INVESTMENT BANKS AND THEIR ROLE IN THE FINANCIAL CRISIS

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Abstract

In this paper we pointed out the general elements relating to investment banks: the definition of these institutions, their customers, the structure and their functions. The purpose of this article is to explore the role of investment banks in the development of the financial crisis. We focus on the activities during the crisis. Those activities contributed to the economic collapse that came full-blown the following year. Finally we made a short presentation of the investment bank Morgan Stanley, the bank that was considered "the best investment bank" at the end of the crisis period (2011).

Key word: *investment banks, financial crisis, Morgan Stanley investment bank*

JEL codes: *C20, G21*

1. INTRODUCTION

Investment banks are "banks that are operating on their own account or are intermediaries for their clients, managing federal securities or public collectivities" (Bogdan Capraru, 2011). In the literature we often met the definition of investment bank that operate to increase the customers' capital by borrowing and providing capital. Therefore, we could say that the investment bank is like a dealer who trades in his own name, or acts as an intermediary between companies that need capital and individual and institutional investors. But unlike brokers, investment banks operate especially with corporations.

The customers of investment banks are companies (mainly listed) and governments, but also we can found non-profit institutions and individuals helped by investment banks to increase their funds in the capital market.

Investment banks have four main departments whatever is their size and their geographical area:

• Investment Department, which provides the following activities: finance, mergers and acquisitions, consulting and management.

• Actions Department, which provides the following activities: trading, research analysis, union shares.

• Fixed Income Instruments Department, which manages the following instruments and activities: derivatives, trading, research, union bond;

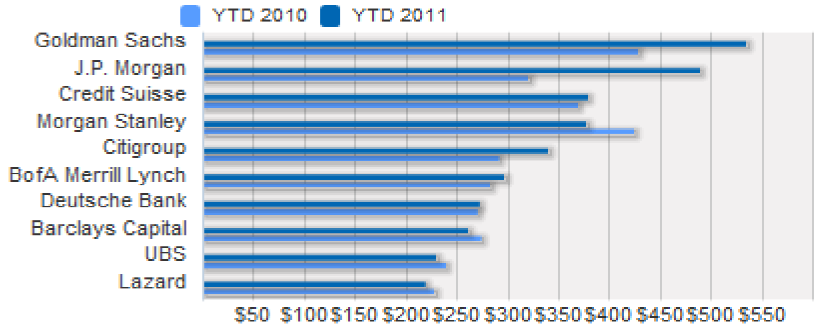
• Financial Management Department, which manages the following activities: risk managemnt, settlement and processing, accounting and legal control. "(Bogdan Capraru, 2011).

Investment banks basically have two functions: to provide financial advice and to increase capital. (Joshua Abor, 2003). The most financial advices provided by investment banks refers to mergers and acquisitions. A company wants to expand their business through the acquisition of another company. Why acquisition of another company? There are many reasons (commercial or financial) to do this. Among commercial reasons we could mention: increase rank products, increasing geographic expansion, complementing existing products, vertical integration (acquisition of suppliers, or customers), protection of a position. There are many financial reasons, such as increasing profitability, increasing size and financial growth, improving the quality of profits, business orientation to much more favorable areas.

The role of the investment banks in these transactions are: identifying potential clients to achieve commercial criteria, coordinating the work of other consultants involved in the implementation of the tranzactions - lawyers, who will prepare the documentation for the purchase, accountants who come with advices regarding financial reports, brokers who will advise shareholders about-the market response and the impact of the transaction in the media ". (Joshua Abor, 2003).

The most important acquisitions made during the financial crisis (2011) by investment banks were: Inc. acquired the company AT & T-Mobile USA Inc. ($ 39,000 million), Express Scripts Inc. acquired Medco Health Solutions Inc. (33 997 mil. $), and Duke Energy Corp acquired Progress enery Inc. ($ 25,814.7 million).

Figure1. **Top investment banks in mergers and acquisitions**

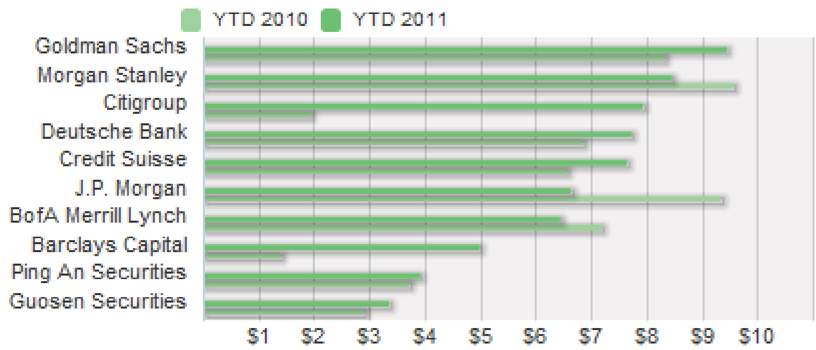


Source: http://graphicsweb.wsj.com/documents/INVESTMENT/InvestmentBankQuarterly_1007.html

If a company needs resources often resort to external sources. Attracting external sources can be either in the form of capital- when the company issuing shares / bonds or debt when calling from banks or directly from investors (eg pension funds or individual). There are several ways in which the capital may be increased: 1) providing rights: which covers the rights to buy a proportional number of additional securities at a given price within a fixed period to existing shareholders of a company. These rights are transferable, allowing owners to sell them on the open market; 2)public issuance of securities- thereby investment bank buys new securities and then resell them to investors. To launch and sell the securities to the market, investment banks go through three stages: a)the preparation of the issue/the origination, at this stage investment bank can make advises on the type of funding required (stocks, bonds), the amount required, the characteristic securities (maturity, coupon rate, amortization fund, etc.) the date on which the sale will be made, b) guaranteeing the issue of securities/ underwriting, at this stage investment bank is obliged to buy securities at a specified price, c) sales and distribution as soon as possible to earn profits from price difference; 3) private placement- this is a way in which the issuer sells securities directly to final investor. Investment banks only make the link between the seller and the purchaser in order to determine the correct price of the securities and to achieve implementation, 4) plan purchase of employees-this is a way in which employees may buy shares from their company at a discount price.

Investment banks that have made the greatest initial public offering during the financial crisis are (2011): Goldman Sachs and JP Morgan and Citigroup ..

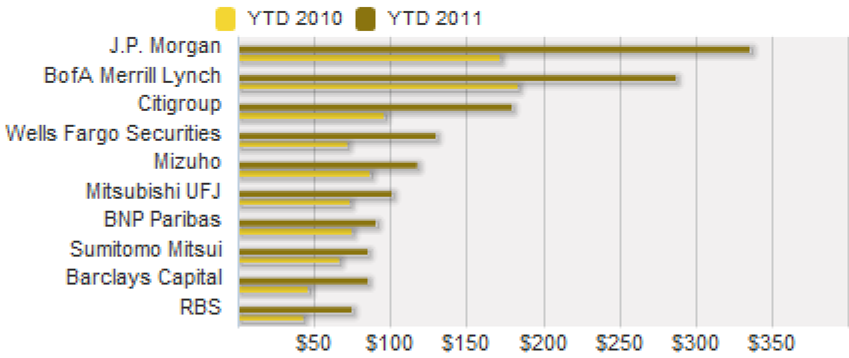
Figure 2. **Top investment banks which have completed initial public offering**



Source: http://graphicsweb.wsj.com/documents/INVESTMENT/InvestmentBankQuarterly_1007.html

Investment banks may grant loans and financing to their clients for mergers and acquisitions, refinancing or other purposes. (see: http://www.investopedia.com/university/banking-system/banking-system11.asp#axzz1ePpTfZin). The gratest loans granted by investment banks in 2011 were to: AT & T Inc. in order to make a purchase (20 $ 000mil), and to Cades company ($ 16,496 million).

Figure 3**. Top investment banks in terms of lending**



Source: http://graphicsweb.wsj.com/documents/INVESTMENT/InvestmentBankQuarterly_1007.html

2. THE ROLE OF THE INVESTMENT BANK IN THE CURRENT CRISIS.

The current economic and financial crisis began in the US in 2007 but soon grew and expanded globally. Initially manifested as a real estate crisis (2007), but then expanded and included the public sector taking the form of a public debt crisis (2010), and today we are facing with a monetary crisis - that some experts call "The Third World War" and which is supposed to last until this year (2015) (Larisa M. Bătrâncea Bătrâncea and John, 2011).

The crisis that began in 2007 showed that the rules laid down in the Glass-Steagal are not sufficient for healthy functioning of investment banks, as evidenced by the instability of the sphere, the collapse of such institutions such as Lehman Brothers and Bears Stearn. Below we present the role of investment banks in the current financial crisis.

In 2001, due to the terrorist attacks of September 11, the FED decided to decrease the reference rate to encourage lending and economic growth. That action encourage lending or granting loans to population but also discourage the formation of deposits due to the fact that the interest rates were low. Therefore, many US investors who had money have chosen to kept them instead of submitting to the bank.

As can be seen in the figure below (figure 1) the American family who wanted a mortgage call a broker who further connects to the mortgagee. Following the transaction, the broker received a fee. The basic principle on which the American family were granted materialized in "job-house-loan" in which the loan guarantee is actually the building. Big mistake comes from the time when such loans are granted to less responsible persons who were unable to pay off the debts taken from the banks, by this we refer to what Americans call "sub-prime mortgages". Subprime sector comprises those debtors who have difficulty in repaying bank loans. The chain continues with the commercial banks which sell that mortgages to investment banks. Therefore, the investment banks lends money and buy many mortgages that puts them in a package, or in other words the investment banks now owns mortgage customers.

Mortgages held by investment banks are called CDO (Collaterallized Debt Obligation) and are classified according to their risk by a rating agency. This classification is correlated with the ability of borrowers or Americans to pay their mortgages. Safe CDOs have the lowest interest rate since the risk is lower and risky CDOs have the highest interest since the risk is greatest. So investors who will buy safe CDOs will get the lowest interest rate,but this interest is greater than the ammount of money received if they had deposits at commercial banks.

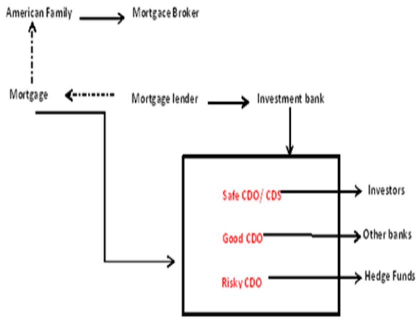
The problems arise when FED decide to increase default rate which determine an increase of lending rate. So many of American citizens have not been able to pay their debt to the bank, the latter remaining with the property. A singular event would not have been a problem but millions of cases determine a housing/real estate crisis that brought down the price of real estate sector. So investment banks found themselves in a position where they had no claims that materialized in payments made by customers, the investment banks held buildings in their physical form. Also in this critical situation created investors no longer invest invest in CMOs because they also were paid with the warranty wich result in physical property/the building.

Based on these CDOs were carried out so-called CDS (credit default swaps). CDS is a derivative contract in which the buyer (in this case investors) makes periodic payments to the seller (in this case the investment bank) and in return receive a certain amount if the loan is not repaid. (http://www.conso.ro/glosar-domenii/29/credit-default-swap-(cds)/credit-default-swap-(cds)/332/1).

CDS is similar with an inssuarance because it gives protection to the buyer of swap against the risk of default, downgrade or other adverse events affecting the issuer (Cristina Ciumaş, Diana-Maria Chiş, Ramona Alexandrina Coca ,2014). The seller assumes the credit risk of the contract in exchange for periodic payments like an insurance premium (spread) and is required to pay the compensation only if there is a negative event. If the adverse event happens, the seller is either settle the obligation by delivering cash value of the bonds. If there is any event affecting the credit quality of the issuer, the swap seller receives periodic payments from the buyer and also his profit.

In the current financial crisis these CDSs were at the core of the problem because the investment banks were in default of such derivatives sold to investors. As an example we mention New Century Financial company and Lehman Brothers which were in default and then it bankrupt.

Figure 4. **The role of the investment banks in the current financial crisis.**



Source: authors' calculation

This mechanism is very interesting especially from the perspective in which investment banks make profits. Suppose that the bank has a capital investment of $ 10,000 and borrow from the interbank market $ 990,000. So with the total amount of money it has ($ 1 million) buys mortgages from commercial banks. These mortgages are available in a package and based on their issue CDO. These derivative securities are sold to investors with $ 1.1 million. The investment bank must pay the loan on the interbank market $ 990,000 plus interest of say $ 10,000. So the profit remaining to investment bank is $ 90,000. In this case we can talk about the leverage for investment bank. This indicator measures the investment bank's ability to invest capital at a higher rate loan interest rate.

There is a positive relationship between bank's total assets and leverage leading which determine therefore procyclical leverage (Tobias A. and Hyun Shin, 2008). Generally there is a negative effect between total active and leverage, if you increase the net worth of the household the leverage is falling down. The appearance of procyclical leverage happens when debt grow up and capital remains constant.

If the bank wouldn't borrow the loan, then the investment bank with an equity of $ 10,000 which buys mortgages for $ 10,000 and it would sell them at $ 11,000 would realize a profit of only $ 1,000.

According to the annual study "World Best Investment Banks 2011" conducted by Gordon Platt most important investment banks today are:

- Best Investment Bank: Morgan Stanley
- Best Equity Bank,-Morgan Stanley
- Best Debt -Barclays Capital Bank
- Best M & A Bank- Morgan Stanley
- Best Up-and-Comer-Qinvest
- Most Creative, Bank of America Merrill Lynch

Selection criteria include market share, customer advice, ability to organize the business, distribution, market reputation.

3.MORGAN STANLEY.

After the Glass-Steagall act settlement from 1933 when were separated commercial banks from underwriting securities, Henry S. MORHAN (son Kack Morgan), Harold Stanley and others have transformed what was then JPMorgan Morgan Stanley & CO. Therefore, Morgan Stanley investment bank was founded on September 16, 1935. The Bank started with an offer of bonds worth of $ 19 million. After a year of existence it already have a market share of 24%.

Currently, Morgan Stanley is one of the largest investment banks in the world. This institution is headquartered in New York and is present in over 40 countries on six continents.Morgan Stanley is a global financial institution that provides products and services to corporations, governments, financial institutions and individuals.

Investment bank services offered are: 1) mergers and acquisitions.- this department realize domestic and international transactions, acquisitions, mergers, corporate restructurings, recapitalizations, exchange offer, raising equity, etc, 2) global capital market-in this respect the bank try to met customers needs and increase the necessary funds, and 3) securitization products.- this department involved in securitization of products provides a variety of activities such as: underwriting and backed securities. Additionally, it provides advices on the securitization of financial derivatives. (See more http://www.morganstanley.com/institutional/invest_bank/corporate_advisory.html)

During the crisis, Morgan Stanley has received financial support from the government and also received support from the Japanese bank Mitsubishi Financial Group USJ. In 2008 the Bank recorded losses for the first time in 74 years. But in 2010 , the level of risk decrease and profitability increase.

The investment bank achieved annual net income: - $ 12,880,000 in 2008 to $ 13,460,000 in 2009 and $ 46,840,000 in 2010. The share of capital in total liabilities was: 7.2% in 2008, 6.05% in 2009 and 7.08% in 2010. In 2010, net profit per share of the investment bank is $ 1.69, and ROE was 5.45%.

4.CONCLUSIONS

Our purpose is to explore the role of investment banks in the development of the financial crisis. We focus on the activities during the crisis. Those activities contributed to the economic collapse that came full-blown the following year.

Morgan Stanley and other investment banks play an important role in our economy. We analyze Morgan Stanley because is one of the oldest and most successful firms on Wall Street. These institutions help channel the nation's wealth into productive activities that create jobs and make economic growth possible, bringing together investors and businesses and helping Americans save for retirement or a child's education.

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