Threats to investment banking

Finance, Investment

Segmentation of the deposit market, irrespective of its origins, was the first requisite for universal banking. Following the revolution in mode of payments, the joint-stock banks moved along a secular trajectory from investment banking toward modern deposit banking. When allowed to capture the market of individuals' deposits unhindered, joint-stock banks became deposit banks, leaving the business of investment banking to institutions especially created for that purpose - trustee banks, investment banks, and the stock market.

They abandoned the field of investment banking altogether in order to match the maturity of their assets with that of their newly-gained short liabilities. The outcome was specialized banking. However, if frozen in mid-course, because local commercial or non-profit banks were entitled to corner the market for smaller depositors, the center banks were left to cater to a wider clientele of large, industrial depositors, with whom they found both their most profitable lending opportunities and, as loans make deposits, their most abundant sources of deposits.

Unable to fully capture the field of deposit banking, joint-stock banks were forced to rely on their own resources to a greater extent than pure deposit banks. Their liabilities showed a greater share of “ own resources” relative to individual deposits (this ratio is used to measure universal banking below). The greater cost of “ own resources” - shares earned more than deposits - was an additional reason to stick to investment banking, a more profitable, because riskier, line of business.

Consequently, unlike joint-stock banks in centralized capital markets, joint-stock banks in segmented markets could not completely vacate the field of investment banking (Forsyth ; Verdier 2002). U. S. investment banks are under siege, Competitors have long tried to force open the doors to the lucrative world of U. S. investment banking. In 2000, when Congress repealed the Glass-Steagall Act, which prevented banks from offering both commercial- and investment-banking services, the final barrier to integration fell.

Today, commercial and universal banks, such as Citigroup and J. P. Morgan Chase, as well as European-owned banks, including Credit Suisse First Boston and UBS, are a formidable competitive threat. Spurred on by the fact that investment-banking services are far more profitable than commercial-banking ones, universal and commercial banks are grabbing an increasing share of the investment-banking market. Their strategy for winning new business in it is often to give clients credit facilities as well-something that investment banks haven't traditionally done.

Still more worrying for investment banks is the fact that some clients now demand credit in return for M; A and underwriting business. In the spin-off of the microelectronics unit Agere Systems, for example, Lucent Technologies did business only with banks that were willing to provide credit too; J. P. Morgan Chase and Citigroup each committed as much as $1. 25 billion in loans, while investment bank Morgan Stanley agreed to buy $2. 6 billion in Lucent debt. Goldman Sachs, though it had co-led the original spin-off of

Lucent from AT; T, declined to take part in the credit package and was excluded from the deal.

Rough analysis suggests that the return on equity of the investment banks could fall by as much as 30 percent if they provided all clients with credit at the rates recently seen. Yet the prevailing view on Wall Street is that lending has become a necessity in the investment-banking world and that universal banks thus have a critical advantage. Investment banks, it is held, must obtain their own credit capabilities, even at the cost of depressing their rates of return.

Some people have gone as far as to suggest that the linking of credit with investment banking will spell the end of the independent investment banks as the remaining ones are forced to merge with or acquire commercial banks to remain competitive. Caims et al. (2002) disagree. While providing credit is an important competitive advantage right now--at the height of a severe credit crunch--it is not sufficient justification for rushing into a potentially difficult merger with a commercial bank on unattractive terms.

Certainly, to remain competitive, investment banks will need to build their credit capabilities and to offer loans selectively to clients. But once the credit cycle improves, credit will not make up for a lack of top-tier capabilities in the investment-banking business. Some universal banks will undoubtedly rise to the top of it, but only by developing superior skills. Conclusion and Recommendations Investment banks shouldn't give in to the current pressures to merge with commercial banks just yet--at least not if the onlymotivationis to gain credit capabilities.

The merger or acquisition route is fraught with pitfalls; integration between the two types of banks is difficult, particularly in today's tough market conditions. The leading investment banks still control the most lucrative parts of the business and will continue to do so if they maintain their advantage in skills long enough to build credit capabilities. Second-tier investment banks, which do not have the same skill advantages over the leading universal banks, face a more acute challenge. But even they should avoid mergers in the currentenvironment.

Investment banks lack experience in extending and managing credit portfolios, but this can be overcome by hiring the right people from commercial banks. Morgan Stanley, for example, lured a credit team from Bankers Trust, created a new position of chief credit officer, and filled it by hiring the former head of risk-rating assessment at J. P. Morgan Chase. Other investment banks should follow suit. A much more difficult obstacle to establishing a viable lending operation is the fact that investment banks have relatively small balance sheets--typically as small as 5 percent of a universal bank's balance sheet.

Investment banks must find funding sources for their loans and ways of laying off credit risk to protect their limited risk capital. In the short term, an alliance with a commercial bank would solve both problems. Such a partnership would naturally require the investment bank to pay the commercial one for providing funding and risk capital. But it has the advantages of avoiding the massive integration costs of a full merger and of establishing a working relationship with a commercial bank--a relationship

that could later lead to a merger if the industry dynamics make that necessary.

Investment banks should also look for creative capital market structures to duplicate the commercial banks' funding and risk-capital capacity. Credit derivatives and credit insurance already make it possible to lay off credit risk, but at present there is no way to provide guaranteed loan funding, particularly for the backup credit facilities (commitments to provide credit if and when it is needed) that companies are now demanding. One option would be to create a pre-funded, securitized vehicle resembling a mutual fund and then to sell participation in it to insurance companies or other investors.

However investment banks may build up their lending capabilities, they should choose their borrowers carefully. To ensure selectiveness, banks must develop explicit criteria for providing credit. It should be offered to clients who use investment-banking services intermittently, for example, and only when it is demanded and only when the overall transaction has an attractive return on equity. Investment banks could extend credit more generously to their most profitable clients as a way of building up long-term relationships, but this approach should be the exception rather than the rule.

Senior management must also provide active oversight to guard against systematic optimism by individual bankers: giving a loan has no downside for them, so they see loans simply as a way to capture more business. Annual reviews of the profitability of individual clients would provide a sensible backup for strictly enforced lending criteria, which might include such ideas

as granting loans only if they carried a higher spread than others in the same credit-rating band or were profitable in their own right, or lending only to blue-chip clients that had a realistic chance of yielding future business.

In addition, bankers might be made accountable for holistic client profit-and-loss (P&L) statements, not seen today, that included all investment-banking and lending revenues and costs. The role of investment banking in the U. S. can be drawn out through its definition. Investment banks in the U. S. perform services related to the financial management of investment. Services such as syndication of loans or bonds, placing of shares (equity), underwriting shares, issuing guarantees, giving financial advice, and managing funds makes the investment banking the high-flying engineer in the U. S. financial system.

Works Cited

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