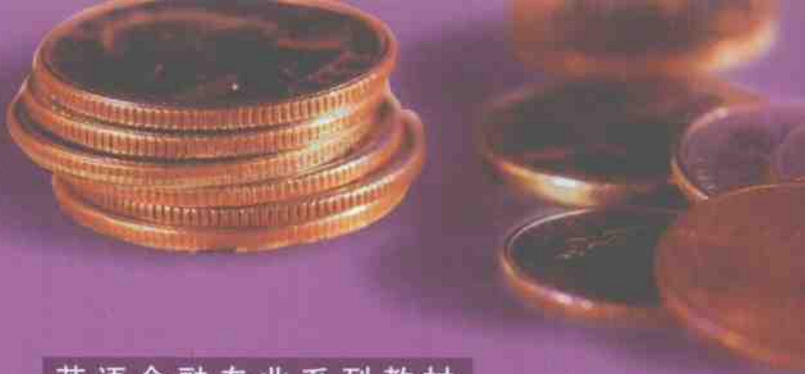

英语金融专业系列教材

投资银行学

INVESTMENT BANKING

刘　克
王新红　　编著
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Chapter *1*

Introduction

Virtually all students who take an investment banking course are required to have had at least one investment course. You may wonder, then, why you need to study investments again. In investments, you have studied the relationship between financial markets and investors; and how to use financial capital in an effort to create more money. This book will merge the financial theory you have learned from investments with financial practices. This book embarks on an interesting journey —a journey into the complex and exciting world of the modern investment bankers, a place where financial theory and financial practice merge as nowhere else.

Our job here is to be scientific and analytical. We will examine the *what*, the *why*, and the *how* of this dynamic industry. This book is a product of extensive study of the industry—both from the perspective of academicians and from the perspective of experienced practitioners.

At the macroscopic level, investment banking is concerned with the allocation of financial resources. That is, it is concerned with how and why money is moved from those who have it (investors) to those who need it (issuers). Thus, the role of investment banking is one of intermediation in resource allocation. If the allocation is efficient, then resources are allocated to their best use. If the allocation is inefficient, then the use of resources is not optimized. Since the efficiency of resource allocation affects all of us, investment banking is important to more than just investment bankers and those who use the services of investment bankers.

This macroscopic view of investment banking is, of course, too general to be more than theoretical interest. To make investment banking concrete, we need to give our definition flesh and bone: that is, we need to make it real. This, then, is our first goal: to define investment banking.

1.1 What Is Investment Banking?

Ever since the passage of the Glass-Steagall Act[①], investment banking has been narrowly defined as those financial services associated with the issuance, also called flotation, of new (government and corporate) securities. Such securities are issued for the purpose of providing financing for the issuing institutions. This is another way of saying that investment banking is the act of making the primary market for securities. The primary market for securities is the market in which the securities are first issued. At an only slightly broader level, investment banking is also understood to include secondary market making by brokers and dealers in securities. The secondary market is the market in which previously issued securities are traded by investors.

Many people, including many in the securities industry, still cling to these traditional definitions. But the truth is that investment banking has been radically transformed over the past several decades. For many investment banks, primary and secondary market making no longer constitute their principal revenue sources. As a matter of fact, many important revenue-generating activities of today did not even exist as recently as 15 years ago.

What, then, is investment banking? The most inclusive answer is that *investment banking is what investment banks do.* This definition is both pragmatic and fluid—in the sense that it continuously adapts to a changing environment.

Our definition will also serve as a useful device for organizing our examination of investment banking by focusing on investment banks' functional areas.

1.2 Investment Banking Activities

An investment bank is a financial institution that helps corporations raise funds. The scope

① Glass-Steagall Act of 1933: legislation passed by the U. S. Congress authorizing deposit insurance and prohibiting commercial banks from owning full-service brokerage firms. Under this Act, commercial banks were prohibited from investment banking activities.

of investment banking operations has increased to include all major capital market activities, such as underwriting, private placement, mergers and acquisitions, venture capital, market making, proprietary trading, financial engineering[2], clearing and settlement, and financing and money management. When a corporation wants to borrow or raise funds, it may decide to issue long-term debt or equity instruments. It then usually hires an investment bank to facilitate the issuance and subsequent sale of the securities. The securities business has also been consolidating. The business of investment banking is intensely competitive and is trending toward one-stop shopping and globalization.

In the previous section, we made a definition for investment banking, that is, investment banking is what investment banks do. Now, what do investment banks do? This section is an overview of the major practices of investment banking.

Investment Banking Activities

Investment banking activities include both revenue generating and support activities.

The revenue-generating areas include:

- primary market making
- secondary market making and trading
- venture capital investments
- mergers and acquisitions
- investment fund management
- financial engineering
- advisory and consulting services

The supporting areas include:

- clearing services
- research
- internal finance
- information services

Each of these functional areas can be subdivided further. For example, primary market making includes corporate finance, municipal finance, and Treasury and agency finance. And these subdivisions can themselves be further divided. For example, corporate finance includes public offerings, private placements, and commercial paper

② financial engineering: development and creative application of financial technology to solve financial problems, exploit financial opportunities, and otherwise add value.

dealing. These activities would be scrutinized and studied in later chapters. Another way to find out what the major activities of investment banks are is to look at their sources of income.

Sources of Income

Despite its name, an investment bank is not a bank in the ordinary sense; that is, it is not a financial intermediary that takes in deposits and then lends them out. Most of investment banks get their net revenues from a variety of sources. Investment banks no longer engage in investment banking operations alone; they have ventured into other areas of financial services to meet clients' demands for one-stop shopping.

As global capital markets have become more integrated, some of the well-known investment banking firms such as Morgan Stanley, Merrill Lynch, and Goldman Sachs have moved to establish a local presence in major financial markets around the world and to enhance their presence with broad cross-border capabilities. Over time, the profitability of the securities business increased, and the practice of investment banking expanded.

Principal transactions (trading and investment), commissions, asset management, and advisory fees are the main contributors to investment bank net revenues.

Table 1.1 How the investment banks earn their money—revenue composition of the big three (as percent of net revenue)

	Goldman Sachs	Merrill Lynch	Morgan Stanley
Commissions	13.9	26.0	13.9
Equity trading	20.8	14.0	17.8
Debt trading	11.9	6.0	9.9
Net interest	5.9	16.0	5.9
Private equity	1.0		1.0
Financial advisory	15.8	5.0	7.9
Equity underwriting	12.9	6.0	6.9
Debt underwriting	4.0	2.0	4.0
Asset management	7.9	21.0	15.8
MWD credit card	5.9	4.0	2.0
Other			14.9

Adapted from: *Euromoney*, Oct. 2001. p93.

1.3 Investment Banking versus Commercial Banking

A Global Perspective

Around the world, there are three basic frameworks for the banking and securities industries.

The first framework is universal banking, which exists in Germany, the Netherlands, and Switzerland. It provides no separation at all between the banking and securities industries. In a universal banking system, commercial banks provide a full range of banking, securities, and insurance services, all within a single legal entity. Banks are allowed to own sizable equity shares in commercial firms, and often they do.

The British-style universal banking system, the second framework, is found in the United Kingdom and countries with close ties to it, such as Canada and Australia. The British-style universal bank engages in securities underwriting, but it differs from the German-style universal bank in three ways: Separate legal subsidiaries are more common, bank equity holdings of commercial firms are less common, and combinations of banking and insurance firms are less common.

The third framework features legal separation of the banking and securities industries, as in the United States and Japan. A major difference between the U. S. and Japanese banking systems is that Japanese banks are allowed to hold substantial equity stakes in commercial firms, whereas American banks cannot. In addition, most American banks use a bank-holding-company structure, but bank holding companies[3] are illegal in Japan. Although the banking and securities industries are legally separated under the Glass-Steagall Act in the United States, in both countries commercial banks are increasingly being allowed to engage in securities activities and are thus becoming more like British-style universal banks.

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③ bank holding company: company that owns or controls two or more banks or other bank holding companies. As defined in the Bank Holding Company Act of 1956, such companies must register with the Federal Reserve System and hence are called registered bank holding companies. The Financial Services Modernization Act of 1999 liberated bank holding companies that qualify as financial holding companies to acquire or create as subsidiaries securities firms and insurance companies.

The United States

In the U. S., the Glass-Steagall Act separated commercial and investment banking functions from the 1930s to the 1990s. During this period, the major businesses for commercial banks were deposit taking and corporate lending; the major businesses for investment banks were securities underwriting and trading.

Just as the scope of investment banking has expanded dramatically over the past three decades, so too has the scope of commercial banking. The expansion of commercial banking is important in the study of investment banking because it is becoming increasingly difficult to distinguish between these two formerly distinct types of business. Commercial banks were prohibited from certain activities, including taking equity positions[4] in firms and underwriting corporate securities. The prohibition on underwriting securities was gradually relaxed, first for debt securities and then for equity securities. In 1999, the Glass-Steagall Act was finally repealed. There are a number of reasons for this.

First, by the late 1970s, risk management theory and practice had advanced to such a degree that it was becoming increasingly apparent that, at least for skilled institutions, the concerns leading to the passage of the securities legislation of the 1930s (the Glass-Steagall Act, in particular) might not be justified any longer. Recognizing this new environment, the prohibitions on securities underwriting by commercial banks were partially relaxed. At first, commercial banks, acting through limited securities subsidiaries, were permitted to underwrite municipal general obligation bonds[5]. Later the exemption was extended to industrial development bonds[6] and, still later, to some corporate issues. These measured relaxations of the law are widely viewed as the first steps in the phased reintroduction of commercial banks into the securities business.

Second, as new financial markets emerged, none of which were specifically addressed in earlier legislation, both investment banks and commercial banks became players. As such, they also became competitors. Without doubt, the clearest example of the

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④ position: an investor's stake in a particular security or market.

⑤ general obligation bond: municipal bond backed by the full faith and credit of a municipality. Also known as *GO bond*.

⑥ industrial development bond: a type of municipal revenue bond issued to finance fixed assets that are then leased to private firms whose payments amortize the debt. Also known as *IDB*.

emergence of a major new market is the introduction of over-the-counter⑦ derivative instruments⑧—principally swaps and other notional contracts. Today, the dominant players in the $5 trillion notional contract market count both investment banks and commercial banks among their number. The development of real estate operations and mortgage products by investment banks are other ways that Glass-Steagall has been gradually eroded.

Third, each subset of the financial services industry, both the investment and commercial banking communities, has discovered ways to undermine each other's areas of advantage. For example, for decades the commercial banking community had sole access to overnight sources of financing through the Fed funds market. The Fed funds market allows a bank to borrow another bank's excess reserves, held within the Federal Reserve System, on an overnight basis. The Fed funds market provides commercial banks with the ability to meet short-term liquidity needs easily and at very low cost. The investment banking community, on the other hand, had no access to this market and no counterpart of its own—so it created one. This took the form of a market in repurchase agreements⑨. Now, investment banks have access to a very liquid repo market and can use it for short-term financing at very low cost. The repo market can also be used to obtain securities for short sales.

Fourth, another force undermining the traditional distinctions between commercial and investment banking has been the emergence of banking on a global scale. Foreign competition for deposits, securities business, underwriting, loan making, and other banking services has increased sharply. Furthermore, many foreign governments do not place the constraints on their financial institutions that U. S. law places on American institutions. Consequently, both commercial banks and investment banks have been forced to focus on ways to become more full-service oriented in order to compete effectively.

The point of this review, which is not meant to be complete by any means, is to highlight the gradual erosion of the wall between commercial banking and investment banking. Thus, if investment banking is "what investment banks do," then the right way to study investment banking is to examine the things that investment banks do—the markets they make and the services they provide. But we cannot forget that commercial

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⑦ over the counter (OTC): securities that is not listed and traded on an organized exchange, or, market in which securities transactions are conducted through a telephone and computer network connecting dealers.

⑧ derivative instrument (or just derivative for short): a contract whose value is based on the performance of an underlying financial asset, index, or other investment.

⑨ repurchase agreement (REPO): agreement between a seller and a buyer, usually of U. S. government securities, whereby the seller agrees to repurchase the securities at an agreed-upon price and, usually, at a stated time.

banks do many of the same things. Thus, though they are not called investment banks, and though they are not classified as investment banks, by the definition of investment banking employed in this book, some commercial banks may, at least in part, be investment banks.

China's Banks

It will be a new experiment in China's financial industry, which is experiencing changes as the lines become blurred between investment banking and commercial banking.

China's banks, insurers and securities institutions are not allowed to deal in each other's core businesses at the moment. For example, deposits can only be made at banks. Insurers take care of insurance policies and only authorized securities firms can underwrite securities and do brokerage work. Still, some cross-border innovation has already started. The three businesses are doing a lot of agency services for each other—such as banks collecting fees for insurers and providing securities trading accounts. The progress is fastest with the insurers. China's securities, banking and insurance laws, adopted in the mid-1990s, listed some core businesses for each of the three sectors that were clearly separated and could not overlap. But the legal framework still leaves the three with a lot of room to develop in each other's territory. Anything that is not prohibited by the law is practicable. And the government should encourage such lawful innovation. Anyway, the three regulatory bodies for the three sectors would collaborate and communicate more closely.

1.4 Industry Overview

Investment banking is about gambling in a pinstripe suit. Most people think that it's about money, but the thrill for many players in this domain stems from the risks as much as from the rewards.

The investment banking industry is a very cyclical industry. During periods of economic growth, the demands for investment banking services and products increase, causing a tendency for the industry to overexpand. However, during periods of recession and downturns, the demands for investment banking services and products decrease, and the industry tends to contract and consolidate. Since the crash of 1987, this tendency to consolidate has taken its toll. Almost every major investment banking firm has undergone major reorganization, reshuffling, merger, and/or bankruptcy. As a result, the industry has become more concentrated into fewer hands, and the players have become more specialized.

The investment banking industry is perhaps best described as an *oligopoly*. That is, a relatively few firms dominate the industry.

Bulge Bracket, Major Bracket, Submajors and Regionals

The largest firms are often called the *bulge bracket*—a term which derives from the tendency of these firms' names to be printed larger and bolder on public offering announcements (called tombstones[10]) and on the front pages of prospectuses[11] than the names of other firms making up underwriting and distribution syndicates. The bulge bracket, also known as the *special bracket*, consists of about 10 firms. The actual number is somewhat arbitrary and depends on where one chooses to draw the line.

After the bulge bracket firms is the second tier of middle-sized firms, known as the *major bracket*, and then the third tier of small firms, called the *submajors* and *regionals*. Although *oligopolistic* in structure, the industry is nevertheless intensely competitive.

Full-Service Shops and Boutiques

Investment banks range from full-service shops to boutiques. *Full-service shops* provide the full range of investment banking services. *Boutiques*, on the other hand, specialize in just a few services. Boutiques are also sometimes called specialty shops.

It is important to appreciate that even full-service investment banks vary tremendously in their strengths and are anything but clones of one another. For example, some, such as Morgan Stanley and Goldman Sachs, are largely issuer driven; others, such as Bear, Stearns, are largely investor driven; still others, such as Salomon Brothers, are essentially trading organizations; and still others, such as Paine Webber, Merrill Lynch and Smith Barney, are primarily wirehouses.

Boutiques, which make no pretense of being full service, must maintain relationships with larger firms to be effective. For example, despite its size and prowess as a trading firm, Solomon Brothers lacks a good distribution network for the securities it underwrites. By employing boutiques which have effective distribution systems and strong investor contacts, Salomon Brothers can reach investors.

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⑩ tombstone: advertisement placed in newspapers by investment bankers in a public offering of securities.

⑪ prospectus: formal written offer to sell securities, containing financial information and a description of an issuer.

Wholesale and Wirehouses

Investment banks tend to be geared to either a retail business or an institutional business. As the terms imply, retail brokers provide services targeted to individuals. Firms with large retail brokerage businesses are called *wirehouses*[12]. Institutional brokerage firms provide services targeted to institutional investors[13] whose transactions tend to be large. Often, large transactions are described as *wholesale*.

Examples of retail brokerage firms include Merrill Lynch, Shearson Lehman, and Prudential Securities. Examples of institutional brokers include First Boston, Bear, Stearns, Goldman Sachs, and Morgan Stanley. For the clients they serve, all the firms mentioned above are full-service.

Partnership and Public Firm

The organizational structure of investment banks differs widely across firms within the industry. There is not any one "typical" organization, and what works for one firm may not work for another. Much of the organizational structure is often related to the internal politics and alliances within the firm.

At one time, the investment banking industry was a close-knit group of mostly privately owned partnerships. Now, of the major investment banking firms, only one partnership, Goldman Sachs, remains, and the other partnerships have either been purchased by conglomerates or gone public.

A *partnership* is a firm owned by two or more persons who share the profits of the firm. A partner is a part owner of the firm. All partnerships have at least one general partner who is responsible for the daily operations and functions of the business, and who is liable for the firm's operations. However, many partnerships also have limited partners whose commitment is limited to the financial side, who are not involved in the daily operations of the business, and who enjoy limited liability.

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⑫ wirehouse: wirehouse used to indicate a national or international brokerage firm whose branch offices are linked by a communications system that permits rapid dissemination of prices, information, and research relating to financial markets and individual securities.

⑬ institutional investor: an organization that trades large volumes of securities. Some examples are mutual funds, insurance companies, pension funds, labor union funds, and college endowment funds. Typically, upwards of 70% of the daily trading on the New York Stock Exchange is on behalf of institutional investors.