



Introduction to Investment Banking

The business of investment banking is intensely competitive. Regulatory changes, globalization, and advances in technology are reshaping the industry. Deregulation in many countries has permitted large financial firms to add different services and products while operating on a global basis. Scandals like Enron and WorldCom, however, have prompted regulators to impose stringent requirements, such as the Sarbanes-Oxley Act of 2002, on the conduct of public companies to restore public trust. Wall Street houses no longer can ask their research analysts to push the stocks of their investment banking clients. Research analysts must make independent recommendations about their assessment of the client's business prospects. Furthermore, advances in technology have enabled clients to access financial services offered by investment banks whenever and wherever they choose. Technology also has allowed investment banks to design and price complex securities. As such, a career in investment banking is challenging and potentially rewarding. This chapter describes the market environment on Wall Street and outlines the coverage of each chapter.

ACTIVITIES OF INVESTMENT BANKING

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 groupings include Industrial, Consumer, Healthcare, Financial Institutions, Real Estate, Technology, Media and Telecommunications, and others.

Investment banks today also encompass 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 as low as 3 percent. In debt offerings, the spread is much lower, often less than 100 basis points.¹ 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 advice on M&As. 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 transactions grow larger and larger, the M&A advisory fees are generally less than 100 basis points and often much lower. Merger and acquisition bankers still gain billions in revenue as the value of transactions each year amounts to trillions of dollars. 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, including proprietary trading and merchant banking, have accounted for a significant portion of total net revenues at many Wall Street houses.² In proprietary trading, the investment bank trades on its own capital. *Merchant banking* invests the firm’s own capital as well as funds raised from outside investors in companies and real estate.

Investment management has become an integral part of investment banks. Major houses such as Merrill Lynch, Morgan Stanley, and Goldman Sachs manage hundreds of billions of dollars for their clients.³ This is an attractive segment of the financial services industry. The income stream is less volatile than trading or underwriting and, hence, contributes to stable earnings.

Another line of revenue-producing business is securities services: prime brokerage, securities lending, and financing. Prime brokerage offers tools and ser-

vices 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. Bear Stearns, Goldman Sachs, and Citigroup all emphasize this line in their service menus.

Other services vary from house to house. Lehman Brothers and Merrill Lynch offer banking services as well. Morgan Stanley has included the Discover Card services in its business offerings. Some houses offer retail brokerage, whereas others do not.

TRENDS IN INVESTMENT BANKING AND CAPITAL MARKETS

Deregulation, new regulations, globalization, and technological advancement are transforming the investment banking industry. To be successful, an investment bank needs to have a strong product line, the ability to provide clients with an integrated solution, a strong global presence, financial strength, and integrity and teamwork. This section provides an overview of the most important changes that are occurring.

Deregulation

The United States, the European Union, and Japan have all taken significant steps toward deregulation by lifting restrictions that limited the activities of financial services firms. Meanwhile, many developing countries are trying to stimulate growth by removing restrictions on their capital markets and on foreign investments.

In the United States, the *Gramm-Leach-Bliley Act* of 1999 (GLB) has created a new regulatory playing field by permitting securities firms, banks, and insurance companies to affiliate with each other under a financial holding company structure. As a result, these financial giants now offer both credit and investment banking. Investment banks that are not part of financial holding companies are facing increasingly competitive pressure from those large full-service financial services firms.

An immediate effect of the enactment of the GLB has been a trend toward consolidation within the financial services industry, as banks and securities firms have rushed to merge with each other. The GLB not only allows firms to consolidate and become larger, but also permits them to offer a wider selection of products and services. The convergence of financial services has permitted a financial services supermarket like Citigroup to offer a vast array of products and

services including savings and checking accounts; credit cards; mortgages; stock and bond underwriting; M&A advice; commercial loans; derivative securities; and foreign exchange trading. Other firms are similarly exploring new ways to develop the best mix of products and services that will enable them to compete in the new financial marketplace. Citigroup, the first one-stop shop in the United States, has virtually sold off its insurance business, and many market observers now believe insurance is not a good line in financial holding companies because of its lower profitability and higher volatility.

In Europe, the advent of the European Monetary Union (EMU) has brought about a common currency, the euro. The European Central Bank (ECB) now establishes and oversees a common monetary policy for member countries. The EMU has brought dramatic changes to the global capital markets and to the way Europeans do business with each other and with the rest of the world. With just one common currency, businesses operating in the euro zone save on transaction costs and are able to plan without currency uncertainty. Another benefit is market transparency because consumers can compare prices of goods and services in different countries. Over time, the euro will be used as an accounting unit in international trade and as a reserve currency (a foreign currency held by a central bank for the purpose of exchange intervention and the settlement of intergovernmental claims). Finally, the introduction of the euro has led to lower interest rates in the EMU countries. To join the union, European governments had to reduce their deficits, and the ECB's goal of maintaining price stability has put downward pressure on interest rates. Since the advent of the EMU, the market has seen a dramatic increase in underwriting business and merger and acquisition activities as well.

In Japan, the financial reform plans, known as Japan's Big Bang, have focused on four areas: deregulation of financial products, promotion of free competition, removal of trading restrictions, and establishment of a reliable framework and rules for fair and transparent transactions. The reforms also provide for a holding company structure that allows various financial institutions to enter each other's business.

Many developing countries are also taking steps to establish sound marketplaces. These governments have introduced measures to enhance the liquidity of their bond markets and deregulate the foreign exchange or currency market. More and more countries have opened their economies to foreign investors by lifting the limits on foreign ownership of stocks and ensuring the convertibility of their currencies. Deregulated markets present opportunities for investment banking. There is a demand for underwriting and advisors for corporate strategic matters. Demand also exists for investment management and a long list of financial services.

New Regulations

Corporate scandals such as Enron and WorldCom prompted Congress to pass the Sarbanes-Oxley Act of 2002 to bolster public confidence in the capital markets. The act imposes duties and penalties on public companies for noncompliance. Under the act, the Public Company Accounting Oversight Board (PCAOB) is empowered to impose disciplinary or remedial sanctions on registered firms for misconduct or negligent conduct. Other major provisions of the act cover auditor independence, corporate responsibility, enhanced financial disclosures, and analyst conflict of interest.

The act imposes auditor rotation in which an audit partner cannot serve as the lead or reviewing auditor for more than five consecutive years. If an auditor has hired an issuer's executives who were involved in the audit during the one-year period preceding the audit initiation date, then that auditor cannot perform auditing services for the issuer for one year. In corporate responsibility, the act requires the chief executive officer (CEO) and the chief financial officer (CFO) to certify periodic financial reports.

One of the most costly elements of the act is the Section 404 certification. Section 404 imposes stringent requirements on public companies to establish proper internal controls. A public company must include in its annual report a clear description of responsibility of management and an assessment of the effectiveness of the internal control structure.

Globalization

Investment banks face competition from both domestic and foreign firms. Large sums of money are moving across borders, and more countries have access to the global capital market. To serve clients better, major investment banks have become global competitors. Top financial holding companies such as Citigroup and JPMorgan Chase and investment banks such as Morgan Stanley, Merrill Lynch, and Goldman Sachs have operations in almost all countries with significant capital market activities.

For U.S. investment banks, doing business overseas sometimes involves payments to local bureaucrats and corporate executives to facilitate the process or to get the deals done. But such payments are in violation of the federal antibribery legislation. One way to make a payment legally is to get preapproval from the Department of Justice and the Securities and Exchange Commission. For example, Goldman Sachs obtained approval before making a payment of \$67 million to Beijing power brokers to ease the way for a joint venture in China.⁴

Advances in Technology

Technological advances and the Internet have changed the way Wall Street firms reach customers and showcase their products. More and more transactions go through the Internet and computer networks. Millions of customers conduct their stock and bond trading online. By presenting research reports and other materials online, investment banks are improving efficiency. Advancement in computer technology, together with financial modeling, has fostered the design and trading of new securities. In addition, new technology is transforming securities trading by shortening the settlement cycle (the time required for payment of funds and delivery of securities) from trade day plus three days (T+3) to trade day plus one day (T+1).

BOOK OVERVIEW

The Business of Investment Banking provides a comprehensive description of the major players and activities in investment banking. It first explains the lines of business from which investment banks derive their revenues. After providing readers with a basic understanding of what Wall Street houses do, the book then describes job opportunities in this market. Subsequent chapters cover investment banking operations, clearing and settlement, and securities regulations as well as the securities markets in China, the EMU, Japan, and the emerging markets.

Chapter 1 describes the functions of investment banks and the major factors affecting the competitive environment in investment banking. These include deregulation, reregulation, globalization, and advances in technology. The last section briefly lists the topics covered in each chapter.

Financial holding companies, full-service investment banks, and boutique investment banks are described in Chapter 2. Full-service investment banks operate in proprietary trading, merchant banking, underwriting, advisory services on mergers and acquisitions, investment management, and securities services. These Wall Street houses include Goldman Sachs, Merrill Lynch, Morgan Stanley, and the investment banking arms at large financial holding companies such as Citigroup, JPMorgan Chase, HSBC, and Deutsche Bank. Boutique investment banks are niche players that specialize in a particular industry or particular segments of the service menu.

Chapter 3 extends the coverage in Chapter 2 and looks at the market trends and sources of revenues of investment banks. As major houses have expanded their business lines, investment banking represents no more than one-third of total net revenues at the big three investment banks on Wall Street (Merrill Lynch, Morgan Stanley, and Goldman Sachs). Large investment banks also operate in all

major capital markets around the globe and derive a significant portion of their revenues from overseas. Investment banking strategies also include risk management, such as market risk, credit risk, operating risk, reputation risk, legal risk, and funding risk.

Investment banks offer many challenging and rewarding career opportunities. College graduates start out as analysts, with opportunities to move up to associates in two to three years. Those with an advanced degree (e.g., MBA) may start out as associates. Successful associates have the chance to move up to vice presidents after three or four years. Some vice presidents eventually are promoted to managing directors. Chapter 4 describes the career paths and the application and interview processes as well as the desired skill-set for a successful career in an investment bank. It also presents the recruiting process at Morgan Stanley and suggestions from Goldman Sachs' head recruiters in New York, Asia, and Europe.

Chapter 5 covers private equity including venture capital and buyouts. Investment banks engage in private equity operations, from raising capital for the funds to taking a portfolio company public or selling out to other businesses. We examine venture capital fund-raising, sourcing, due diligence, investing, risk factors, management fees, profit-loss allocations, and exit strategies. Similar issues relating to buyout operations are addressed as well.

Mergers and acquisitions market advice is at the heart of investment banking. Investment bankers take in large sums of fee income every year. The volume of deals reached \$1.6 trillion in the United States and \$3.4 trillion in the global market in 2000. The stock market downturn slowed the M&A activities in subsequent years. By 2004, however, the volume of deals trended upward to \$1.9 trillion in the global market. The activities in M&As will continue to generate significant fee income for Wall Street. Chapter 6 discusses the motivations, negotiation process, valuation techniques, M&A banker's fees, regulatory issues, and closing. In addition, there is a discussion of risk arbitrage, in which arbitrageurs trade on securities of both the acquiring and the acquired to profit from price movements.

Investment banks help companies issue new securities. The investment bank that wins the mandate to run an issue of a new security is the lead manager. Other houses could participate as members of the underwriting syndicate or the selling group. Investment banks earn billions of dollars each year through underwriting equity and debt securities. Chapter 7 focuses on equity underwriting and Chapter 8 provides coverage on fixed-income market. After the Gramm-Leach-Bliley Act of 1999, full-service financial holding companies such as Citigroup, JPMorgan Chase, and Bank of America put pressure on traditional investment banks, such as Goldman Sachs and Merrill Lynch, to lower fees. The equity underwriting market reached a peak of \$205 billion in 2000. Volume declined after the stock market turned south. By 2004, the equity underwriting business had bounced back to

\$203 billion. This chapter covers the major aspects in underwriting equities, including the mechanics and process, pricing, underwriter risks, and compensation.

The U.S. Department of the Treasury issued a record \$3.8 trillion of government securities in 2004. Corporate bond issuance was at \$728 billion, and municipal issues added an additional \$418 billion during the same year. Furthermore, agency mortgage-backed securities and asset-backed securities are valued in the trillions of dollars a year. Chapter 8 begins by covering the activities in the government securities market, including the auction process, dealer bidding strategies, trading, short squeeze, and market practices. Chapter 8 also discusses corporate fixed income and focuses on the underwriting process, shelf registration, underwriting spreads, and underwriting risk management. The subsequent section covers the Rule 144A market in which issuers do not file registration materials with the Securities and Exchange Commission and sell securities to a group of qualified investors. The last section covers the municipal debt market.

Asset-backed securities are covered in Chapter 9. Investment bankers' creativity has been the driving force behind the powerful revolution in a new era of structured finance. Securitization generates fee income for bankers and provides them with additional trading opportunities. Asset types used in securitization include mortgages, automobile loans, credit card receivables, equipment leases, high-yield bonds, tax liens, and tobacco settlements. Chapter 9 describes the development of the market and then identifies the major types of asset-backed securities in the subsequent sections.

Investment banks help foreign companies list on Wall Street in the form of American depositary receipts (ADRs). American investors also use ADRs to diversify their portfolios globally and reduce risk. Chapter 10 discusses how ADRs are used by investors who do not or cannot invest directly in non-U.S. dollar denominated securities overseas. Market hours in Europe overlap partly with the U.S. trading day, and Asian hours do not overlap at all making it inconvenient to trade. As a result, Americans seeking exposure to foreign stocks are increasingly turning to ADRs, which present an efficient, cost-effective, and liquid way to make specific foreign investments.

Chapter 11 looks at trading and trading strategies. Many investment banks put up huge amounts of capital for proprietary trading. Major players include many of the best-known investment banking houses and hedge funds. Trading for market making is part of a dealer's business. Day trading involves taking advantage of short-term volatility. Scientific approach-based trading and arbitrage play high-stake games. It is fascinating to read news headlines about George Soros making \$2 billion by betting against the Bank of England and John Meriwether taking a \$12 billion position in Italian tax-driven arbitrage trade. This chapter discusses the fundamentals for successful trading, arbitrage strategies, and technical trading techniques.

A repurchase agreement (repo) is a sale of securities with a contract to repurchase the same securities on a later date. Dealers use repos to finance their market making and trading activities, and conduct reverse repos to invest excess cash or provide customer funding. The repo desk has become the hub around which the trading, hedging, and arbitrage strategies revolve. At many firms, the repo desk has become a key profit center. Understanding the market is essential to assessing value in the government securities markets. Chapter 12 first describes the structure, development, trading mechanics, and market practices. Subsequent sections cover special repo rates, brokering, and matched-book transactions.

Financial engineering puts the investment banker's creativity into practice. The competition among investment banking professionals to meet borrowers' and investors' needs for hedging, funding, arbitrage, yield enhancement, and tax purposes drives the explosive growth in the structured and derivatives markets. The development of junk bonds and asset-backed securities provides borrowers with additional funding sources at lower costs. Structured notes add another dimension in the funding and investment spectrum. Transactions in repurchase agreements provide borrowers with lower funding costs and give lenders legal title to the collateral. Through swap contracting, borrowers and investors obtain a high degree of flexibility in asset-liability management at better terms. Credit derivatives are the new trend with widespread applications. Chapter 13 illustrates the financial engineering process and then covers some widely used products as well as the new trends in the derivatives markets.

Major investment banks all have hundreds of billions of assets under management. Investment management is an important segment of the capital markets and has become an integral part of the investment bank's business. Wall Street firms are buying into fund management because it expands the menu of products and services they offer to clients. Furthermore, the income stream is less volatile than trading, underwriting, or M&A activities. The affiliated funds also provide synergy to the investment bank's underwriting business. Chapter 14 describes the structure and organization of a mutual fund and the regulatory environment. This chapter also explains hedge fund operations and the typical range of management and incentive fees. Wall Street firms have hedge fund operations because of rising demands for alternative assets and attractive fee revenues.

The posttrade process begins with a trade ticket that goes to the back office and to clearing corporations. Timely and reliable clearance and settlement are the foundation for a safe and efficient trading environment. Automated posttrade procedures result in fewer inaccuracies, lower transaction fees, and lower operational and fail costs. The major clearing corporations covered in Chapter 15 include Fixed-Income Clearing Corporation, National Securities Clearing Corporation, Clearstream, and Euroclear.

The main objectives of securities regulation are facilitating capital formation and protecting the interest of the investing public. Registration of new securities ensures full and accurate disclosure of material information. Exemptions of registration are available when issuers sell their securities to certain qualified institutional investors. Active secondary market trading is key to successful primary market capital raising activities. Hence, regulating sales and trading in the secondary markets ensures fairness and maintains public trust. As such, investment banks have set up proper safeguards to prevent potential conflict of interests by analysts. As discussed in Chapter 14, investment management has become an essential revenue-producing business for investment banks. Regulations for investment companies and investment advisors are in the public interest and for the protection of investors. Furthermore, integrity and professionalism are basic to success on Wall Street. The Sarbanes-Oxley Act of 2002 imposes new duties and significant penalties on public companies for noncompliance. Chapter 16 briefly covers the full spectrum of these issues.

Chapter 17 discusses major activities in Eurocurrency, Eurobonds, floating rate notes, Euro-commercial paper, and medium-term notes. The chapter also discusses the euro and the Japanese capital markets. The advent of the EMU has transformed the face of Europe. It has removed different currencies, monetary policies, and, to a degree, fiscal policies from EMU member countries. In recent years, the Japanese capital markets have undergone a dramatic reshaping. Facing a prolonged decline in the equity market and a serious banking crisis, the Japanese government instituted a series of financial reforms that have come to be known as Japan's Big Bang. In undertaking these reforms, the government had two goals: to revitalize the Japanese economy and to upgrade Japanese financial markets.

To capitalize on the profit potential in investment banking operations in emerging markets, bankers should be aware of the specific environment in each sector of the market. Chapter 18 first discusses several risk factors unique to emerging markets, including liquidity risk, political instability, insufficient legal infrastructure, and risk of contagion effects. Issuance and trading of Brady bonds have dominated emerging market activities for many years. However, there is no longer a pipeline of Brady restructuring to feed the market. Most Brady bonds will eventually be paid off, exchanged, or bought back in the secondary market. Chapter 18 also covers financial crises and emerging market derivatives.

Many bankers see tremendous opportunities in China. Investment banking houses such as Goldman Sachs, Morgan Stanley, and Citigroup have all positioned themselves to take advantage of the market potentials. Access to China's market became a reality after China joined the World Trade Organization. Foreign securities houses now can establish joint venture operations to underwrite A shares. In addition, they can engage in underwriting and trading B and H shares

as well as government and corporate debt securities. At the same time, privatization means many Chinese companies will seek listings in foreign markets. China Life, Sinopec Shanghai Petrochemical, China Telecom, Bank of China, and Bank of Communications offerings are all examples of privatization. Chapter 19 provides a description of how several Wall Street firms have entered China's markets. The chapter also discusses the stock and the fixed-income markets.

The final chapter in *The Business of Investment Banking*, Chapter 20, discusses the future trends of and challenges facing the investment banking industry. Regulatory changes will affect how investment banks position themselves in the marketplace. For U.S. houses, Europe and China present higher growth opportunities. Because risk is inherent in the business and the market is increasingly competitive and volatile, investment banks have to manage various risks effectively. Successful risk management together with diversified income streams will help investment banks achieve sustained earnings growth.