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Newest dino: I-bankodon?

Can investment banks survive without a big bank's cash? Lehman demise and Merrill takeout have depleted ranks. Goldman stands firm, for now.

By Tim Catts

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BANK BIGS 1) Varley of Barclays; 2) Merrill's Thain; 3) B of A's Lewis; 4) Lehman's Fuld; 5) Steel of Wachovia; 6) Bear Stearns' Cayne; 7) J.P. Morgan's Dimon; 8) Morgan Stanley's Mack; 9) Goldman's Blankfein

Plagued by hundreds of billions of dollars in write-downs and flagging investor confidence, Wall Street's biggest investment banks have been an endangered species for months. But with Lehman Brothers' collapse into bankruptcy and Merrill Lynch's decision to sell itself last weekend, they took a big step toward extinction.

The big winners to date: U.S.-based universal banks, like Bank of America, which snapped up Merrill on Sept. 14 in an all-stock deal worth more than $50 billion when it was announced, and J.P. Morgan Chase, which took over Bear Stearns in March with the Federal Reserve's help.

But mid-size investment banks could start competing for more—if not bigger—business as the number of market players dwindles. And foreign firms that had previously found the U.S. a tough market to infiltrate could snatch up prime U.S. franchises to expand their footprints or take advantage of the new competitive landscape.

For now, it's a back-to-the-future development for the U.S. financial industry. Depression-era reforms split investment banks from institutions that took deposits and instituted different regulations for each in an effort to protect savings and foster confidence in the financial system. Those prohibitions were reversed in 1998, but universal banks offering a wide range of services to both businesses and individuals remained out of favor, largely because of struggles at companies like Citigroup, which merged with insurance giant Travelers Group but ultimately couldn't digest it.

"We've come full circle because of the fact that investment banks have to get their funding from the short- and medium-term capital markets, vs. commercial banks that have a stronger depository base of funding," said Peter Bond, a partner at Milestone a financial services consulting firm. "Now we're back to where we started."

That reality has pushed investment banks into the arms of financial institutions with a solid base of deposits to fund their operations.

By buying Merrill Lynch, Bank of America—already the third-largest U.S. financial institution, with more than $1.7 trillion in assets at the end of the second quarter—added a powerful investment banking business that Thomson Reuters ranked fourth in debt and equity capital markets and ninth in mergers and acquisitions so far this year. The move caps a string of bold deals by CEO Ken Lewis—including the $2.5 billion purchase of Countrywide Financial in July, the $3.3 billion acquisition of U.S. Trust in July 2007, and his biggest bet before Merrill, the $35 billion merger with MBNA in 2006.

U.S. banks weren't the only ones to benefit. Barclays, the big British bank that reportedly considered buying Lehman but withdrew after it became clear neither the U.S. Treasury nor the Federal Reserve were willing to backstop the deal, suddenly found its appetite again after Lehman filed for bankruptcy protection. It announced it would acquire Lehman's broker-dealer arm (not to mention its Manhattan headquarters and two data centers) for a mere $1.7 billion, transforming Barclays overnight into one of the biggest securities underwriters and dealmakers in the U.S.

So while five giant investment banks towered over Wall Street at the beginning of this year, only two remained by early last week, leaving many in finance wondering which would be next to fall. A possible answer emerged on Wednesday, when Morgan Stanley reportedly began talks to sell itself to Wachovia, the fourth-largest U.S. bank by assets.

IT'S A SMALL WORLD The stand-alone investment bank has become an endangered species, especially in the U.S. The above tombstone ad for a 1985 International Business Machines debt offering shows 27 banks involved. Today only six remain that haven't been dissolved or acquired.

Attempting to head off speculation over its ability to survive, Morgan Stanley announced better than expected quarterly results Tuesday, a day earlier than planned. Speaking during a conference call with analysts, CFO Colm Kelleher expressed confidence that the firm would outlive mounting speculation about its prospects for survival.

"Frankly, I believe this nonsense will end," Mr. Kelleher said. "We believe in the diversified business model of an investment bank and its ability to adapt to different environments. This has been proven over the [market] cycles."

But many Morgan Stanley investors apparently disagreed, selling the company's stock heavily and pushing its share price down 24% on Wednesday, the day the news of the talks with Wachovia emerged. A deal hadn't been reached by 6:00 p.m. Friday.

Regardless of what happens to Morgan Stanley, it may be too early to say whether the ascendance of universal banks is permanent. First of all, Goldman Sachs remains fiercely independent.

In a conference call after announcing a 70% drop in quarterly profit last Tuesday, David Viniar, Goldman's CFO, dismissed a merger with a bank as a cure-all. "Bank deposits can basically be used to fund the business of a bank, not the capital markets business we are in," he told analysts. "Most of the businesses we're in could not be funded by banks."

Despite their troubles, stand-alone investment banks may yet prove to be more nimble and more responsive to their clients' needs, some observers said.

"In terms of muscles, there will be an advantage for those who are owned by big commercial banks," said Georges Ugeux, CEO of Galileo Global Advisors and previously a New York Stock Exchange executive. "In terms of agility, creativity, innovation and closeness to the customer, I wouldn't be surprised if the investment banks will flourish again."

Mr. Ugeux said smaller, specialized investment firms could find themselves in a position to expand their businesses while giant universal banks fight among themselves for the largest deals: “Second-tier investment banks, like Greenhill, Lazard and Evercore, are probably seeing some of the biggest opportunities.”

But if, as Barclays’ move to pick up some of Lehman’s assets suggests, the investment banking scene is becoming more global, mid-size firms may find it harder to compete, said Seamus McMahon, a partner in the financial services practice of consulting firm Booz & Co.

“It’s going to take a global reach and access to capital to provide the flow the U.S. will want over the next couple years, and I don’t think the medium-size firms will be able to provide that,” he said. “If anything, the capital crunch we’re going through may push them toward more of a niche play than up into the next level.”

Deep pockets and more stable balance sheets will give the universal banks a big advantage, according to Mr. McMahon. “If we’re stuck with these universal banks, because that’s where capital safety is these days, in some sense you won’t be part of a large playing field unless you’re part of a large conglomerate.” **FW**

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