

INVESTMENT BANKING- CERTAIN MYTHS AND REALITIES

The origin of investment banks can be traced back to the middle ages when the Jewish traders performed both underwriting and finance functions. These traders could meet the financial requirements of farmers against the future crops at a time when the Christians were forbidden from the sin of usury by the Church. The transactions initially started in commodities slowly spread into financing activities. These merchants, due to the reputation enjoyed by them locally, could assist the overseas merchants to raise funds from the domestic market. Later on the investment banks emerged to undertake the functions of raising finance, underwriting, buying and selling securities in the capital and securities market, offering advisory services for mergers and acquisitions etc. They also dealt with pension funds, mutual funds, hedge funds. Their expertise in the area of investments enabled them to offer high returns which attracted large number of investors to these institutions. Wall Street became the major breeding ground for many of the big brothers in investment banking such as Lehman Brothers, Merrill Lynch, Goldman Sachs, Morgan Stanley, J.P. Morgan etc. which could later on, even play with the US economy.

The attractiveness of the venture brought other countries also to the folds of investment banking. Consequently investment banks like Barings Bank London started and played in the capital market. The investment banks perform through their front office consisting of investment banking which assists the customers to raise funds from capital market, advise on mergers and acquisitions, structures corporate finance etc., investment management like management of investments in shares, debentures, bonds etc., selling and trading of financial products, structuring of derivative products, merchant banking, equity and investment related research and formulating strategies for their clients. The middle office deals with risk management, finance and compliance. The back office is responsible for operations and technology developments. As time passed the investment banks grew vertically and horizontally conquering the whole global financial markets.

The investment bankers were instrumental in developing the economy of many of the third world countries by bringing substantial foreign direct investments. Their presence in Asian market was substantial. They operated through private equities and hedge funds and brought foreign capital to the domestic soil at a mutually advantageous price. India also was a beneficiary to this deal. Our capital market grew to the present size thanks to the continuous flow of foreign institutional investments. Many of our industrial and business units could turn to multinational and transnational status on account of the FDI flow to these sectors facilitated by the investment banks. Now the question is what is wrong with them?

Every thing would have been smooth unless they were greedy. The investment banks were taking risk beyond their capacity in order to ensure higher return to the investors and attract more funds. They hired people from their competitors and top business schools by offering fat salaries, without much thinking about their contributions. The benefits were shared by everyone from the top to bottom. The pleasure of enjoyment lasted only short. Everything came to an end when at last the bubble burst out. They did not think that any balloon will burst if you pump air beyond its capacity.

If we look at the stories of failures there are many. 200 year old Barings failed because of the rogue trader Nick Leeson. Amaranth Hedge Fund failed due to the over exposure created by its trader Brian Hunter. Now the chain of investment bankers like Lehman Brothers, Merrill Lynch, Goldman Sachs, Morgan Stanley and so on, since we do not know whether the fall of the card castle is complete or not. The top management, of course, should be blamed. But can we absolve the middle managers who were drawing fat salaries, spending expensive vacations at company cost, enjoying cozy flats and chauffeur driven BMWs and Mercedes. Were they sleeping behind the beer bottles when the fall started? Or were they enjoying their holidays in expensive resorts? Did they do justice to the salary and benefit they earned from the company? What were their commitment to the investors who paid their fat salaries and other benefits? What is the responsibility of the business schools which trained them in this way?

If we look at the history of these investment bankers we can find that they were taking disproportionate risk in derivatives. Take for example; Amaranth Hedge Fund had substantial exposures in energy futures. The Lehman Brothers had taken high exposures in credit derivatives. Thus if we analyse the role of each of these merchant bankers in the current crisis, we can find that the overexposure was the root cause for the failure for which we have to squarely blame the dealers for their wrong trading strategies and the top brasses for their supervisory failures. SEC is also responsible for the present plight because they failed to ensure the desired level of financial supervision. The impact on Indian banking and financial institutions was less solely thanks to the efficient supervisory and regulatory system practiced in the financial sector by our regulators like RBI and SEBI. We have to appreciate these agencies for not surrendering to the pressures from various quarters for diluting the rules and regulations.

Now US has ultimately realized their folly and decided to stop the era of investment banking. We have to wait and see whether this is a wise decision. Till now the losers were only large investors like corporates, governments and high net worth individuals. Now these institutions are entering the retail market. The retail investors may have to swallow their financial blunders if they continue with the same practices. Let's hope that SEC will pull up their sleeves to ensure that the history does not repeat in the retail market.