Reflections on the Financial Crisis and Investment Banking

By Robert J. Rhee

THE FINANCIAL CRISIS OF 2008 HAS PERMANENTLY changed Wall Street. Conventional wisdom says that Wall Street—the "bad guy" in the simple narrative—enabled the crisis by providing the financial technology, primarily securitization and derivatives, that brought the global financial system to its knees. I don't disagree, except to suggest that there is nothing intrinsically wrong with these financial instruments. But I take a slightly different perspective on the relationship between Wall Street and the crisis. With the caveat that in hindsight we are all an Einstein or a Buffett, I posit that one of the root causes of the crisis (and there are many) is the way Wall Street organized itself during the 1990s and beyond.

During this period, Wall Street was consolidating at an aggressive pace. The consumption of firms was startling. Consider these venerable names from the not so distant past: Alex. Brown, Bankers Trust, SG Warburg, Donaldson Lufkin & Jenrette, Montgomery Securities, First Boston, JP Morgan, Salomon Brothers, Smith Barney, Paine Webber, just to name a few. Many of these firms were consumed by commercial banks, which had enormous balance sheets but lacked the intellectual capital and operational scale to break into the top-tier of investment banking. These banks included Deutche Bank, UBS, Credit Suisse, Swiss Bank, Barclays, Bank of America, Chase Manhattan, and the predecessors of Citigroup. These firms brought an enormous amount of new capital to the activity of investment banking.

Like most financial executives, I accepted the idea that global finance required intense concentration of capital and a global network of intellectual capital and cross-selling capabilities within a single firm structure. I was wrong. And so too were the titans of Wall Street who engineered this mega-catastrophe. The consolidation combined stable commercial banking with volatile investment banking. The investment banking business now had far more capital. During this time as well, vast pools of private capital, private equity, and hedge funds also came into prominence and were searching for returns. With the convergence of these factors, Wall Street was primed to take larger risks.

In hindsight, as I try to make sense of what is happening now, my moment of insight should have been a valuation study I performed for a large financial institution. The question concerned the value of a large fixed income trading operation. There were no comparable public companies, and so no easy answer to the question. The work required an implied sum-of-the-parts analysis of bulge bracket (full service) investment banks. The study's essential conclusion was that proprietary trading operations, the type of activity that is at the epicenter of this crisis, are and should be lowly valued. Even then, this made intuitive sense: Such activity requires large amounts of capital and is highly risky, thus necessarily resulting in low valuations.

When investment banks were independent, capital was precious and judiciously applied. True, Wall Street is littered with firms that self-destructed as a result of poor risk management. But notable accidents and malfeasances aside, the risks of proprietary trading were contained by an appreciation of risks that could blow out one's capital. This fear instilled discipline. In the past, Wall Street had focused on high value, high return activities—some of which such as mergers and acquisitions advisory require little capital.

The balance radically changed when Wall Street consolidated in the 1990s. Firms were getting larger, fueled by an occasional shot of anti-regulatory steroids. A landmark event was the conversion of Goldman Sachs from a partnership to a public company. The logic is





apparent: bigger meant more capital; more capital required greater returns; greater returns are achieved only with greater risk. There are only so many highly profitable, lower risk opportunities to go around. Where would the returns come from? The banks had to take bigger risks, and this meant that the focus would turn to trading—that lowly valued, highly risky business, which was "juiced up" with high leverage to yield greater profits. Just as there was a global credit bubble that fueled the housing bubble, there was a glut of capital on Wall Street, with commercial banks, investment banks and private capital all searching for returns. The resulting financial pressures transformed Wall Street from a value-added, intermediation service provider to an enormous hedge fund.

The organizational changes on Wall Street left it highly vulnerable to a seismic shift in market volatility, just the way a decade before Long-Term Capital Management was vulnerable to the abnormal disturbance in the fixed income market triggered by the Russian debt default crisis. This time around, in the wake of the housing crash and credit illiquidity, it is no surprise that the first casualties were the independent investment banks that did not have the capital to withstand a catastrophic shock: Bear Stearns, Merrill Lynch, and Lehman Brothers. These firms did not have the balance sheets to survive a financial shock, or at least to delay an ultimate demise. I would never have thought that in one fell swoop, these firms would go the way of the dinosaur. Nor could we have foreseen that Goldman Sachs and Morgan Stanley, the two surviving patricians of American investment banking, would be forced to convert to banking holding companies.

So what is the future of investment banking? Any answer is speculative. We know that financial institutions cannot be allowed to take the type of risks they took. In hindsight, it was a continuing game of Russian roulette and ultimately the odds caught up. We do not know whether universal banks will voluntarily divest their investment banking operations. My guess: probably not. Investment banking is an alluring activity, and there may still be an appeal of cross-selling financial products under a one-firm umbrella. In any event, it seems that the genie is out of the bottle. Investment banking is no longer the prime domain of American firms, and the financial market is truly globalized. We can only better regulate the risk-taking activities.

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My hope is that, from the ashes of the 1990s and the financial crisis of 2008 Wall Street, will come a different business model. Market forces have brought down an industry of titanic scale, and Wall Street is certainly far smaller now than it was just a year ago. There is no longer a glut of capital in search of returns (indeed we have the opposite problem in that capital is seeking shelter from risk). In life as in fashion, what was once old is sometimes the "new" new. A possible future of investment banking may be a return to the old model of focusing on intermediation services, high profitability products, measured risk taking, and a renewed appreciation that capital is the lifeblood of a firm and it cannot be so easily staked. In any event, the crisis does not mark the death of Wall Street, or capitalism for that matter, but only its transformation into a new form.

Assistant Professor Robert Rhee's scholarly interests include risk-focused economic analyses of legal and social problems. He has served as a law clerk on the U.S. Court of Appeals for the Third Circuit, and a trial attorney in the Honors Program of the U.S. Department of Justice. Professor Rhee also has worked as a vice president in financial institutions investment banking at Swiss Re, as an M&A investment banker at UBS Warburg in London, and as a real estate investment banker at DeutcheBanc Alex. Brown in Baltimore.