INVESTMENT BANKING. REGULATORY FRAMEWORK ALTERATION UNDER FINANCIAL CRISIS

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ABSTRACT: *The current financial crisis triggered by the collapse of US securities market determined dramatic changes on Wall Street: bankruptcy for some financial institutions and restructuring for other. The most hit were independent investment banks, which, after two times last century (1930 and 1998), it had once again, in 2008, to overcome fierce challenges and adjust their business principles.*

This paper tracked the evolution of financial markets and the impact of major crisis on investment bank model; it followed the changes in the regulatory framework determined by major financial crisis which influenced investment banks' activity.

Based on empirical evidence, it analyzed how financial crisis influence investors' perception on markets and affect informational flows and it tried to assess long term implications for financial markets.

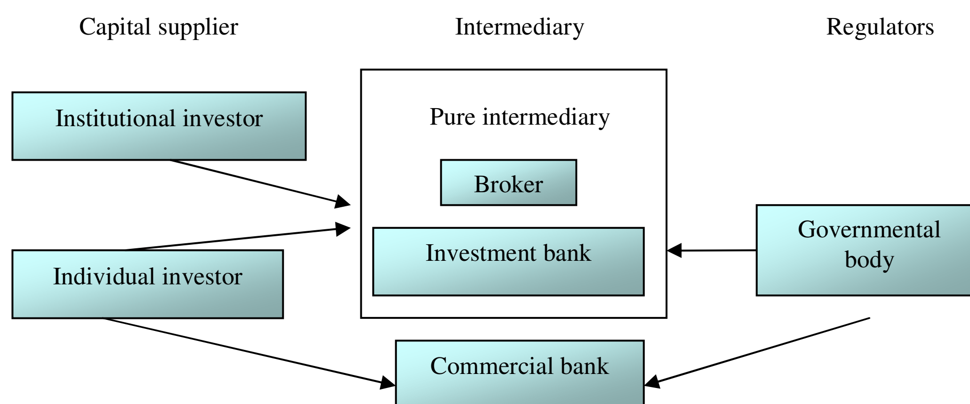
Key words: *conflicts of interest, investment banking, Glass-Steagall Act, Gramm–Leach–Bliley Act, Federal Reserve*

JEL Classification*: G24, G01*

INTRODUCTION

Investment banks reach economies of scope and scale by providing financial services which face the asymmetrical distribution of information on capital markets: underwriting, merger and acquisition consultancy, dealing and brokerage, research and market maker activity. As an intermediary, investment banks have an important role in raising capital and providing liquidity to financial markets. They have to deal with the issue of conflicts of interest that arise from the fact that it serves two types of clients: issuers and investors; issuers benefit from optimistic research while investors are looking for unbiased recommendations. When conflicts of interest are obvious, regulatory bodies impose sanctions and restrictions that ended up, during the US crisis in 1933, with complete separation between investment and commercial banking activities.

Fig. no. 1
Financial intermediation structure[i]:



CONTENT

First signs of conflicts appeared in 1929 immediately after American capital market collapse, a period of financial market turmoil dominated by investors' reluctance towards stocks acquisition. After previously, starting 1927, it experienced a capital market exuberance, when investors were buying massively stocks, especially those of companies specialized in technology, once the market began falling, they felt mislead by the bankers who recommended those stocks, the most aggressive promoters being the new formed investment banks. The possibility of transferring clients from one specialized department to another due to specialized services performed, offered banks the advantage of business synergy but made room to potential conflicts of interest. Following the further investigations which revealed that banks have profited on behalf of their position in spite

of clients' interests, US Congress passed Glass-Steagall Act which completely separated commercial activities from the underwriting ones within banking field.

In 2000, for the second time in history, an American capital market speculative balloon determined by the excessive growth of high-tech companies' stock prices ended up by a sharp fall, dragging along the European market. Following a series of trials that caught media attention, several investment banks were pecuniary penalized because they encouraged their own analysts to issue extremely optimistic recommendations regarding the stocks of companies of which poor financial soundness they were aware of and which ended up being disastrous investments. One of the factors that contributed to theses scandals was the conflict of interest through which investment banks, which were supposed to provide investors with trustful information, had interest in hide the reality for their personal gain. After the scandals that followed, the US regulatory bodies - US Securities and Exchange Commission, New York General Attorney and New York Stock Exchange – imposed drastic measures, the main restrictions being the following:

- Banks must separate underwriting from research activity;
- The practice so called "spinning" was banned;
- Each bank was forced to make public the recommendations of their own analysts, including their rating and forecasts regarding stocks they evaluate;
- On a five years time frame, brokerage firms were obliged to hire no less than three independent research firms who will provide research reports to their clients; the regulators will chose an independent consultant which will monitor the selection process.

The total amount of penalties the main investment banks had to pay amounted $1.4 billions.

In 2008, in the turmoil of the US subprime crisis, none of the major US independent investment banks managed to keep its status unchanged:

- Bear Stearns was bought by JPMorgan Chase on May 29th;
- Lehman Brothers filed for bankruptcy on September 15th;
- Goldman Sachs and Morgan Stanley became commercial banks in October.
- Merrill Lynch was acquired by Bank of America on December 5th;

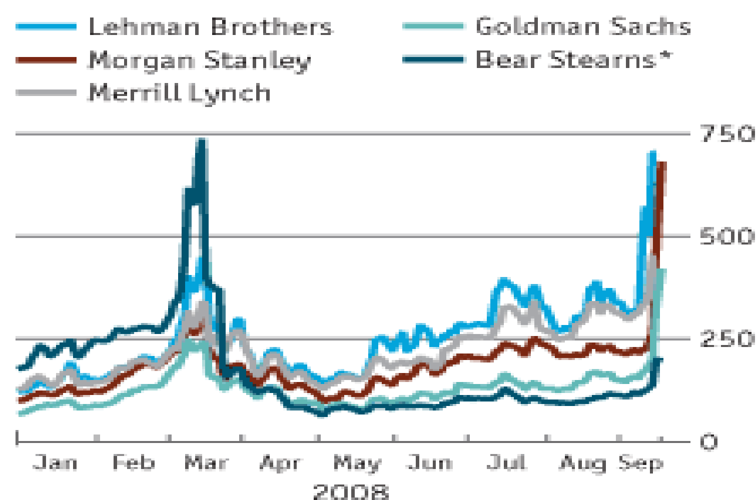
2008 marked also the end of independent investment bank era, universal bank status being one of the most desired; Citigroup, seen as one of the most hit by the financial crisis, presently enjoys the steadiness of the revenues generated by classic banking activity and the advantages of deposit financing. The pressure regulators put on universal banks has decreased due to the current market conditions; even though Glass-Steagall Act, which separate investment banks from commercial ones, was repealed in 1999, universal bank model is still regarded with suspicion in US. As of December 31, 2008, the top of US commercial bank taking into account the assets size was the following[ii]:

1. JPMorgan Chase - $2.1 billions
2. Citigroup – $1.9 billions
3. Bank of America – $1.8 billions
4. Wells Fargo – $1.3 billions

As you can see in the graph bellow[iii], credit default swaps spread (expressed in basis points) increased substantially in March 2008 (i.e. Bear Stearns default) and September 2008 (Lehman Brothers bankruptcy) evidence of investors' risk aversion and the tremendous influence investment banks activities had on financial markets.

Fig. no. 2

Credit default swaps spread evolution between January – September 2008



* starting April 2008 Bear Stearns is part of JPMorgan Chase

Goldman Sachs and Morgan Stanley decisions to become commercial banks allow them to have access to the credit facility, facility offered by Federal Reserve to commercial banks. There is an important difference between commercial and investment banks: while the first ones are regulated by Federal Reserve and Federal Deposit Insurance Company, the second ones are under less severe scrutiny and follow US Securities and Exchange Commission regulations. Among the measures Federal Reserve took on September 14, 2008, was the temporary suspension of the rules that put a cap on the amounts banks could lend to their affiliates. Even though investment banks affiliates could finance themselves, the rating of the group they were part of could influence the cost of the financing; following the same logic, any major loss will deter the balance sheet of its parent bank. Even so, the new structure of Wall Street sealed the repealing of the Glass-Steagall Act.

Officially, the Gramm-Leach-Bliley Act allowed commercial banks to merge with investment banks but in reality the consolidation wasn't that easy as believed because, at that time, many investment banks didn't wanted to be regulated by Federal Reserve. Following the 2008 financial turmoil, pressures from supervision authorities and political side began to become visible, so that banks to adopt the universal bank model considered safer.

During the Great Depression, one out of five American banks went bankrupt and the general public, along with politicians, considered that banks speculative activities were the cause for the crisis. In 1933, Senator Carter Glass and Congressman Henry Steagall passed the law that bears their name, trying. to limit the conflicts of interest created by commercial banks providing underwriting services to its costumers. At that time, a series of conflicts of interest were made public and, under the pressure of investors who were hurt the most, banks had to choose between investment banking status and the commercial one. This law gave Federal Reserve more regulatory powers on credit institutions and established Federal Insurance Deposit Company.

In 1956, the Banking Act was passed thus tightened the restrictions on banks and, starting 1960, banks begin lobbying US Congress to gain access on municipal bond market; in 1970, brokerage companies started offering banking services like: deposit accounts, checks and debit and credit cards.

Between 1984 and 1988, there were several attempts of US Congress to remove some of the restrictions imposed by the Glass Steagall Act, but didn't find House of Representatives support. In December 1986, Federal Reserve reinterpreted Glass Steagall Act's 20th Section (which banned commercial banks from being engaged in underwriting business), thus allowing them to have a maximum of 5% of their revenues generated by investment banking activities.

In spring 1987, Federal Reserve board voted in favor of loosen regulatory framework despite Paul Volker, its chairman, opposition which considered that, given the new circumstances, the market will be flooded with bad loans and low rated securities. The favorable vote came on the pressure put by Citicorp, JPMorgan and Bankers Trust's demand to engage in underwriting commercial paper, municipal bonds and mortgage-backed securities activities. In august 1987, Alan Greenspan, ex-director within JPMorgan, became Federal Reserve's chairman and indicated that he intended to raise commercial banks' investment banking activities threshold from 5% to 10%; this will take place in January 1898 and, in 1990, JPMorgan will become the first commercial bank to get involved in underwriting business. In December 1995, backed by Alan Greenspan, a fervent supporter of financial market deregulation, Federal Reserve raise the threshold to 25% and, in August 1997, it removed most of Glass Steagall Act's 20th Section restrictions (including the acquisition of/from foreign investment banks).

In April 1998, a $70 billions stock swap between Travelers (an insurance company which previously acquired Salomon Brothers, an investment bank) and Citicorp (Citibank parent) created the world's largest financial services company, in what was the biggest corporate merger in history. The merger had to comply with the outstanding regulations which were implemented precisely to prevent this type of company: a combination of insurance underwriting, securities underwriting, and commercial banking. The merger gave regulatory bodies three choices:

- end these restrictions;
- stop the deal;
- force the merged company give up the businesses that failed to comply with the law.

In May 1998, the Gramm–Leach–Bliley Act, which repealed the Glass Steagall Act, passed US Senate Committees and House of Representatives and, with the White House support, was turn into law on October 22nd 1999; thus, after 12 attempts within 25 years interval, the Glass Steagall Act was finally repealed, paying off years of sustained efforts and more than $300 millions spent on lobby[iv].

Consumer Education Foundation and Essential Information, two US non-profit associations, issued recently a report[v] indicating that American banks spend between 1998 and 2008 almost $5 billions in order to gain American government political support regarding a loosen regulatory framework; no less than 3.000 persons were involved in 2007 in the lobby process (this number includes only the official registered lobbyists).

Table no. 1
Amounts allocated for lobby by different categories of US financial institutions

Type of financial institution	Campaign contributions (mil. $)	Amounts spend for lobby (mil. $)
Investment banks	512	660
Commercial banks	155	383
Insurance companies	221	1002
Audit firms	81	122
Investment funds	56	33
Hedge funds	33	32
Total	1.058	2.232

The lobby process and the financial contributions had the following results:

- Removal of the barriers between investment and commercial banks by repealing the Glass-Steagall Act in 1999;
- US Securities and Exchange Commission loosen constraints regarding investment banks' leverage;
- Permission to book a series of assets outside balance sheet, thus allowing banks to hide a part of their debt;
- A more deregulate financial derivatives market;
- Abandon of anti-trust principles and regulations that allow mega banks to develop guided by "too big to fail" principle;
- Federal refuse to act against predatory and subprime lending.

Even though main US political parties, republican and democrat, shared this responsibility almost equally, it is important to mention that 142 lobbyist hired by top 20 financial institutions were previously "high ranking officials" (it worth mentioning also the case of Robert Rubin, ex-secretary of US Treasury who, after repealing the Glass-Steagall Act as part of the governmental body, became vice-president of Citigroup, the main beneficiary of this legal intercession).

In the bellow table, we can see the amounts allocated for lobby purposes by some of the most important US financial institutions (we can find here universal banks - Citigroup and JPMorgan Chase, commercial banks - Bank of America, investment banks - Merrill Lynch and Goldman Sachs, audit firms - Ernst & Young, Deloitte & Touche and KPMG).

Tabel no. 2
Amounts allocated by US financial institutions for lobby[vi]

Financial institution	Amount (mil. $)
Citigroup	108
Merrill Lynch	68
JPMorgan Chase	65
Pricewaterhouse Coopres	55
Goldman Sachs	46
Bank of America	39
Ernst & Young	37
Deloitte & Touche	32
KPMG	27

We can observe that Citigroup had from far the biggest contribution especially in the context of acquiring the status of universal bank in 1999. Following the merger with Travelers, Citigroup become a financial conglomerate, the first of this kind in US financial system history. At that time, taking into account that Glass-Steagall Act was still in place, this type of mergers weren't allowed and one of the conditions of its acceptance from regulatory bodies (i.e. Federal Reserve) was that, in the case the legislation remained unchanged for more than two years, the two financial institutions would separate in order to comply with existing regulations. This condition determined Citigroup to put intense efforts (with pressures on Federal Reserve, White House, US Senate and House of Representatives) to change the current legislation; the efforts paid off once Glass-Steagall Act was repealed on October 22, 1999.

CONCLUSIONS

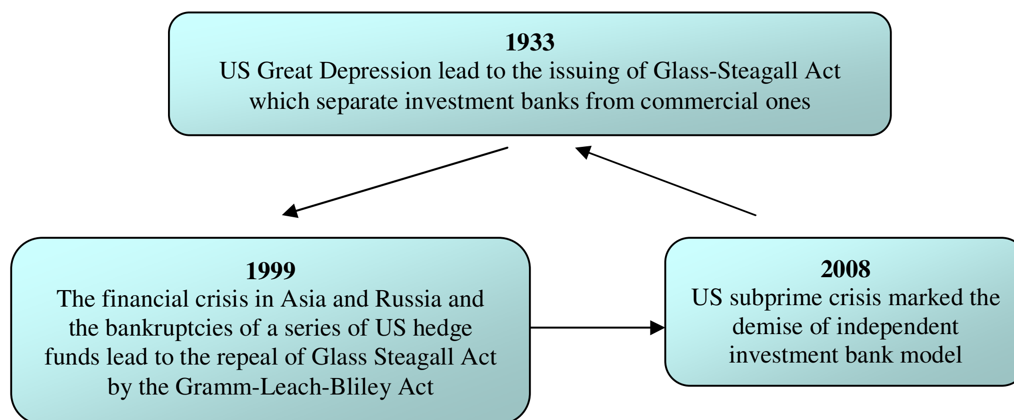
A pool made by the American magazine Time in 2009[vii], when the financial crisis was at its peak, regarding public perception of who's to blame for the recent negative evolution of the economy followed by a series of bankruptcies and government bailouts, the first place was granted to Phil Gramm, the president of the US Senate Banking Committee, fervent supporter of financial market deregulation. By passing, in 2000, with the support of

US Senate, a law regarding futures commodity contracts, he managed to have derivatives contracts traded without of strict supervision of Commodity Futures Trading Commission. This deregulation allowed investment banks to operate with much bigger leverage, which lead eventually to their demise; in the moment financial assets encountered a dramatic downfall, banks were put in the situation of not being able to bring additional collateral to compensate for the write-downs of their assets portfolio was facing.

Looking back in time at the evolution of investment banking field, it can be noticed a direct link between main changes that took place in investment banks' regulations and a series of capital markets' speculative bubbles:

Fig. 3

Evolution of US banking model[viii]



A problem of investment bank and of the financial system is that of the reward mechanism of the personnel involved. Compensational structure, if not set properly to avoid the potential conflicts of interest, can lead to loss in reputation and even firm's failure. At the end of 2008, in full financial crisis, John Thain, Merrill Lynch's CEO, decided to grant his employees annual bonuses of $4 billions (his own was around $10 millions) even though the company managed to lose only in Q4 2009 merely 15$ billions[ix]. Exploiting conflicts of interest lead throughout the time to a loss in reputation not just to Merrill Lynch, but to some important names if the field like Salomon Smith Barney and Credit Suisse First Boston and, generally, to investment banks' analysts.

We can notice that financial markets have the tendency to self regulate and there is evidence in this respect. Formal separation between the underwriting and depositary divisions was well perceived by the investors but their complete separation brings along side effects as Glass-Steagall Act did by completely separating investment from commercial banks. It proved in the end that complete separations reduces economies of scope, increase informational costs and, on a long run, has unwanted consequences. The investors can penalize investment banks by reducing the size of their business and the weight put on their investment advice; the regulatory bodies can impose drastic sanctions and tighten the guidelines which investment banks have to follow, but the market is the main driver of underwriting activity. The market "sets the rules for the game", expands an activity or shuts it down; the economic environment drives through cyclic turns which are followed closely by the financial sectors. Investment banking blooms when economy is at its peak and suffers the most when financial crisis hit.

Passing Glass-Steagall Act after the financial crash in 1930's is a solid evidence of an excessive answer to market problems, solution that made financial intermediation more expensive.

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