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OUTLINING OF INVESTMENT BANKING IN THE POST CRISIS EPOCH

Abstract

This article seeks to provide the main aspects, associated with the modern practice of the investment banking. Moreover, the research is directed on the analysis of the global financial crisis influence on the activity of investment banks in general. There is the most general effect from the financial crisis on the investment banking sphere: the vast destruction of confidence in banks and of their reputation.

Key words: *investment banking, world financial crisis, world market of investment banking services, underwriting, M&A, corporate governance.*

Problem definition. Three years after the world economic breakdown, banks are recognizing the need to carry out better governance practice in the investment banking sector. No doubt, the banking sector is undergoing considerable changes as a result of the financial collapse. It will become a less “trendy” and even more regulated industry with higher state participation, amplified investor control and substantially greater capital levels. This will lead to lower profits, lower development and volatility for banks.

Literature review. Basant Venugopal (2007) investigates that the global investment banking industry is often described as an oligopoly as a relatively few firms dominate the industry. The largest firms are the ones who find their names in the largest size in the tombstones of the public offering announcements also known as the “Special bracket” or “bulge bracket”. The second-tier of firms are known as “Major bracket” and then come the “Regional” or “Sub-major”. The industry

though denominated by a small number of players is characterized by intense competition.

Thuy Vu Nga Hoang & Kamolrat Lapumnuaypon (2007) focuses on the list of ten critical success factors for M&A projects.

Allen N. Berger & Christa H.S. Bouwman (2008) compare the connection between financial crises and bank liquidity creation from two perspectives. Firstly, they examine the aggregate liquidity creation of banks before, during, and after five major financial crises in the U.S. from 1984 to 2008. Secondly, they consider the effect of pre-crisis bank capital ratios on the competitive positions and profitability of individual banks during and after each crisis.

At the same time the issue of the major challenges and features of the investment banking after the crisis period still needs further research.

Central Aim of Research. This article is devoted to the description of the current trends and challenges of the investment banking market in 2008 – 2011. Our study aims to examine the main investment banking features and key factors that determined the banks` success in investment sphere during the post-crisis period. The research identifies major players and events, problems of global investment banking services market, including key areas of this industry.

Results of Research. Investment banking has been narrowly defined as those financial services associated with the issuance of corporate securities or primary markets maker for securities and broking and dealing services in securities (secondary market). This was the traditional view of investment banking after the passing of the Glass-Steagall Act.

However, on November 12, 1999, President Bill Clinton signed into law the Gramm-Leach-Bliley Act (GLBA) that repealed the Glass-Steagall Act of 1933.

The GLBA allowed commercial and investment banks to consolidate and the combined industry came to be known as the “financial services” industry. [1]

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[1] Gramm-Leach-Bliley Act, available in Wikipedia (http://en.wikipedia.org/wiki/Gramm-Leach-Bliley_Act)

Banks tried to get higher returns that could be realized only through big leverage and big risktaking. This legislative act allowed investment banks to substantially increase debt level and leverage, it led to rising vulnerability of banks in the event of a recession in prices for mortgage-backed securities.

Following a financial crisis was intensified government regulation of investment banking. After the financial crisis the President USA administration signed into law a global reform of the financial industry that directs to prevent any recurrence of the situation economic crisis. Now the Federal Reserve and new 10 member Financial Stability Oversight Council reporting directly to Congress—will observe company' stability and if necessary, separate firms that pose actual threats of the instability. The reform also suggests the re refusal of the companies providing emergency financial assistance, preferably to go bankrupt.

Until the financial crisis world investment banking income grew for the fifth year running in 2007, to a record indicator of $84.3 bln, which was 22% more than the year before and more than double the level of 2003. As for geographical division the USA was the main channel of the investment banking revenue in 2007, with approximately 53% of the total, a proportion which has fallen somewhat during the past decade. Europe, including Middle East and Africa generated approximately 32% of the total income. As for Asian investment sphere it remained stable at the point of 15%. Moreover, fee income from the US raised by 80%. This compares with a 217% growth in European banks and 250% development in Asia during the same period. Investment banking industry is mostly presented in a small number of major world financial centers, specifically City of London, New York City, Hong Kong and Tokyo.

Thus, due to the world financial crisis the investment banking sphere lost Lehman Brothers (business was bought by Barclays in the USA, and by Nomura in Asia and Europe), Silver State Bank, Merrill Lynch (was bought by Bank of America), AIG (nationalized), Ameribank, HBOS (was bought by Lloyds TSB), Washington Mutual (was bought by J.P.Morgan Chase), Bradford&Bingley (nationalized), Wachovia (was bought by Wells Fargo). Morgan Stanley was

forced to sell 21% of the shares to the Japanese Mitsubishi UFJ Financial Group (MUFG).

The reasons of the global financial crisis were rather complex. Many scientists and economists note that it was the investment banks that performed particularly badly, and put forward some hypotheses that could explain the lack of adequate corporate governance practice in such banks:

1) weaknesses in corporate risk-management strategy;

2) weak underwriting standards;

3) necessity to focus on the system, not just individual institutions:

4) just-in-time management can be problematic;

5) systemic risks have increased in recent years.

It is important to explore more deeply the main reason of the financial crisis– shortcomings of corporate governance.

Results of our research show that CEOs were holding sizeable equity stakes even as the crisis hit, and did not decrease their ownership in 2007 or during the peak of the crisis in 2008. CEOs suggested that the risks they took before the crisis would pay off, but this did not happen. On the other hand, we can criticize the stimulating structures of bank managers. The top managers of Lehman Brothers and Bear Stearns cashed out a significant amount of options before the crisis. We found a close relation between enormous executive compensation and risk taking. Overpaying bank managers who take high risks is related with the share of institutional ownership of the bank.

The complexity of the business is a very important part of operation of investment banks. Banking and finance in general, have evolved extremely rapidly, creating very complex products.

Complexity creates a very serious problem for corporate governance. It is worth nothing that most board members, particularly non-executive board members, and many of executives, even some of the CEOs of these financial institutions, and people with large economic experience may not be quite competent of all the risks that are being taken. The variety of risks, of innovations,

of products and that take place in a contemporary financial institution is just beyond the knowledge and comprehension of a single person.

The next weakness of Wall Street banks identified to the Risk Metrics overview, which include the shortage of finance experts on the boards of directors of the banks., Merril Lynch, Morgan Stanley, JP Morgan and Bank of America only had two or three financial experts on their boards during the exacting years from 2006 to 2008, while Wachovia, Washington Mutual, JP Morgan, Lehman Brothers, Bear Stearns had only one financial expert on the board. So, it prevented the board from the independent understanding of all the financial transactions. [11]

RiskMetrics research (2009) reveals some fundamental problems in the governance of the Wall Street investment banks. These banks combined CEO/Chairman position (in Morgan Stanley, Citigroup, Merril Lynch, Bank of America, Washington Mutual, Bear Stearns, Wachovia, JP Morgan, Lehman Brothers and Goldman Sachs, the roles were combined during 2006-2008. [9]

In 2008 Bear Stearns and Citigroup made some effort at splitting the roles of COE and Chairman. The CEOs in other banks insisted on retaining both roles despite the international trend of separation these positions to ensure more balanced board direction.[2]

Lehman Brothers as the other investment banks had a system through which a half of annual bonuses were deferred into shares. Actually Lehman Brothers had deferred them into shares longer than most of its peers. So, there is a huge lack of alignment between the executives` and clients` interests and shareholders' interests, which are driven by annual bonuses.

Talking about the post crisis period investment banking is characterized by the following figures.

Global investment banking revenue totaled $66bn in 2009, up 12% on the previous year, but over a fifth down on record fees earned in 2007 (Chart 1). Growth in fund raising through capital markets, the recovery in equity markets

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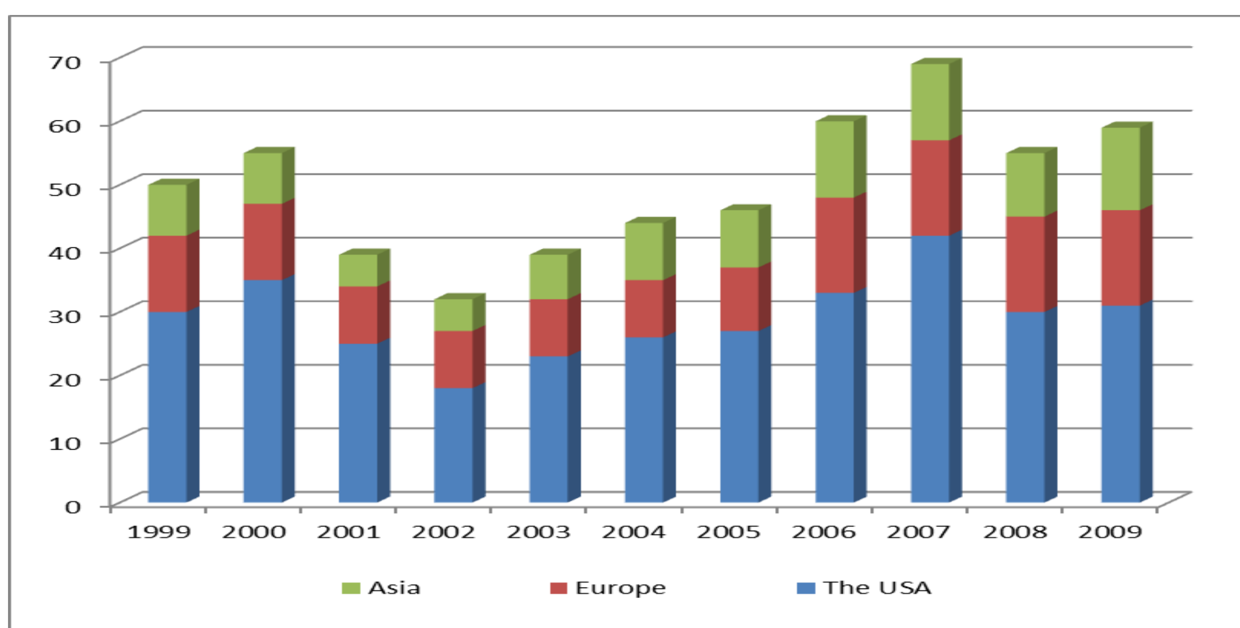
[2] In April 2009, Ken Lewis, the CEO/Chairman of Bank of America, was stripped of his Chairman's role after a shareholder vote following the Bank's takeover of Merril Lynch, the loss of 75 % of its market value and the US$45 billion rescue by the US government

along with high trading volumes helped to increase global investment banks' revenue. This follows a very difficult year for the industry during which some investment banks suffered from large trading losses and unprecedented writedowns. Many investment banks posted large profits in 2009 as they were not faced with trading losses and write-downs to the same extent as in the previous two years. Goldman Sachs for example posted profits of £13.4bn in 2009, compared with £2.3bn in the previous year.

Chart 1 - Global investment banking sources of revenue by region, 1999 – 2009, $ bln [3]



Source: Freeman Consulting Services

The US accounted for 46% of total investment banking revenue in 2009, down from 56% a decade earlier. Europe accounted for nearly a third of the total, a proportion which has remained relatively stable during this period. Asian countries on the other hand increased their share from 14% to 21%.

As market conditions improve, investment banks will not be able to rely to the same extent on fees generated by financial restructuring. Regulatory changes may bring stricter conditions with respect to capital costs and liquidity requirements. On the other hand, a low interest rate environment, along with an increase in corporate confidence and less volatile markets, should help to facilitate

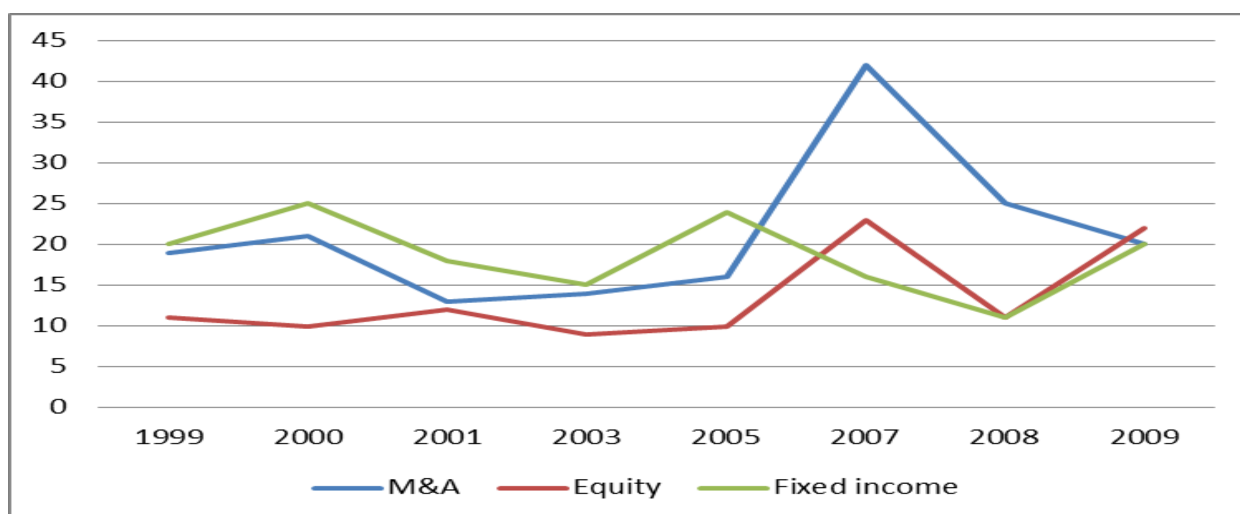
a pickup in M&A activity. Commodities trading in emerging markets and continuing industrialization of China and other Asian countries as well as funds from the Middle East are likely to become a more important source of investment banks’ business in the coming years.

Most investment banks' work is undertaken on behalf of large companies, banks and government organizations with some also providing a service to wealthy individuals. A number of investment banks, particularly from the US, have expanded into the retail sector while at the same time some commercial banks through M&A have increased their presence in investment banking.

Investment banks' business can broadly be categorized into: corporate finance and advisory work, treasury dealing, investment management and securities trading. Only a few investment banks provide services in all these areas. Most others tend to specialize to some degree and concentrate on a few product lines. A number of banks have diversified their range of services by developing businesses such as proprietary trading, servicing hedge funds or making private equity investments.

Product breakdown. Equity underwriting, fixed income underwriting and mergers and acquisitions (M&A) business each accounted for around a third of total fee revenue in 2009 (Chart 2).

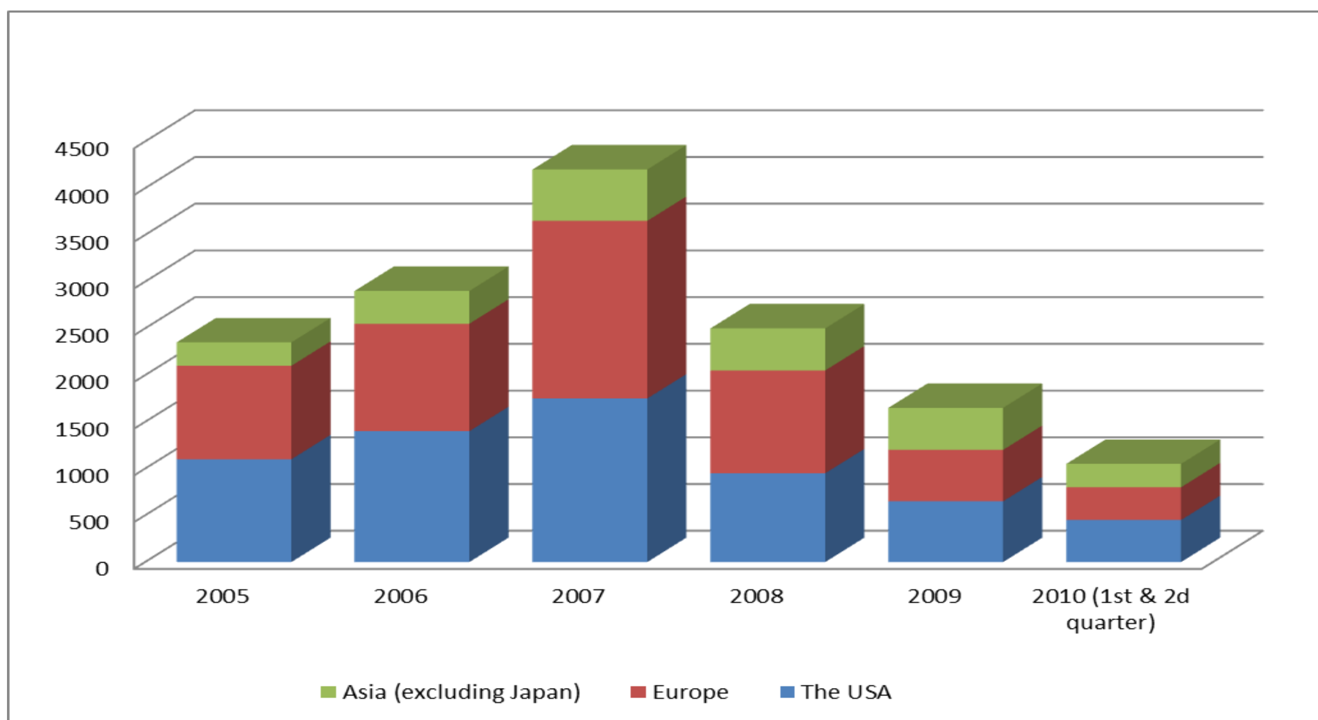
Chart 2 – Global Investment Banking Sources of Revenue by Product, 1999-2009, $ bln. [3]



Source: Freeman Consulting Services

As a proportion of total revenue M&A has fallen considerably since the start of the economic crisis while other areas of investment banking have increased. *M&A advisory* had been the main source of fee income in the decade prior to the current economic slowdown, typically generating more than 40% of investment banks' revenue. M&A activity has however declined markedly since the start of the financial crisis. Fees from M&A advisory work totaled $21.5bln or 32% of total fee revenue in 2009, down on its 52% share in the previous year. Announced corporate mergers and acquisitions fell by 28% in 2009 to $2.1 trillion. This was the lowest level since 2003 and down by a half on the record $4.2bln in M&As announced in 2007. By number of deals, M&A activity is down just 6.6% compared to the previous year with over 38,000 announced deals. The US generated 44% of deal volume, up on its 40% share in the previous year. Activity in Europe nearly halved during the year to $580bln (Chart 3).

Chart 3 - Volume of M&A Transactions, 2005 -2010, $ bln. [1]



Source: Thomson Reuters

The volume of M&A activities stood at the point of $2,4 trillion in a result of 2010. The growth was 22,9 %, and it is possible to make the conclusion that the

investment banking market was restored to the level of 2008, but the figures of the first half-year were less optimistic. 33 % of the total M&A transactions accounted for emerging markets. This figure has increased compared to 2009. The most active markets were China, Brazil and Russia. The highest activity was observed in the energy sector. Private equity results stood at the point of $ 225 billion, which was the highest value for the industry since 2008.

Equity underwriting generated $24.4bn or 37% of investment banks' fee revenue in 2009. The proportion of investment banks' income originating from equity underwriting has ranged between 30% and 38% over the past decade. The failure of a number of investment banks during 2008 has enabled other banks to raise prices.

Fixed income underwriting accounted for 31% of total investment banking fee revenue in 2009 or $20.4bn. This was significantly up on its 19% share in the previous year. As with equity underwriting, fees charged for fixed income underwriting have also increased. For example margins on European government bond sales have increased between 25% and 50% on the previous year. Despite a 3% drop in its share to 30% in 2009, the financial sector, with the exception of 2000, was the largest generator of investment banking revenue over the past decade. Technology companies' share of fee revenue declined sharply from their 39% peak at the start of the decade to 13% in 2009. Fee income from the energy sector, particularly oil, gas and power companies, increased markedly over the past decade, having grown more than four-fold. Other fee generating industries include the consumer, healthcare and capital goods sectors.

Largest investment banks. The credit crisis has had a profound effect on the investment banking industry. Several investment banks failed, were bailed-out by governments, or merged since the start of the downturn (Table 1). While the specific circumstances varied, in general the decline in the value of mortgage-backed securities held by these companies resulted in either their insolvency or inability to secure new funding in the credit markets. The five largest US investment banks with combined debts of $4 trillion either went bankrupt (Lehman

Brothers), were taken over by other companies (Bear Stearns and Merrill Lynch), or were bailed-out by the US Government (Goldman Sachs and Morgan Stanley) during 2008. Consolidation in the investment banking sector has created a smaller number of global companies which dominate the industry. Other investment banks have focused on particular products or regions. In 2009 the largest eight global investment banks generated more than a half of global investment banking revenue. Consolidation in Europe has created larger investment banks, although these are still not as big as their US counterparts, whose capital resources enable them to offer a broad product range supported by strong international distribution networks.

Table 1 – Best Investment Banks 2008 – 2011 [4]

	2008	**2009**	**2010**	**2011**
Best Investment Bank	Goldman Sachs	J.P.Morgan	J.P.Morgan	Morgan Stanley
Best Equity Bank	Merrill Lynch	J.P.Morgan	J.P.Morgan	Morgan Stanley
Best Debt Bank	Citi	J.P.Morgan	J.P.Morgan	Barclays Capital
Best M&A Bank	Goldman Sachs	Goldman Sachs	Morgan Stanley	Morgan Stanley
Best Up-and-Comer	Falcom Financial Services	CastleOak Securities	GulfMerger	QInvest
Most Creative	Citi	RBC Capital Markets	Bank of America Merrill Lynch	Bank of America Merrill Lynch

Source: Global Finance - http://www.gfmag.com/

The selected criteria included market share, customer service and advice, deal-structuring capabilities, distribution network and staff dedicated to investment banking. We also considered efforts to overcome difficult market conditions, pricing and after-market performance of underwritten securities. The winners are not necessarily the biggest banks, but rather the best banks—the ones that

corporations around the world should consider when looking for a financial adviser to meet their investment banking needs.

Table 2 - Best Investment Banks by Regions 2008 – 2011 [4]

		Best Investment Bank	**Best Equity Bank**	**Best Debt Bank**	**Best M&A Bank**
NORTH AMERICA	*2008*	Goldman Sachs	Merrill Lynch	Merrill Lynch	Goldman Sachs
	2011	Morgan Stanley	Morgan Stanley	Barclays Capital	Morgan Stanley
WESTERN EUROPE	*2008*	Deutsche Bank	J.P. Morgan	Deutsche Bank	Deutsche Bank
	2011	Morgan Stanley	Morgan Stanley	Deutsche Bank	Morgan Stanley
ASIA	*2008*	Citi	UBS	Citi	UBS
	2011	Morgan Stanley	Morgan Stanley	Standard Chartered Bank	Morgan Stanley
CENTRAL & EASTERN EUROPE	*2008*	UniCredit	Deutsche Bank	UniCredit	Morgan Stanley
	2011	Bank of America Merrill Lynch	Bank of America Merrill Lynch	J.P. Morgan	Morgan Stanley
LATIN AMERICA	*2008*	Citi	Credit Suisse	Citi	Citi
	2011	Citi	Bank of America Merrill Lynch	Citi	Credit Suisse
MIDDLE EAST	*2008*	Samba Financial Group	Samba Financial Group	Deutsche Bank	Citi
	2011	Bank Samba Capital	Samba Capital	HSBC	Morgan Stanley
AFRICA	*2008*	Samba Financial Group	Samba Financial Group	Deutsche Bank	Citi
	2011	Standard Bank	Vetiva Capital Management	Standard Bank	J.P. Morgan

Source: Global Finance - http://www.gfmag.com/

Investment banking is one of the most global financial industries and is hence continuously challenged to respond to new evolution and innovation in the world financial markets.

Conclusions. Basic directions of changes in investment banking sector in post crisis epoch:

1. It should be noted that Goldman Sachs & Morgan Stanley were the last banks which in 2008 changed status of independent investment banks on the bank holding. Passing of all independent investment banks to this status was related to strengthening of state control, which practically during 3 years after the beginning of crisis is actual direction of reformation of the financial system in the USA.
2. For many financial institutions the year of 2011 became extremely difficult. Toughening of adjusting in the USA and Europe compelled them to revise the business model of investment banking. The direction of business strategy became more conservative. A current tendency is a transition from strategies that were based on cheap loans and liberal adjusting, to strategies of development mainly in low-risk segments like assets management and payment transactions.
3. After completion of financial crisis the investment banks, which remained at the market got dividends on the streams of "cheap" money from FRS. And the crash of Lehman Brothers resulted in disappearance from the market of many competitors. First of all they got the record income from transactions with bonds, raw material and currency (FICC).
4. Strengthening of regulation. In 2011 the United States Securities and Exchange Commission (SEC) extended the plenary powers in area of bonuses regulation in the financial sector companies. All appearances, toughening of legislation in this sphere seemed too little for the department and it decided to take compensative payments under the complete control, up to possibility to deprive some employees of the bonuses, which were promised earlier. It is expected that business representatives must expose the supposed volume of bonuses one time per a year, whereupon this information will be exposed to the careful analysis from the side of SEC employees. If they will get the information, that payments negatively

affect on the financial indexes of company or the size of bonuses stimulates employees to the acceptance of superfluous risk, the SEC employees will have an opportunity to set embargo on stimulation of the program.

5. Increase of transparency. In 2010 the largest investment banks accepted a voluntarily decision about opening business information. According to the data of Association for Financial Markets in Europe, the question is about the companies' trade operations, which were accomplished in the so-called "dark whirlpools" - closed trade systems allowing to the banks to interchange the large packages of securities without the privities of regulator and other market participants.

6. Governmental programs of banks support. The program of the US government on the rescue of banks during financial crisis has already brought to the state approximately 10 % incomes.

7. Corporate governance matter. In the article we remained on the basic weaknesses of investment banks, and we determined the most effective changes in corporate governance, which led it to rescue during the financial crisis:

1) Boards are now required to have independent members and separate compensation and audit committees. Evidence shows that independent directors do bring more independent decision-making.

2) For corporate governance to be effective, steps must be taken to ensure that directors, managers, and professionals working for companies are made more accountable.

3) Splitting the roles CEO and Chairman.

4) Risk management must be seen in a corporate-wide perspective where the risk management system is continuously adjusted in line with a corporate strategy and the appetite for risk. The oversight of risk management by board members must also be improved and they must also be given all the information they need to make informed decisions.

This can be done is to encourage corporations to appoint a special risk officer. Moreover, to keep information clear, that person would report directly to the board of directors and not only via the CEO.

5) We also need to do better in monitoring implementation Principles of Corporate Governance and their effectiveness. That is why the OECD will put in place a process of peer reviews based on the OECD principles. These peer reviews will obviously scrutinize implementation, though they will also encourage transparency, consistency and mutual learning.

To sum up, presented article shows that the nearest prospects for American and European banks are decidedly downbeat. The global financial crisis will bring to the most considerable changes to their operating chain banks have seen during the last 10 years. There will be fundamental changes in regulation of the industry, ownership structures are shifting towards heavier state involvement and investor scrutiny is rising strongly. Equity ratios will be substantially higher. As a result, growth and profitability of the banking sector as a whole are likely to decline. After the financial crisis government regulation of investment banking was intensified. It is quite obvious that a basic legal and government regulation is needed for maintaining the stable economy, order of free market competition and for effective governance. The financial crisis shows that more stringent regulations are particularly needed in the finance industry. But we also need understand of the limits of regulations, as regulations are often reactive rather than proactive to corporate activities, and inappropriate regulations may also lead to corporate governance reverse or business failure. Consequently, a balance between regulatory governance and other governance modes and mechanisms needs to be scrupulously considered.

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