# Investment banking: Is there a future?

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The loneliness of the independent Wall Street bank

IN THE early years of this decade, when banks did quaint things like making money, the mantra on Wall Street was: "Be more like Goldman Sachs". Bank bosses peered enviously at the profits and risk-taking prowess of the venerable investment bank. No longer. "Be less like Goldman Sachs" is the imperative today.

Of the five independent investment banks open for business at the start of the year, only Goldman and Morgan Stanley remain. Doubts about the sustainability of the model are rife. In earnings conference calls on September 16th, the chief financial officers of both firms had to bat away analysts' questions about their ability to survive on their own. Spreads on their credit-default swaps, which protect against the risk of default, soared as investors digested the implications of Lehman Brothers' demise (see chart at the end of the article).

Universal banks, which marry investment banking and deposit-taking, are in the ascendant. Bear Stearns and Merrill Lynch found shelter in the arms of two big universal banks, JPMorgan Chase and Bank of America. Barclays, a British universal bank, is picking at the carrion of Lehman Brothers. The mood at Citigroup, seen until now as one of the biggest losers from the crisis, is suddenly bullish: insiders talk up the stability of its earnings and the advantages of deposit funding.

Regulatory antipathy to universal banks has also eased. Although the 1933 Glass-Steagall act, which separated investment banks and commercial banks, was repealed in 1999, the universal model is still viewed with suspicion in America. Among measures announced on September 14th, the Federal Reserve temporarily suspended rules restricting the amount of money that banks can lend to their investment-banking affiliates. Many are sceptical that this rule makes much practical difference. Even if the investment-banking arms of universal banks nominally have to raise money separately, their parents' ratings still make their funding cheaper. By the same token, if they get into trouble, the effects ripple through the entire balance-sheet. Even so the suspension, and the dramatic reshaping of Wall Street, represents the final repeal of Glass-Steagall.

Can Goldman and Morgan Stanley survive as independents? In normal times, the question would seem ludicrous. Both banks had profitable third quarters, with Morgan Stanley beating expectations comfortably. Rivals' disappearance should allow them to grab new business and has already helped to increase pricing power: Morgan Stanley hauled in record revenues in its prime-brokerage business. Both have reduced their most troubling exposures; both can call on decent amounts of capital and strong pools of liquidity. And both can marshal strong arguments that they are better managed than their erstwhile peers.

The problem, of course, is that these are not normal times. Although the firms condemn the rumour-mongering, stories that Morgan Stanley was looking for a partner continued to swirl. As The Economist went to press, Wachovia, an American bank, and Citic of China were among the names in the frame.

Three doubts hang over the independent model. The first concerns the risk of insolvency. Investment banks have higher leverage than other banks (in America at least), which worsens the impact of falling asset values. They do not have the safety-valve of banking books, where souring assets can escape the rigours of mark-to-market accounting. And they lack the stable earnings streams of commercial and retail banking. In other words, they have less room for error. Goldman's reputation for risk management is excellent, Morgan Stanley's a bit patchier. But asking investors to take valuations and hedging processes on trust is getting harder by the day.

The second, related doubt concerns their funding profile. As a group, the pure-play investment banks have relied heavily on short-term funding, particularly repo transactions in which counterparties take collateral as security against the cash they lend. Both survivors say they are nowhere near as exposed to the risk of a sudden dearth of liquidity as Bear Stearns was. They could also argue that retail deposits can be as flighty as the wholesale markets: just ask Northern Rock and IndyMac, both of which suffered rapid withdrawals. Even so, a further shift towards longer-term unsecured financing will be the price of survival for Morgan Stanley in particular.

That would increase costs, which in turn raises the third doubt, profitability. As well as dearer funding and lower leverage, the investment banks face the prospect of weakened demand for their services. As and when the market for structured finance revives, it will be smaller and less rewarding than before. Demand for many services will not go away, but in a world of scarcer credit, universal banks will be tempted to use their lending capacity to win juicier investment-banking business from companies. "Don't give me the bone," says one European bank boss. "Leave some meat on it."

By these lights, universal banks appear to offer clear advantages to both shareholders and regulators. Yet some of those advantages are illusory. For regulators, larger, diversified institutions may be more stable than investment banks but they pose an even greater systemic risk. "The universal bank is the regulatory equivalent of the super-senior mortgage-backed bond," says one analyst. "The risks may look lower but they do not go away." And deposit funding is cheaper than wholesale funding in part because those deposits are insured. Measures to protect customers may end up allowing banks to take on risks that endanger customers.

For shareholders, too, the universal bank may offer false comfort. A model that looks appealing in part because assets are not valued at market prices ought to ring alarm bells. Sprawling conglomerates are just as hard to manage as turbo-charged investment banks. And shareholders at UBS and Citi will derive little comfort from the notion that the model has been proven because their institutions are still standing. If the independent investment banks survive, they will clearly need to change. But they are not the only ones.
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