

# The end of the investment bank and prime broker model?

As the bear market continues to tear down investment banks around the world, Global Value Investors' Matthew Hegarty explores the new battlefield.

The investment bank as we have come to know it is, if not yet severely impaired, then certainly forever changed.

In the United States, we have seen investment banks being bought out by other banks or being 'asked' by the Government to obtain a banking licence or merge with commercial banks.

This will place these institutions under much greater regulation and scrutiny by federal and government authorities to comply with essential capital requirements.

The end of the easy credit era, the catalyst for this current crisis, also marks the end of the credit binge that had grown exponentially since the beginning of the deregulation of financial markets. I met last month the chief financial officer of a major European bank who lamented that investment banks had led the financial system into the current crisis. He said that at an investment bank, five people in a treasury department could generate US\$100 million (\$126 million) in earnings just by setting up a special purpose investment vehicle and loading it up with complex and opaque structured products. He said 200 branches working for a full year would only then be able to generate those sorts of earnings.

However, investment banks and prime brokerage units have become victims of their own excesses to the point where they are unlikely to exist in the structure that existed pre-crisis.

In Australia, the thirst for yield and yield-based products led to investment banks packaging highly-leveraged products to manufacture yield. Many investors have been burnt by these structured products as the so-called yield was illusory and typically coming out of capital, rather than any cash

flow. Additionally, any cash generated went towards investment bank fees and servicing the huge loans used to purchase the assets in the first place.

The question that many people – from governments to retail investors – are now asking is how was this allowed to happen? Is this just a natural part of the economic cycle or will financial markets be forever altered?

If you look at the global economy's growth dynamics over the past 20 years, it does help in part to understand better the previous financial cycle and the 'normalisation' cycle that commenced in 2007.

The 1990s and up until 2003 was chiefly characterised as a period of falling inflation and sharp interest rate cuts. The period of 2003-07 was characterised as being a period that can only be described as a liquidity bubble. A strong perception of 'easy money' and a belief that there was an environment of zero risk started to permeate global financial markets and banks in particular. Strong credit growth was the glue that kept many economies globally growing and it invited the global banking and financial sector to move further up the risk curve into asset classes such as sub-prime mortgage segments and the financing of highly-leveraged structures.

The only apparent remedy for banks, once the global credit shock hit, was to deleverage; that is, to shed assets and to embark on balance sheet shrinkage. As is now widely recognised, global financial markets have not been able to accommodate the significant and simultaneous shrinkage of multiple balance sheets without major damage being incurred to institutions and to the overall system.



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Last month we witnessed the migration of this disorderly unwinding of balance sheet leverage into other essential components of any financial market – the smooth and orderly functioning of cash, collateral and counterparties. The pace of readjustment now as banks continue to manage down their risk and to deleverage further depends on how logjammed global credit markets remain.

The banks that will be vindicated out of this crisis will be those banks that stuck to a disciplined approach to banking and that did not compromise balance sheet quality for the sake of short-term growth.

Those that adopt the following priorities will most likely emerge positively and strongly out of this current crisis:

1. more balanced growth profile;
2. solid retail banking model;
3. focus on deposit growth (funding stability);
4. well-diversified commercial banking operations;
5. margin management to reflect the scarcer liquidity and rising spreads; and
6. conservative balance sheet and credit management.

We will continue to look closely at and monitor those banks that have these sorts of priorities and those banks that look attractive on a capital-adjusted basis. ✱

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