CHAPTER 1

Introduction to Investment Banking: How the Financial Crisis and Reforms Changed the Industry

The investment banking market has experienced dramatic changes since 2008. Three of the top five investment banks in the United States have disappeared, while Goldman Sachs and Morgan Stanley have converted to commercial banking charter. The bankruptcy of Lehman Brothers has also brought about unprecedented quantitative easing in monetary policies in many countries. Recent financial regulation overhaul will have significant impact on what investment banks do and how they operate those activities. The Volcker rule will shake up trading desks. Investment banks such as Goldman Sachs, Morgan Stanley, JPMorgan, Deutsche Bank, and Credit Suisse have reshuffled proprietary trading. Therefore, the investment banking market is very different today.

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The New Investment Banking

One important lesson from the financial crisis is the need for more effective regulation. The recent financial reform legislation, most notably the Dodd-Frank bill, aims at setting standards for financial operations and preventing another crisis. The reforms focus on several essential areas. The first is to end "too big to fail." Taxpayers should not be protecting the shareholders and bondholders of even the most systemically important financial firms. Instead, these firms should be required to structure themselves so that they can be recapitalized without taxpayer money, and before local problems can spiral into a systemic crisis. Second, financial firms are required to practice consistency. Regulators should require that all assets across financial institutions be similarly

valued. Within each financial firm, there needs to be greater consistency and rigor in the way assets are valued and accounted for. Firms should no longer be allowed to move risk around to areas where it will be less rigorously monitored or more generously valued. Third, the regulatory system has more dynamic regulation. Across the board, the regulatory system should be comprehensive and strong enough to identify and constrain excesses in markets, before they can threaten the broader economy.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) is a comprehensive regulatory overhaul. Certain portions of the Act were effective immediately; other portions follow an extended transition period. Implementation of the Act will be accomplished through numerous rulemakings by multiple governmental agencies. The Act also mandates the preparation of studies on a wide range of issues, which could lead to additional regulatory changes.

In addition, legislative and regulatory initiatives continue outside the United States that will affect investment banking business. Basel III, the new global regulation on bank capital adequacy and liquidity, introduces new capital, leverage, and liquidity standards. It is designed to improve the banking sector's ability to deal with financial and economic stress. A provision of the Dodd-Frank Act (the Volcker rule) will over time prohibit investment banks from engaging in proprietary trading. The rule will also require banking entities to either restructure or unwind certain relationships with hedge funds and private equity funds. The rule is expected to become effective in July 2012, and banking entities will then have a two-year period to come into compliance with the Volcker rule.

Through the Dodd-Frank Act, investment banks face a comprehensive regulatory regime in over-the-counter derivatives. The regulation of swaps and security-based swaps in the United States will be effected and implemented through the CFTC, SEC, and other agency regulations. The Act requires central clearing of certain types of swaps and also mandates that trading of such swaps be done on regulated exchanges or execution facilities. As a result, investment banks will have to centrally clear and trade on an exchange or execution facility certain swap transactions that are uncleared and executed bilaterally. The Act further requires registration of swap dealers and major swap participants with the CFTC and security-based swap dealers and major security-based swap participants with the SEC.

Investment Banking Business

Investment banks engage in public and private market transactions for corporations, governments, and investors. These transactions include mergers,

acquisitions, divestitures, and the issuance of equity or debt securities, or a combination of both. Investment bankers advise and assist clients with specialized industry expertise. The industry or sector grouping often includes industrial, consumer, health care, financial institutions, real estate, technology, media and telecommunications, and others. As noted throughout the book, investment banks today go far beyond investment banking to also include other securities businesses such as trading, securitization, financial engineering, merchant banking, investment management, and securities services. For those activities, investment banks earn fees, commissions, and gains from principal transactions.

Investment banking includes capital raising and merger and acquisition (M&A) advisory services. Investment banks help clients raise capital through underwriting in which investment banks purchase the whole block of new securities from the issuer and distribute them to institutional and individual investors. For the service, investment bankers earn an underwriting spread, the difference between the price they receive from investors and the amount they pay to the issuing firm. The underwriting spread has been in the range of 6 to 7 percent of the total proceeds raised for equity offerings. The competitive pressure has forced bankers to charge less, especially for a large deal in which the spread could go much lower. In debt offerings, the spread is much lower, often less than 100 basis points. Several chapters in this book describe the relevant regulatory issues and the processes investment banks and issuers go through to offer the new securities.

Another major line in investment banking is strategic advising on mergers and acquisitions. Services offered include structuring and executing domestic and international transactions in acquisitions, divestitures, mergers, joint ventures, corporate restructurings, and defenses against unsolicited takeover attempts. Fees are usually negotiable. As the size of transactions gets larger and larger, the M&A advisory fees are generally less than 100 basis points and often much lower. M&A bankers still take in large sums of money, as the value of transactions grows larger. This line of business is attractive, because, win, lose, or draw, bankers earn fee income.

Other Securities Businesses

Full-service investment banks offer a service menu that goes beyond just investment banking. Principal transactions have accounted for a very significant portion of total net revenues at many Wall Street houses. These transactions include proprietary trading and merchant banking. In proprietary trading, the investment bank trades on its own capital. Under the Dodd-Frank Reform Act, investment banks are permitted to operate proprietary trading only on a

restricted and limited basis. Merchant banking invests the firm's own capital as well as funds raised from outside corporate and real estate investors.

Investment management is an integral part of investment banks. Major houses such as Morgan Stanley, Goldman Sachs, and JPMorgan each manage hundreds of billions of dollars for their clients. This is an attractive segment of the financial services industry. The income stream is less volatile than trading or underwriting and, hence, contributes to the stability of earnings.

Another line of business is securities services that include prime brokerage, securities lending, and financing. Prime brokerage offers tools and services desired by clients looking to support their operations in trading and portfolio management. In security lending services, investment banks find securities for clients to make good delivery so as to cover their short positions. Alternatively, financing services provide funds to finance clients' purchases of securities.

CAUSES OF THE FINANCIAL CRISIS

During the recent global financial crisis, the world stock markets declined, large financial institutions collapsed or were bought out, and governments in even the wealthiest nations had to come up with rescue packages to bail out their financial systems. In its reports, the Financial Crisis Inquiry Commission concluded that factors contributing to the financial crisis included widespread failures in financial regulation, dramatic breakdowns in corporate governance, excessive borrowing and risk-taking by households and Wall Street, the poor preparation of policy makers for the crisis, and systemic breaches in accountability and ethics at all levels. The following lists the commission's principal findings.

1. This financial crisis was avoidable. The crisis was the result of human action and inaction. The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public.
2. There were widespread failures in financial regulation and supervision that proved devastating to the stability of the nation's financial markets.
3. Dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis. There was a view that instincts for self-preservation inside major financial firms would shield them from fatal risk-taking without the need for a steady regulatory hand, which, the firms argued, would stifle innovation. Too many of these institutions acted recklessly, taking on too much risk,

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with too little capital, and with too much dependence on short-term funding.

4. A combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis. Clearly, this vulnerability was related to failures of corporate governance and regulation, but it is significant enough by itself to warrant our attention here.
5. The government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets. As part of our charge, it was appropriate to review government actions taken in response to the developing crisis, not just those policies or actions that preceded it, to determine if any of those responses contributed to or exacerbated the crisis.
6. There was a systemic breakdown in accountability and ethics. The integrity of our financial markets and the public's trust in those markets are essential to the economic well-being of our nation. The soundness and the sustained prosperity of the financial system and our economy rely on the notions of fair dealing, responsibility, and transparency. In our economy, we expect businesses and individuals to pursue profits, at the same time that they produce products and services of quality and conduct themselves properly.
7. Collapsing mortgage-lending standards and the mortgage securitization pipeline lit and spread the flame of contagion and crisis. When housing prices fell and mortgage borrowers defaulted, the lights began to dim on Wall Street. This report catalogues the corrosion of mortgage-lending standards and the securitization pipeline that transported toxic mortgages from neighborhoods across America to investors around the globe.
8. Over-the-counter derivatives contributed significantly to this crisis. The enactment of legislation in 2000 to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis.
9. The failures of credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seals of approval. Investors relied on them, often blindly. In some cases, investors were obligated to use them, or regulatory capital standards were hinged on them. Their ratings helped the market soar and their downgrades through 2007 and 2008 wreaked havoc across markets and firms.

THE DODD-FRANK ACT AND THE VOLCKER RULE

The purpose of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) is to "... promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail," to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." In addition, the Volcker rule imposes restrictions on proprietary trading for banks.

The Dodd-Frank Act

The Dodd-Frank Act significantly restructures the regulatory regimes under which investment banks operate. The implications of the Act on investment banks depend on the provisions of future rulemaking by the Board of Governors of the Federal Reserve System, the SEC, the Commodity Futures Trading Commission (CFTC), and other agencies, as well as the development of market practices and structures under the regime by the legislation and the rules adopted. However, the principal impacts on investment banks include:

1. The prohibition on proprietary trading and the limitation on the sponsorship of, and investment in, hedge funds and private equity funds (the Volcker rule).
2. Increased regulation of and restrictions on over-the-counter derivatives markets and transactions.

The Dodd-Frank Act, enacted in July 2010, significantly alters the framework within which investment banks operate. Under the Act, the newly created Financial Stability Oversight Council (FSOC) oversees and coordinates the efforts of the primary U.S. financial regulatory agencies in establishing regulations to address financial stability issues. The act directs the FSOC to make recommendations to the Federal Reserve Board as to supervisory requirements and prudential standards. Those include risk-based capital, leverage, liquidity, and risk management. The Act mandates that those standards be more stringent for systematically important financial institutions than for other financial companies.

The Act contains "derivative pushout" provisions that prevent investment banks such as Goldman Sachs and Morgan Stanley from conducting swaps-related activities through their insured depository institution subsidiaries. There

are exceptions for certain interest rate and currency swaps and for hedging and risk mitigation activities directly related to banking business.

The Act also calls for the imposition of expanded standards of care by market participants in dealing with clients and customers. It provides the SEC with authority to adopt rules establishing fiduciary duties for broker-dealers and directs the SEC to examine and improve sales practices and disclosure by broker-dealers and investment advisors. The Act also contains provisions designed to increase transparency in over-the-counter derivatives markets by requiring registration of all swap dealers, and the clearing and execution of swaps through regulated facilities. Under the Act, federal banking agencies are required to develop rules whereby anyone who organizes or initiates an asset-back security transaction must retain a portion, generally at least 5 percent, of the credit risk.

Volcker Rule

The Volcker rule prohibits proprietary trading (other than certain risk mitigation activities) and limits the sponsorship of, and investment in, hedge funds and private equity funds by banks. Proprietary trading, defined mainly as engaging in short-term trading, is subject to several exceptions that allow a banking entity significant leeway to engage in some short-term trading, including trading:

1. In U.S. government, state, and municipal obligations
2. In connection with underwriting or activities related to market-making
3. In connection with certain risk-mitigating hedging activities
4. In any security or instrument on behalf of customers

The exception for regulation on hedge funds and private equity funds is for funds that are organized or offered by the banking entity, subject to:

1. The banking entity owning no more than 3 percent of the fund
2. An overall limit of 3 percent of the entity's Tier 1 capital invested in private funds

CONCLUSIONS

This chapter reviewed the causes of the financial crisis and the subsequent regulatory reforms afterward. The chapter also discussed the changing environment under the new regulatory regime, including capital requirements, leverage, proprietary trading, and hedge funds and private equity funds–related operations.