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INVESTMENT BANKING - A COMPREHENSIVE OVERVIEW

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ABSTRACT

Over the decades, investment banking has always fulfilled the requirements of the finance community and thus become one of the most energetic and thrilling part of financial services. Investment banking, as a segment of financial services sector has assumed greater significance, with the intensified financial market and the fast-paced flows of global trade and capital. Globally investment banking deals with both fund-based business of their own in the capital market and non-fund based service portfolio. Investment banking channel the country's wealth into fruitful activities that generate employment opportunities and improve the growth rate of economy, bringing together the users of money and providers of capital, and serving people to save for retirement or a child's education. Despite of its importance and need, most of the consumers often confused with the term investment banking, hence this article is designed to cover the basic concepts such as evaluation, meaning, services, merits and demerits, of investment banking, best ways to seek the service, criteria to be considered for selection, list and rating, performance, challenges current and future scenario of investment banking so as to facilitate better understanding of the concept.

KEYWORDS

FDI, retail, investment banking, reforms, Merger& Acquisition.

EVOLUTION OF INVESTMENT BANKING CONCEPT

In the words of John .F. Marshall and M.E. Eills , "Investment banking is what the investment banks do."The investment banking concept is originated in America. It has come up to fulfill the financial need of the civil war. To meet the financial need of civil war, the federal government in- trusted the task of raising funds from the public through the floatation of securities to the modern day father of investment banking, Jay Cooke and he distributed the securities throughout the US and Europe by means of salesman. Thereafter, during the last quarter of 19th century number of private investment banking houses emerged in US, notably JP Morgan and company in New York and N.W. Harris & Co in Chicago.etc. Meanwhile investment banking is termed as merchant banking in UK which had restricted them to capital market intermediation activities until, the US banks entered U.K and European countries. But later the scope of business is expanded and in the US the Glass-Steagall Act of 1933 prohibited the banks from rendering both commercial banking services and investment banking services. In 1999, Gramm –Leach-Bliley Act repealed the Glass-Steagall act. In India, the origin of investment banking can be traced back to 19th century. In 1967, ANZ Grind lays bank established merchant banking division separately to deal with the fresh capital issue matters. In 1972, the banking committee advised the commercial banks and financial institutions to establish merchant banking division and to undertake investment banking activities to overcome the monopolized services of foreign banks. State bank of India has established a separate bureau in 1972, and ICICI bank was the first bank which started to provide merchant banking service in 1972.

MEANING OF INVESTMENT BANKING

It is the traditional aspect of the investment banks which assists the government and corporate to augment funds from the capital market through underwriting arrangements and facilitate mergers and acquisition and divestitures matters. Generally, the investment banking activities are divided into industry coverage and product coverage groups. Industry coverage groups concentrate on a specific industry such as retail, oil, Financial Institution Group (FIG) or Technology, Media and Telecommunications (TMT). Product coverage groups focus on financial products, such as mergers and acquisitions, leveraged finance and equity. The product coverage activities are different from the commercial banking activities which accept deposits and lend loans and advances. But nowadays, the difference between these banks is distorted and commercial banks have also started to provide investment banking services. Further, although brokerage, broker – dealers and investment banking are often assumed to be similar; investment banking is different from these entities. Their line of business is classified into sell side and buys side. If, trading of securities is undertaken for cash or securities or promotion of securities then it is known as sell side whereas, buy side refers to dealing with mutual fund, pension fund, hedge funds.

CORE INVESTMENT BANKING ACTIVITIES/ SERVICES

Investment bank is divided in to front office, back office and middle office.

FRONT OFFICE

- **Investment Banking:** It lends a hand to customers for raising funds from the capital market and provides advisory services on merger and acquisition matters. This division is otherwise known as corporate finance. The investment banking division is generally classified into industry coverage groups and product coverage groups. Industry coverage groups concentrates on specific industry and secure business by keeping the relationship with the firms in the same industry, whereas, the product coverage groups concentrates on financial products such as, merger and acquisition , leasing , equity, debt etc.
- **Sales and Trading:** The most important function of investment banking is buying and selling of products on behalf of its clients. This is considered to be the revenue generating area. In case of sales, the sales force invite institutional and high net worth investors to propose trading ideas and take orders ,which will be executed by the concerned desk on the recommendation of sales desk.
- **RESEARCH:** This division reviews firms and makes report on the future aspects of the firm, with buy or sell ratings.

MIDDLE OFFICE

- **Risk management:** Risk management division is responsible for the task of analyzing and evaluating the risk of market and credit assumed by front office employees while conducting their daily trading . This is possible by setting the limit on the amount of money on hand for trading purpose. Further, middle office provides the assurance for addressing the risk.
- **Corporate treasury:** It involves the activities of observing liquidity risk, managing capital structure and funding investment banks.
- **Financial control:** This division provides valuable advice to the senior management on essential matters related to risk exposure, profitability etc. Further it helps in tracking and analyzing the capital flow of the firm.
- **Compliance:** This division is responsible for the compliance of government regulations by the firm.

BACK OFFICE

- **Operations:** It engages with the checking of data, ensuring the correctness of entry and transacting transfers which are demanded.
- **Technology:** It means information technology used for sales and trading, and for various purposes.

FUNCTIONS PERFORMED BY INVESTMENT BANKING

Investment banking extends multi-dimensional services such as raising capital, merger and acquisitions, sales and trading and general advisory services. Let's see in detail about the above mentioned services.

- **Raising capital:** Investment banks facilitate firms to augment funds through Initial Public Offering, private placement, underwriting etc., to attain the various objectives of the firm.
- **Mergers & Acquisitions:** Investment banking facilitates firms in buying or selling of a company, identifying and implementing merger. Further, it presents detailed analysis of the firm, valuation range, etc.
- **Sales and trading:** In this kind, investment banking offers service such as publishing research reports, issuing fresh shares, market making. Etc.,
- **General Advisory services:** In this category, investment banking extends its valuable advisory services on correctness of proposed action, capital restructuring, valuation of business, etc.,

MERITS AND DEMERITS OF INVESTMENT BANKING

MERITS

- ✓ In addition to the service it offers, investment banking through its good image can increase the value of the firm by creating competition over the firm, so as to create interest among the probable purchaser to buy the firm which intends to sell.
- ✓ Moreover good personal relationship can be established between the buyer and seller during the delegation.

DEMERITS

- ✓ Investors especially shareholders need to spend lot of money i.e. up to 2% of the sale, by means of commission to investment bankers.
- ✓ In case if any new company decides to utilize the services of investment banking in their project like, raising of capital etc, it needs to spend a huge money i.e., from 1% to 5% by means of commission to obtain their service. So, generally it is considered to be costly one.
- ✓ Investment banking used to represent the small companies to the big corporations with whom they maintain long lasting good relationship. But big corporations may not like this kind of involvement by investment banking.

Investment banks effectively extend their helping hand in the areas of financing sales, merger and acquisition activities of business firms. But the investment community often used to misinterpret their role and functions. Hence, to improve the benefits of investment banking, and to reduce the demerits, one or investment community should understand how to utilize their services in an effective manner. Here, the best ways to seek the service of investment banking are described below.

WAYS TO SEEK THE SERVICE

- Have a clear idea of the functions or services offered by the investment bankers from their menu list.
- Try to find out the necessity of the involvement of investment banking, since, if the business is small in size, the investment bank may refuse to take up the assignment as they always have desire to deal with big business concerns.
- Scrutinize the experience, success, of investment banking in handling similar kind of transactions, after deciding the services required from them.
- Select and finalize the kind of service required from investment banker and negotiate the terms and conditions, like the fees, time limit, duties to be done, contribution level etc.,
- Furnish all the required data to the investment banker to perform the assigned task productively. Never hide any data, and try to be honest.
- Immediately after settling all the things, try to implement the plans without any further delay, as it affect the plan.

WHAT TO LOOK FOR IN INVESTMENT BANKING

Most of the firms seek investment banking services such as analysis of industry and finance, documents preparation, preparing accounts, negotiation of transaction terms, and helping all the stages of their project which are considered to be very important, and any minor mistake in any of these will seriously affect the productivity of the plan. The execution of the plan in an effective manner and without committing any mistake is truly in the hands of the investment banks to which the task is entrusted. Hence, due care should be shown in selecting the investment bank. To get better served the client firms or individuals have to consider the factors such as active involvement of senior persons in the execution of project, experience of the firm in the exact industry, extensive network of links, the record of success, its ability to complete the work before the deadline, suitability of fee structure with the firm, etc., before selecting the investment bank. Let's have an idea about the popular investment banks in India.

INVESTMENT BANKS IN INDIA

Investment banking industry has seen lot of change all over the world during the last three decades and it is considered to be a booming industry in India. It has started to attract the attention of firms by executing the task successfully. Commercial banks have started to realize the need to establish a separate division for providing investment banking service to attract and fulfill the needs of their clients and formed. A few popular banks which are offering investment banking service in India are listed below.

- ✓ JP Morgan (Mumbai & Bangalore)
- ✓ UBS(Hyderabad & Mumbai)
- ✓ Goldman Sach(Bangalore)
- ✓ Lehman Bros
- ✓ ANZ
- ✓ ABN
- ✓ Morgan Stanley (Mumbai)
- ✓ Citigroup (Not in India)
- ✓ BNP Paribas(Not in india)
- ✓ Deutsche Bank (delhi, Bangalore , bom)
- ✓ HSBC (Blr)
- ✓ Merrill Lynch
- ✓ Enam
- ✓ Kotak Mahindra
- ✓ SBI Capital Markets
- ✓ Ambit Corp Finance
- ✓ IICI Securities

RANKING OF INVESTMENT BANKS

The customers of investment banking needs to identify the best bank for entrusting their task such as raising capital, asset and wealth management and helping to carry out the merger and acquisition function to attain productive results, without committing any mistake. But it becomes decisive for any budding customer of any service industry to obtain an unbiased 'true and fair' independent judgment of the investment bank's ability to serve and satisfy the demands of investors. Thus, the credit rating agencies provides rate and rank of investment banks which are evaluated on the basis of various parameters such as market penetration of the bank, customer satisfaction, association and workforce. In this way, Global finance has announced the world's best investment banks for the year 2011. In addition to the above said parameters, it has also considered the parameters such as, deal completed in the previous year, efforts to tackle the

problem of changing market situation, structuring capabilities, distribution networks, innovation, pricing after-market performance of underwritings and market reputation. The best banks as per global finance report are listed below.

GLOBAL WINNERS

Best Investment bank	Morgan Stanley
Best Equity Bank	Morgan Stanley
Best Debt Bank	Barclays winners
Best M&A Bank	Morgan Stanley
Best Up-and-Comer	QInvest
Most Creative	Bank of America Merrill Lynch
COUNTRY AWARDS	
INDIA	Morgan Stanley

Source: <http://www.gfmag.com/tools/best-banks/11097-worlds-best-investment-banks-2011.html>

PERFORMANCE OF GLOBAL INVESTMENT BANKS

The crucial role occupied and will be played by investment banks on behalf of investors, firms and government cannot be easily ruled out. However, at present, these banks which had been considered as the king of Wall Street once are teetering on the border of firmness owing to the bankruptcy of Lehman brothers, a top concern, due to the financial crisis happened in the year 2008. This has resulted in a major economic recession in the world during the second part of the year 2008. Under these circumstances, another top investment bank Goldman Sachs has been charged for purportedly selling the securities that were formed to be unsuccessful. These things have deeply affected the reputation of investment banks which will in turn affect the income and profit of the industry also. Despite of all these issues, the investment banks in the world were managed to remain strong in terms of finance and constructive characteristics during the year 2010. But, the year 2011 was observed as particularly tough for all investment banks in the world due to uncertain global economy, stock market volatility, euro zone debt crisis and US economic woes, and these factors put many deals on ice. The product-wise volume of business carried out by the global investment banks in the year 2011 comparatively to the year 2010, has been given below:

PRODUCT -WISE VOLUME OF INVESTMENT BANKING IN WORLD					
PRODUCT	PERIOD	2011	2010	CHANGES IN AMOUNT	CHANGE IN %
M & A	VOLUME IN BILLIONS (\$)				
	Q1	665.091	616.44	48.651	7.89
	Q2	729.818	584.839	144.979	24.79
	Q3	607.713	747.908	-140.195	-18.74
	Q4	609.164	709.522	-100.358	-14.14
	Total	2611.786	2658.709	-46.923	-1.76
DEBT	Q1	1867.317	1860.87	6.447	0.35
	Q2	1574.466	1299.984	274.482	21.11
	Q3	1177.366	1614.722	-437.356	-27.09
	Q4	1149.824	1325.837	-176.013	-13.28
	Total	5768.973	6101.413	-332.44	-5.45
EQUITY	Q1	208.011	176.303	31.708	17.98
	Q2	219.238	165.919	53.319	32.14
	Q3	103.13	202.853	-99.723	-49.16
	Q4	97.945	351.024	-253.079	-72.10
	Total	628.324	896.099	-267.775	-29.88
LOAN	Q1	907.284	543.023	364.261	67.08
	Q2	1168.425	789.353	379.072	48.02
	Q3	985.182	728.324	256.858	35.27
	Q4	961.304	880.891	80.413	9.13
	Total	4022.195	2941.591	1080.604	36.74

Source: Investment Banking Scorecard created by the Wall Street Journal and Dealogic

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

It is obvious from the above table that the volume of deals regarding Mergers & Acquisitions, Debt, and Equity has got considerably reduced during the third and fourth quarter of the year 2011 comparatively to the year 2010. In total, the volume of merger & acquisition, Debt, and Equity went down by 1.76%, 5.45%, and 29.88% respectively in the year 2011 when compared to the previous year 2010 as a result of uncertain global economy, stock market volatility, euro zone debt crisis and US economic woes. But, Loan deals rose by 36.74% in the year 2011 comparatively to the year 2010. Similarly, Indian Investment banks have also exposed to global shocks. For instance, Mergers and acquisitions (M&As) have declined from \$60.7 billion in the year 2010 to \$43.9 billion in 2011 i.e., by 28% according to the data released by Dialogic report. It also states that the debt capital market volume went down by 13% to \$39.48 billion. Further, the equity capital market transactions have declined by 67.26% to \$9.76 billion as against the previous year performance.

In spite of unsuccessfulness in volume of business, the total revenue of Global investment banks has not gone down much and it can be observed with the help of table below:

TABLE SHOWING THE CHANGES IN GLOBAL INVESTMENT BANKING REVENUE (in Billion)			
	2011	2010	% Change
Quarter- 1	20.235	15.757	28.42
Quarter -2	21.792	14.963	45.64
Quarter -3	14.34	15.736	-8.87
Quarter -4	13.366	3.466	285.63

Source: Investment Banking Scorecard created by the Wall Street Journal and Dealogic

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

It is apparent from the above table that the total revenue of global Investment banks has increased in each quarter to a greater extent irrespective of many issues raised except in the third quarter. This decline was due to the reduced volume of deals as a result of stock market fluctuations, the European debt crisis and the U.S. budget happened in the third quarter of 2011. In contrast to this global trend, Indian investment bank's revenue has decreased from \$741 million in the year 2010 to \$515 million in 2011 i.e., to an extent of 30%, according to data from Dealogic Holdings Plc., a UK-based research organization that tracks deals.

The above presented facts had made it clear that, Investment banks in India as well in world are now in tough phase, facing complex challenges emerged from global meltdown. In addition to this, more stringent rules and regulations which has been imposed recently in order to retain their reputation and to protect them from failure will also affect the performance of these banks. The challenges ahead for investment banks are presented below in three broad categories:-

CHALLENGES FOR GLOBAL INVESTMENT BANKS

1. Adherence of stringent regulations

Basel –III was developed on July 2010 by Basel Committee on Banking Supervision (BCBS) with the intention of strengthening the banking regulation and supervision. It has upgraded the standards with regard to capital, leverage, and liquidity regulations. As per the Basel-III capital standards, Banks are required to maintain a common minimum equity ratio of 7% of RWA, plus a new capital conservation buffer of 4.5% and the total capital at the rate of 10.5% (previously it was 8%) of RWA etc. These tightened norms are expected to consume high capital, cost and resources. These stringent regulations are difficult for investment banks to implement, because of limited timescale.

2. Embedded risk management

The Basel -III has tightened the norms on risk management system to protect the investment banking industry from recession. As per this more stringent norms, I- banks are required to evolve from the traditional system of risk management (where risks are identified as a factor of interruption to routine activities) to the Enterprise risk management which identifies the threats and opportunities in advance. The implementation of enterprise risk management system requires deep enterprise-wide collaboration and feedback loops that reinforce proactive discussion and implementation, standardized data and reports.

3. Focus on customer needs

Post-crisis, a number of trends are forcing all investment banks to reapply client focused approach of services. A thorough understanding of clients' requirements and their service history would assist investment banks to build strong client insights. But the wide-ranging needs of different client segments (institutions versus hedge funds, for example) limits the ability to integrate the customer relationship management effectively in to the investment banking system.

4. Implementation of fluid architecture

The application of innovative technologies has so far been restricted to front office level in investment banks. But in the wake of financial crisis, now investments banks are started to infuse service oriented architecture (SOA) across the enterprise. However, developing the technology to a new level is practically unfeasible due to the challenges such as the perception that SOA cannot keep up with the speed of business change, lack of commitment from senior persons, insufficient capital to adopt new technology, limited reuse of new technology across various functional areas, requirement of new way of thinking by banks.

5. Cost reduction

The combination of new regulatory norms on capital limits, leverage, and increasing regulatory cost are deemed to have a serious impact on revenue of Investment banks. Therefore, I-banks, to ensure the same level of return are required to create cost awareness culture amongst the employees. Moreover, they need to shift from the old strategy of slashing costs to consistently reviewing costs and reduction strategy. The abandonment of old cost culture and knee-jerk response to changes in profit would be a great challenge for these banks.

6. Other challenges

- Claw back provision which requires repayment of bonus by those who made loss in their Transaction has been made more tighten.
- Treatment of commodities in asset class
- Investment bankers are acting as fund arrangers, processors and distributors rather than investors.
- More pressure on fund managers to perform the task at low - cost

These challenges along with uncertain economic condition would not allow investment banks to ensure success. Despite, global investment banks are continue to chase towering performance. Moreover, it is expected that, the tougher regulations and stringent norms will influence and take small investment banks on par with their giant counterpart after the improvement of economy. Optimism is a good thing; however, it is worth bearing in mind that adoption of competitive strategy will not turn out sufficient positive results. Therefore, to ensure success, investment banks should concentrate on implementing the following points in their organization.

- Build refined strategic planning and commercial targets to face the complex challenges.
- Build creative and efficiently engaging team from cross functional departments such as Trading, Sales, Operations, Risk, Compliance, IT, Legal, Financial Control.
- Conduct competitive and market research.

CONCLUSION

Investment banking has faced fabulous transform during the last three decades. The sudden unexpected fall of big investment bank Lehman brothers, and the decision of the Goldman Sachs and Morgan Stanley to enter into commercial banking activities have given a likely picture that investment banking industry has attained the saturation stage. Moreover, global economic problems, changes in rules and regulations, technology and lot of other issues have also affected the shape of this industry. However, many analysts opine that the investment banking industry will again develop towards towering performance by meeting its challenges through numerous effective strategies. In spite of that, the service of investment banking is badly required by the clients. Hence, it can be concluded that, the industry can be successful by rebuilding the confidence of this strong capital base and developing the strategic skills to execute the task efficiently.

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