What is... INVESTMENT banking?

BANKTrack

Unlike traditional banks, investment banks do not accept deposits from, nor provide loans to, individuals. An investment bank is an institution that acts as an underwriter or agent for companies or governments that issue securities (bonds and stocks). They thus act as "market makers," or intermediaries between potential investors and companies or governments that wish to raise capital.

The services offered

By underwriting, the investment bank buys all the new securities from the issuer (a company or government) at an agreed upon fee. Thus the issuer is guaranteed a certain minimum amount raised from the issue, while the underwriter bears the risk. The underwriter then resells the new shares directly to the market or to another investor. The underwriter may agree to "support the issue" by buying any shares which are not bought by the public, thus creating public confidence. The profit for the underwriter lies in the difference between the price paid to the issuer and the public offering, which is called the underwriting spread. The first issue of a company's stock to the public is called Initial Public Offering (IPO).

The investment bankers' role begins with pre-underwriting counseling and goes on with pricing the securities. Investment banks may stabilize the price of an issue during the offering and distribution period, and they often provide clients with ongoing expert advice and guidance, sometimes taking a seat on the board of directors of the company. Investment bankers can also form an underwriting group, which pools and spreads the risk, while allowing the issue to be efficiently distributed among the banks' clients.

In other arrangements, investment bankers market a new issue without underwriting it, acting as agent, and take a commission for whatever amount of securities the banker succeeds in marketing.

Investment banks also play a large role in facilitating corporate restructuring and mergers and acquisitions through fee-based advice and financing.

Finally, investment banking deals with converting loans and other assets into securities (securitization).

American investment banks dominate the global market

The top global players in investment banking are American financial firms, which include Citigroup Global Markets (formerly Salomon Smith Barney), J.P. Morgan Chase, Goldman Sachs and Morgan Stanley.

The top five Investment banks:

Citigroup Global Markets
J.P Morgan Chase
Goldman Sachs
Morgan Stanley
Merrill Lynch

Trends & Critical Issues

- **More bonds, less shares.** Corporate bond issues have been on the rise in recent years as investors become weary of the unstable income from corporate stocks. Moreover, bonds have become a major way for corporations to raise debt, as an alternative to obtaining bank loans. Companies at the edge of bankruptcy issue junk bonds, which are bonds that are rated as "below investment grade" by independent credit rating agencies such as Moody's or Standard

& Poor's. Junk bonds are bought by investors willing to take high risks in return for high rewards if the companies recover.

- **Bursting of the dot-com bubble.** After the dot-com bubble burst, business for investment banks slowed down. Fewer businesses were interested in issuing new shares, which resulted in less income for investment banks. Just prior to the slump, investment banks were avidly selling new shares particularly from IT (information technology) companies, which helped create the dot.com bubble.

- **Growth of mergers and acquisitions (M&A).** Many investment banks strongly promoted multi-billion dollar M&A's, which during the boom years inflated the stock market, and created huge profits for investment banks. Some financial conglomerates expanded their investment banking operations during the 'high' times, at the expense of retail banking. The benefits of M&A's are not always obvious, as many companies are left with massive debts that are difficult to repay in an economic downturn (e.g. Vivendi). In addition, research shows that problems in merging corporate cultures contribute to merger failure rates of over 60%. After the stock market bubble, M &A activity slowed down, but has recently rebounded.

- **Conflicts of interest.** Banks that underwrite securities are often the same banks that provide asset management and advisory services to investors who buy securities. Regulations require that underwriters and issuers fully warn investors of a security's potential risks in the prospectus, a legal document that accompanies a new issue. Recent corporate scandals, which were triggered by the collapse of US-based Enron, revealed that some investment banks misled investors with biased information in order to win or retain lucrative underwriting contracts. The scandal opened a floodgate of investigations into the overall standards and practices of the American financial services industry, as well as the big auditors and credit rating agencies. The world's top investment banks such as Citigroup, Goldman Sachs, J.P. Morgan and Morgan Stanley were fined huge amounts of money, which in 2003 totaled more than $ 1.4 billion, for conflicts of interest and generally misleading investors in the US.

- **World Bank bonds.** Many investment banks underwrite World Bank bonds, which are bought by institutional investors such as pension funds. The World Bank receives 80% of its funds from the selling bonds. Many civil society groups criticize the World Bank for its "structural adjustment" programs, which condition developing country aid to harsh macroeconomic reforms that often hurt the poor and the environment. Investment banks that underwrite World Bank bonds have been criticized for its role in helping the World Bank raise capital.

Glossary:

Underwriting: the process by which an investment bank assists a company or government to issue securities. The underwriter guarantees a certain amount to the issuer, and purchases any securities that are not bought by the markets.

Bonds: promissory notes that obliges the issuer to pay back a certain amount of money within a certain time (with or without regular payments, or 'coupons').

Securitization: the process of aggregating assets in a pool and issuing new securities backed by the revenues expected to be generated by the pool.

IPO (Initial Public Offering): the first time newly-issued stocks or bonds are offered to the public.

Useful websites:

www.sec.gov (US regulatory agency for securities)
www.iosco.org (International regulatory agency for securities)

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T: +31-30-2334343, F: +31-30-2381112, E: coord@banktrack.org, www.banktrack.org