and return profile of the securities<sup>6</sup>. One of the characteristics of structured products is that they are based on an underlying asset that can be represented by shares, indices, exchange rates, interest rates, commodities etc. Moreover, in the case of the structured products, the cash flows characteristics of bonds are replaced with non-standard flows that depend on the underlying asset’s performance. They are issued to a certain proportion or rate to the underlying asset (usually 1:10 or 1:100), thus investors having access to the same exposure to the underlying asset but with a lower investment. Structured products’ maturity can be at a specified time in the futures or they can have an open-end maturity. The issuers of structured products can be credit institutions, investment firms or other financial institutions.

Erste Group Bank AG was the first issuer of structured products on the Romanian capital market, having as underlying assets the blue chip DAX index of German Stock Exchange (Deutsche Boerse), gold and oil. Erste Group Bank AG has issued two classes of certificates: Index certificates and Turbo certificates, which are issued and traded on the BSE in the national currency (RON). In the case of index certificates, their price increases or decreases in proportion to that of the underlying asset (i.e. assuming that the price of a barrel of oil - Light, sweet crude-oil, quotation futures contracts maturing in September 2011, is \$ 82.06, higher with 0.09%, then the price of index certificate will rise by 0.09%, to \$ 82.06 (ratio 1:1)).

The Turbo certificates (long or short) allow investors to benefit from market trends in both directions (increase or decrease). Thus, Turbo long certificates bring benefits to investors when the supporting asset prices are rising, and investors in Turbo short certificates are recording profits in a decline market. Unlike Index certificates, Turbo certificates have an exercise or strike price and a barrier or knock-out price, these elements being maintained until the end of the instrument. In the case of Turbo long certificates, at the time of issue, the knockout price < current price and in the case of certificates turbo short, knock-out price > current price. The certificates are withdrawn early by the issuer from trading if the underlying asset’s price equals or exceeds knock-out price.

The Romanian Commercial Bank (BCR) is acting as liquidity provider for Index and Turbo certificates issued by the Erste Group Bank AG, providing market liquidity by placing purchase and sale orders, and acting as a counterpart for any order placed on the market.

The issuance of structured products by Erste Group Bank AG on the capital market in Romania was followed shortly by another bank, namely Raiffeisen Centrobank AG (RCB). Thus, as of 17<sup>th</sup> August 2010, nine certificates were introduced to trading on the BSE. These products are index certificates having as underlying assets the ROTX index, the S & P 500 index, EuroSTOXX50 index, DAX index, gold and futures contract the oil (Brent Crude Oil). These certificates are also listed and traded on the Vienna Stock Exchange, EUWAX (Stuttgart Stock Exchange), Scoach (SIX Group AG and Deutsche Boerse) and Warsaw Stock Exchange. Raiffeisen Centrobank AG has also the role of provider of liquidity for the issued structured products.

The largest number of certificates traded on structured products market from BSE, since their launch date and so far, was recorded in the trading session on August 24, 2010, respectively 12,453 certificates<sup>7</sup>, totaling approximately 580,734.34 Lei, 70% higher than daily average registered by the date mentioned above.

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<sup>6</sup> <http://www.bvb.ro/structured>

<sup>7</sup> [http://www.bvb.ro/press/2010/comunicat\\_de\\_presa\\_record\\_piata\\_structuratelor\\_25\\_august\\_final.pdf](http://www.bvb.ro/press/2010/comunicat_de_presa_record_piata_structuratelor_25_august_final.pdf)

## **Banks as Investors in Capital Markets**

Banks participate in capital markets as investors, being considered qualified investors. Banks invest in capital markets to diversify their portfolios, to hedge risks, and to obtain profit following speculative strategies. For making investment in capital markets, banks use both fixed income instruments (investments in bonds, government bonds) involving a lower degree of risk and tools with a higher level of risk (shares, futures, options, swaps etc.).

Banks also intervene in capital markets as market makers, and they make simultaneous purchase and sale of various assets, with the stated aim to make profits and to ensure liquidity in the market for some assets. As market makers, banks provide the market with a certain quantity from a particular asset (market liquidity provision) and they also initiate reverse operations to correct various asymmetries that may occur in the market. Thus, the market volatility is diminished. Market makers are assigned to a particular asset (currencies, shares, derivatives contracts on currencies etc.), but the banking companies are registered as market makers in particular on currencies markets.

In Romania, in order to increase the stock market's liquidity, the two institutions – the Bucharest Stock Exchange (BSE) and the Monetary-Financial and Commodities Exchange from Sibiu (SIBEX) have granted the quality of market makers to some brokerage companies and banking companies. Thus, on the BSE spot market the Romanian Commercial Bank has acted as market maker since 2008 and on the futures market RBS Bank Romania has been declared market maker since 2009.

## **Conclusions**

The involvement of banks in the capital market should be considered in conjunction with the profound transformations that have marked the financial markets over the past quarter of the century, banks having a significant role in what means developing new financial products to better satisfy the requirements of investors, and regarding the issue of securities (shares and / or bonds) listed on a regulated capital market.

The current trends evident in the banking system consist of internationalization banks' activities by extending on other markets and their focus on operations with increasing volumes, which led to the necessity to unify the banks in consortia, unions or banking alliances. Increasingly, more banks were taken over by powerful financial groups, and have expanded internationally, including in addition to banks, insurance companies, reinsurance, brokerage companies, leasing companies, investment funds or pension funds being able to provide integrated financial services. Thus, banks have become extremely diversified credit institutions (universal banks), performing a wide range of transactions on financial markets.

The direct involvement of banks in capital markets takes the form of the issues of shares and bonds, securities that are traded on stock exchanges around the world. Banks as issuers of shares and bonds must meet the specific requirements of stock exchanges for admission to trading of issued securities; these requirements may cover aspects such as: the bank must have the activity and make a profit in the last 3-5 years; a minimum level of capital, or a minimum percentage of company shares to be made available to the market. It appears that many international banking companies choose to list their shares on a regulated capital market, which brings them a number of advantages such as implicit and permanent advertising in business circles but also easier access to financing.

Some of the shares of banking companies are included in the structure of reference indices and new indices are created in order to follow the performances of these shares. In addition, these indices are underlying assets for derivatives contracts (futures and options contracts), providing



different ways of investing in shares issued by banks but also of hedging the risks implied by investing in such securities. Moreover, the bonds issued by banks take different forms depending on the issuing entity, the purpose of the issue or the means of loan's guarantee. The World Bank has significant contributions to the development of bond market by introducing innovative products, bonds known as Green Bonds. These bonds are issued in order to mobilize funds to mitigate the impact of climate change, but they are also planned to reduce the greenhouse gas emissions. The funds are directed to funding eligible projects that aim to reduce climate change and help people to adapt to climate changes.

The various operations conducted by banks, target capital markets transactions too, both for investment purposes and/or hedging facing and speculative purposes. It was found that the existence of derivatives, originally conceived as hedging instruments, has increased the risk appetite of banks, which means risk increase within the entire banking system.

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## Considerații privind implicarea directă a băncilor pe piața de capital

### Rezumat

*Intensificarea instabilității financiare a condus și la o diversificare a activității băncilor. Acestea s-au implicat nu numai în activitatea de inovare financiară, ci și în operațiuni specifice pieței de capital, în principal prin emisiunea de acțiuni și obligațiuni. Asistăm însă și la apariția de noi instrumente financiare create de bănci, cum ar produsele structurate care sunt listate la bursă și oferă investitorilor noi oportunități de construcție a portofoliilor.*