

Were investment banks destined to fail?

Viral V Acharya

Within thirteen months of August 2007 - the official outbreak of the sub-prime crisis – the investment banking sector of the United States collapsed. Bear Stearns was the first to fold in mid-March 2008, followed by the bankruptcy of Lehman Brothers and the sale of Merrill Lynch to Bank of America in mid-September. Soon after, Morgan Stanley and Goldman Sachs formed bank holding companies and for a while were looking to survive by acquiring regional deposit-taking banks. It is not inconceivable that over time these remaining investment banks will also become like JPMorgan Chase and Citigroup – universal banks, leaving no trace whatsoever of any pure investment bank on the financial landscape.

Was the pure investment banking structure destined not to survive in the long run? The answer is: Yes, due to a government subsidy not present in the capital structure of investment banks – namely deposit insurance – which is present in that of universal banks.

It is useful to rewind history to 1933, when the passage of the Glass Steagall Act in the United States set up the Federal Deposit Insurance Corporation (FDIC) and introduced the separation of commercial and investment banking activities. The aim of the Glass Steagall Act was to avoid the conflicts of interest that characterized the granting of credit to a borrower and the provision of investment and underwriting services in securities of the same borrower. The investment activities were also deemed too risky to be put under the same umbrella as a commercial bank since the Act found it important to protect depositors' interests and reduce the risks FDIC was exposed to. The passage of the Act clearly shaped the financial arena in the United States in the years to come and from 1933 until 2007, the world witnessed the supremacy of US investment banks.

As investment banks thrived and flourished, the pure commercial banks felt at a disadvantage. Commercial banks wished to but could not underwrite and trade instruments such as mortgage-backed securities. They also complained about the lack of a level-playing field given the many regulations they were subject to compared with the unregulated investment banks and foreign universal banks not subject to scope restrictions. Lobbying efforts, and concessionary responses from regulators, during 1963 to 1987 meant that for all practical purposes commercial banks could do what investment banks were doing. The Act was formally repealed by the Gramm-Leach-Bliley Act of 1999 that also removed other scope restrictions, for instance, allowing insurance business under the bank holding company. The hope was that there would be a perfect level-playing field in the financial sector.

However, the repeal did not create the intended level-playing field; rather it worsened the situation. Take Citigroup, a universal bank. Citi could invest in risky

securities since the repeal but still had the cushion of government-insured deposits. In contrast, Morgan Stanley, an investment bank, also pursuing similar investments, *did not* have access to government guarantees, unless it became a universal bank or acquired deposit-taking banks (as Merrill Lynch did to an extent). The repeal of the Act meant that the same economic activity of investment banking and trading could be pursued under two structures – one with government guarantees and one without.

How did investment banks survive the lack of a level-playing field until 2007? The answer lies partly in their relative expertise and partly in their higher leverage and risk-taking activities. The first was a historical accident as commercial banks had just entered investment banking. The second was due to investment banks' leverage being unregulated. They funded themselves with uninsured, short-term commercial paper debt – often up to thirty three times their equity – so that their shareholders earned as high a return as from competing universal banks.

Short-term commercial paper debt is not too different from retail deposits – both forms of debt are meant to be demandable forms of debt. But deposit insurance means that the demandable aspect of deposits triggers a run for a universal bank only at much higher levels of losses than for an investment bank. Thus, by offering debt guarantees to some institutions engaged in investment banking but not others, the repeal of the Glass Steagall Act effectively ensured the demise of pure investment banks when a systemic crisis hit. Post-Lehman, Goldman Sachs and Morgan Stanley lost their clients to universal banks that took similar bets but were funded by government-guaranteed deposits. Losses incurred by universal banks - from investment banking activities - suggests however that these banks were lucky to have had guaranteed deposits. In fact, the worst of their lot failed in spite of it.

Investment banks were late to realize the significance of deposit funding if they were to survive competition of universal banks. But it is questionable if the regulators themselves understood fully the subtle implications of repealing one part of the long-standing Glass Steagall Act – the scope restrictions – but not the other – the deposit insurance.

If you remove the lane restrictions between cars and trailers on a high-speed road, cars don't survive when there is an accident.

The author is a Professor of Finance at New York University Stern School of Business and co-editor of the book "Restoring Financial Stability: How to Repair a Failed System".