Lecture 1

DEFINITION: "invest" - invests/advise/trades servicing individuals, corporations and governments -

Chapter I – The Origins of Investment Banking

- Commercial Banking vs. Investment Banking
  - Retail banking / Taking Deposits
  - Issuing Securities / Distribution

- Italy (Venice) 14th c Renaissance Era – Invention of modern Banking
  - Medici Bank – Giovanni de' Medici – Fx Dealers (Bakers (Bancieri) - "Bills of Exchange" – at a discount

- France (Napoeleonic Era)-
  - **Merchant Banker (Modern Investmetn Banking)**, Deposits vs. Investments, offering credit to the clients (commercial bills)
  - Modern Investment Banking in France (Soc Gen, Credit Lyonnais)

- Germany
  - DB, Commerz Bank, Dresdner Bank, 1948 True Investment Banking, Transaction Banking Business of all kinds plus promote and facilitate trade relationships. Biggest customer- Siemens (industrial)

- U.S. – BANKING WAS CREATED TO SERVE THE NEEDS OF THE INDUSTRIAL REVOLUTION (RAILROAD, MINING)
  - 1863 National Banking Act, National Bank vs. Private Banking (Kidder Peabody Brokerage) Investments in Railroads, Insurance
  - New York Firms Specialize in Railroad Financing – Distributed Bonds and Pay Interest, Railroad Firms were highly leveraged
  - "Morganization" – the bank would take several steps to improve their financial position and assist the degree of control
  - JP Morgan – During the panic of 1893, President Cleveland appealed to Morgan for help. Morgan backed $62M of Gold

Advise Customers

Bond to support the U.S. Gold Standard and thus prevent a financial collapse of the U.S. Dollar
- Goldman Sachs – **Marcus Goldman** arrived from Germany in 1848 and founded Marcus Goldman & Co. – broker of "IOU's" in New York; 1882 it became Goldman Sachs
- Lehman Brothers – Co-underwriter of equity issues (IPO's). First IPO was Sears Roebuck, 1906 – a chain department store that was founded in 1893. **Henry Lehman**, an immigrant from Germany opens a small shop (commodity business) in Montgomery, Alabama in 1844. The stock market crash in 1929 placed tremendous pressure on the availability of capital. Lehman innovated financial techniques through private placements.
- Lazard Freres – started in a dry goods business in New Orleans, 1948 and moved to San Francisco for the Gold Rush
- Merrill Lynch – Charles Merrill 1914 established a brokerage firm and investment house and purchased control of Safeway Grocery stores in 1926 – a bad timing before the depression of 1929. **<u>His idea was to sell securities to average Americans</u>**. He would lend money to them to purchase the stock which today is considered a conflict.
- October 24, 1929 – Black Thursday run on the banks.
- 1930-1933 – 10,000 banks failed – which affected a lot of loans in Europe and impacted Germany specifically – that was the beginning of Hitler taking office in 1933 that nationalized all the banks in Germany
- Consequences of the Crash. President Roosevelt introduced three important acts:
    - The Securities Act of 1933 (Primary market)
    - Banking Act of 1933 (Glass-Stiegel Act)
    - Securities & Exchange Act (Securitization)

Surging demand for capital

Lance Davis has demonstrated that the process of capital formation in the nineteenth century was markedly different between the British capital market and the American capital market. British industrialists were readily able to satisfy their need for capital by tapping a vast source of international capital through British banks such as Westminster's, Lloyds and Barclays. In contrast, the dramatic growth of the United States created capital requirements that far outstripped the limited capital resources of American banks. Investment banking in the United States emerged to serve the expansion of railroads, mining companies, and heavy industry. Unlike commercial banks, investment banks were not authorized to issue notes or accept deposits. Instead, they served as brokers or intermediaries, bringing together investors with capital and the firms that needed that capital

MILESTONE #1 DEPRESSION CHANGE BANKING

- **Banking Act of 1933** (Glass Steagall Act of 1933)
    - Forced the banks to choose between commercial banks & investment banks. JP Morgan chose commercial banks. People from JP Morgan left the firm to form Morgan Stanley and called themselves investment banks.
    - Banks cannot lend more than 15% of the capital to single borrowers (Japan 30% and Germany is 50%)

- **Securities Act of 1933**

  Congress enacted the Securities Act of 1933 in the aftermath of the stock market crash of 1929 and during the ensuing Great Depression.

  The 1933 Act was the first major federal legislation to regulate the offer and sale of securities. The primary purpose of this act is to require full and fair disclosure in connection with the sale of securities to the public (during the 1920's – fraud in the issuance of securities /purchase on margins as little as 5% down). The Act enforces what securities & types of transactions need to register (Exempted (Regs A,D,S,147) and Non-Exempt).

- **Securities Act of 1934**
    - Created the SEC – delegated authority to enforce federal laws
    - Required the registration of Broker/Dealer
    - Required the registration of all exchanges and all national securities associations
    - Required the registration of securities information process (SIP)
    - Control the extension of credit (Loan/Margin) on securities
    - Issuers of securities to file financial reports (10k, 10Q, 8K)
    - Rules on insider trading / trading activity, market manipulation (Reg M, Rule 101, 102, 103,104 (Stabilization), 105 (selling short constraints)

- **Trust Indenture Act of 1939**
  - Governs Corporate Debt Securities (Fixed Income market) including registration, trust indenture and trustee appointment,

- **The Bank Holding Act of 1956** any national bank association or any state bank, savings bank and trust bank. Bank means accepting deposits and making commercial loans.

- The interest differential is called Arbitrage. As the Arbitrage narrowed, the banks got into the fee based business. These banks were allowed to invest outside the U.S. to make money – that was a development of the Euro Dollar Market.

- Notable Dates
  - 1981 – Solomon Brothers sold itself to Phibro Company
  - 1981 – Dean Witter sold itself to Sears
  - 1984 – Lehman Brothers was bought by Shearson American Express
  - 1986 - Kidder Peabody acquired by GE
  - 1987 – Solomon Brothers merged with Smith Barney
  - 1994 – Lehman Brothers spun off from American Express
  - 1995 – Paine Webber acquired Kidder Peabody from GE

- Many state independent by relying on the equity markets
  - Bear Stearns – IPO 1985
  - Morgan Stanley – IPO 1986
  - Goldman Sachs – IPO 1999, 25% of the capital was provided by Sumitomo in 1986

**MILESTONE #2
CITI BUYING
TRAVELERS**

- **Banking Act has successfully eliminated competition for investment banks – 1999 the Gramm Leach and Bliley Act or the Financial Services Modernization (Citibank Relief Act)**

- Universal banks
  - 1998 – Merger of Travelers with Citibank
  - 2001 – JP Morgan with Chase Manhattan
  - 2003 – Wachovia with Prudential Finance

- European banks
  - 1997 – UBS merged with Warburg Pincus
  - 1998 – Credit Suisse merged with First Boston
  - 1999 – Deutsche Bank merged with Bankers Trust

**MILESTONE #3
Volcker Rule /
Dott-Frank**

***Volcker Rule / Dott-Frank (**2000 pages)*

2008 Financial Crisis

The 2007 credit crisis proved that the business model of the investment bank no longer worked without the regulation imposed on it by Glass-Steagall.

Formerly, the guidelines said that in order to take a company public, it had to be in business for a minimum of five years and it had to show profitability for three consecutive years. After deregulation, those standards were gone, but small investors did not grasp the full impact of the change.

Investment banks Bear Stearns, founded in 1923 and Lehman Brothers, over 100 years old, collapsed; Merrill Lynch was acquired by Bank of America, which remained in trouble, as didGoldman Sachs and Morgan Stanley. The ensuing financial crisis of 2008 saw Goldman Sachs and Morgan Stanley "abandon their status as investment banks" by converting themselves into "traditional bank holding companies", thereby making themselves eligible to receive billions of dollars each in emergency taxpayer-funded assistance. By making this change, referred to as a technicality, banks would be more tightly regulated. Initially, banks received part of a $700 billion Troubled Asset Relief Program (TARP) intended to stabilize the economy and thaw the frozen credit markets. Eventually, taxpayer assistance to banks reached nearly $13 trillion dollars, most without much scrutiny, lending did not increase and credit markets remained frozen.

Chapter 2 – History of Key Products

- T-Bills (Money Market)
  - Short-term securities issued by the U.S. Treasury to finance the national debt
  - Issued at a Discount to FV – i.e – pay $960 for $1,000 at expiration - $40 or 4.0% if one year

- *Church influence – paying interest was a blasphemy – innovation for new products*

- Repurchase Agreement (Money Market)
  - Sale and buyback – lent without interest charges - Histroy: sell goods and buy back these goods for a higher price (farmer - a flock of sheep)
  - Today – a person sells securities for a price and buys back at a higher price
  - *Another church influence – paying interest was a blasphemy – innovation for new products*

- Mortgage-Backed Securities (Capital Market)
  - Loans secured by Real Estate properties
  - Mortgages became very important in the US to finance Private Homes
  - 1968 – U.S. Congress sponsored the GNMA (Government National Mortgage Assets – Providing liquidity – lenders move their mortgages off their balance sheet while retaining the service rights
  - Pool of mortgages (ABS: CDO, CMO, CLO)

- Bond Syndication (Capital Market)

- Options - insurance on merchandising – delivery in good shape – pay less (certain price) – avoid pirates, etc.

- Bonds/Notes (Capital Markets)– *"cash is King"*
  - <u>Invention of Bank Notes and Paper Money</u> replacing coins, issuing Promissory Notes to finance the English Floating Debt Exchange. Today, the 10lb Note says: "I promise to bearer of demand the sum of 10 pounds" and signed by the Chief Cashier
  - *Cash is the root from Casu, which means coins*

- The Corporation – Structure – Economic Growth – Issue Capital

- Stock Exchanges – Bank Notes – Commodities – Equity

Investment Banking

Definition: Investment Bank of Invest, Underwrite, Purchase, Sale or Brokerage of Securities from one account to another and Advise.

- Commercial Bank is an intermediary between customers who save money and customers who borrow money

- Investment Bank does the following **functions:**
  1. Advisory Services
     - Raising Capital / Underwriting (Dealer)
     - M&A
     - Financial advisors for corporations, government, individuals and institutions.
     - Research / Recommendations
  2. Trading Securities (Stock, Bonds, Derivatives)
     - Intermediary between sellers & buyers (Broker)
     - Buy/Sell from their own inventory (Dealer)
     - Market Maker

- Investments Bank act in three ways:
  1. **Services to clients**
     - Advise for solutions
     - Capital markets for insurers
     - Portfolio management for investors
     - Executing transactions for equities, bonds, currencies, options, futures
     - Research reports and information and mergers & acquisitions, valuations

  2. **Available products**
     - Client relationship management
       - Equity Issuance
       - Debt Issuance
       - Derivatives

  3. **Financial Role**
     - Trade on Account
     - Take risk
     - Hedge risk

Chapter 3 - **Organizational Structures**:

Front Office / Middle Office / Back Office or Banking services

FRONT OFFICE

1. Investment Banking Division (Help companies)
    - Regional
    - Industrial
    - By-Product Group

    - Financial Advisory
        - Mergers & Acquisitions
        - Restructuring

    - Underwriting (Capital Markets)
        - Public & Private Offering

2. Sales & Trading Divisions
        - Trading (buying and selling) in the capital markets (fixed income, currencies, commodities, equity)
        - Intermediaries between seller and buyers
    - FICC (Fixed Income, Currencies & Commodities)
        - Credit products (bank loans, other debt)
        - Mortgage Backed Securities or ABS
        - Interest Rate Products (derivatives)
        - Currencies (swaps)
        - Commodities (swaps)
    - Equity
        - Securities
        - Futures
    - Options

3. Research (Financial Analysis)

4. Asset Management & Security Services Division
    - Mutual Funds

  - Prime Brokerage Product Services (hedge funds)
  - Private Wealth Management / Private Client Services

5. Merchant banking (investments)

MIDDLE OFFICE

1. Risk Management
   - Market Risk
   - Credit Risk
   - Operating Risk (Patriot's Act, KYC)

2. Corporate Treasury
   - Funding
   - Liquidity Risk

3. Financial Control

4. Planning (portfolio management / trading ideas, asset allocations

BACK OFFICE

1. Operations
   - Data Check/ trade settlements

2. IT (Technology)
3. Compliance

- Revenue Mix – 5 Sources of Revenue
  1. Commission
     - Act as an intermediary between seller & buyer
  2. Trading Income
     - Make markets/primary & secondary
  3. Underwriting Fees
     - Underwrite security issues
  4. Interest on Loans

5. Other fees such as asset management, portfolio, management of funds and advisory fees

CLASSIFICATION

1. Bulge Bracket Firms (Large Caps and Mid caps – MS, GS, Merrill)
2. Tier One
3. Regional Broker (Raymond James)
4. Boutiques (Lazard)

Commercial banks (JPM own Bear Stearns, CS owns BT)