**MODULE 2: Chapter 5 – Investment Banking**

**Introduction**

Investment banking is an important function of IB. Mainly, investment banks are engaged in underwriting securities to raise capital through initial public offerings. They also undertake mergers and acquisitions, whether hostile or friendly, for a fee. This module will explain the functions of investment banks, the types of securities they hold in their portfolios, risks they face, and regulatory issues. We will also look at some examples of financial engineering, which is a part of an investment bank’s functions and responsibilities.

**Objectives**

Upon successful completion of this module, the student should be able to:

- Describe the function of an investment bank.
- Examine and articulate the initial public offering activities by investment banks.
- Describe loan syndication by an investment bank.
- List the due diligence checklist.
- Describe mergers and acquisitions and corporate financing.
- Differentiate between the types of securities that are issued by an investment bank.
- Articulate the activities of merchant banking.

Investment banking activity evolved like every other aspect of IB. The financial collapse of 1929 led many people to believe that banking institutions recklessly packaged loans to the point that they compromised their reserve level and liquidity necessary for safeguarding the bank’s status as good-standing. With the Glass-Steagall Act, banks were prohibited from underwriting corporate securities and separated this function from their day to day orientation and responsibilities, such as loan packaging, deposit taking and providing saving accounts to their customers. With this law in place, we can easily assert that the foundation of investment banking activity was set in place, and evolved into what we see today. For example, investment banks perform an elaborate underwriting role for major corporations, from issuance of the security to its distribution, maintenance and maturity process, which completes their involvement in the said underwriting endeavor. An investment bank can purchase a security from an issuing company and sell it to the public. They can also distribute it to the public without purchasing it. A large percentage of an investment bank’s revenue is derived from participating in the role of underwriter. Also, investments banks provide consulting services to corporations for mergers and acquisitions, whether vertical or horizontal, and offer advice to start-up companies on organizational hierarchy. For further information, please see Footnote #1.

Furthermore, an investment banking institution’s functions can be described as underwriting and marketing securities, consulting and advisory services, currency trading, financial engineering, merchant banking, and bridge financing. Moreover, investment bankers are involved in raising capital in the capital market by selling their stock in the stock market, and often undertake venture capital activity. The Glass-Steagall was sunset in 1999 and was replaced by the Gramm-Leach-Bliley Act which again legalized the banking system’s venture into investment activity, though that activity must be completely independent of the overall banking operations. For further information, please see Footnotes #2, #3 and #4.
It is necessary to understand at this point that the major difference between underwriting securities and loan syndication is that the investing public provides capital for the entity that issues the security, whereas with syndicated loans the capital is provided by the syndicated banks. Investment banks commonly use equity market (shares) and capital market (bonds) securities to raise capital for their clientele. For further information concerning underwriting, please see Footnote #5.

Further elaboration of the function of an investment bank as an underwriter is necessary to fully comprehend this process. In this section, activities of investment banks for underwriting purposes will be discussed, which comprises qualitative and quantitative factors and issues that must be taken under consideration in order to successfully complete this complex process. It is a common understanding that investment banks’ historical trustworthiness, due diligence and prudence are prerequisites to establishing a relationship in the financial market for underwriting securities to raise capital for their clientele. This process is known as winning the mandate, which is highly competitive amongst investment bankers, that implicitly guarantees that the underwriting of the securities will be done by the investment bank that is seeking to undertake this activity. Through this process, the client of the investment bank is assured that the investment bank’s empirical experiences demonstrate the knowledge and the competence of the strategic posture that it needs to display in order to be successful in this financial relationship. The investment bank, as an underwriter of the securities, is also responsible for determining whether the issue is going to be newly issued securities that would be transacted in the primary market, or previously issued securities that would be transacted in the secondary market. Throughout this process, the investment banks are responsible for maintaining the financial integrity of their clients. Under U.S. Security Rule 415, the investment banker is responsible for preparation of the issue and its shelf, the type of security and its proper supervision for the shelf period. For further information, please see Footnote #6.

The decision by the investment bank on whether to sell the entire issue to an economic entity, private or institution, without publicly offering it in the financial market is known as Private Placement. For further information, please see Footnote #7.

As mentioned in the course objectives, investment bankers are required to go through seven steps of due diligence in order to complete the underwriting activity, from its issuance through its maturity. For further information, please see Footnote #8.

Another function of an investment banker is to bring together banks as partners in order to reduce and distribute the risk of loan packaging. Known as syndicated loans, these are largely packaged for economic development purposes in developing nations. The important players in this process are: a Syndication Manager, also referred to as a Managing Underwriter, which is the originating investment bank, and the bulge bracket, who assume the responsibility as the largest contributors of the securities for investment purposes. For further information, please see Footnotes #9 and #10.

Further players and activities in this process are the Mezzanine Bracket, or the second largest players in the syndicated loan, and a contract wherein the underwriter agrees to be the intermediary between the issuing firm and the investors in the market, and to make the best effort
to sell as many securities as possible, while not being held responsible for any securities that are not purchased by the public. The best effort process is essential for the completion of the security issuance. The next step is standby underwriting that allows an investment banker to obtain the leftover securities that were not purchased by the public. Though risky for the investment banker, because it reduces the risk by the issuer of the security, investment bankers are nevertheless compelled to assume the said risk. For further information, please see Footnotes #11, #12 and #13.

Ultimately, an investment banker offers the securities to the public to raise capital for the firm that agreed to underwrite its securities through the process of an Initial Public Offering (IPO), which includes the sale of the firm’s common stock to the public. For further information, please see Footnotes #14, #15 and #16.

Because of the competitive nature of the industry, investment banks resort to a wide variety of financial services to raise revenue for the firm in order to increase profitability. An example of the services that can be provided by the investment bank is advisory service where the bank provides investment advice for a fee. The law requires that advisory services must also be registered with the Securities and Exchange Commission. To name a few, investment banks advise their clients on corporate restructuring. The purpose of corporate restructuring is mainly to restructure the firm’s liability and the owners’ equity, since under normal circumstances of a public offering the capital raised by the firm is not sufficient to cover its debts and liabilities. Other benefits of corporate restructuring are that it allows a firm to postpone debt repayment, possibly avoid bankruptcy, and cancel any unfavorable financial agreement with other parties. For further information, please see Footnote #17.

Investment banks can also help clients with mergers and acquisitions (M&A). Many financial entities and corporations have to compete fiercely for acquiring and retaining customers in the financial market, factors market, and goods market. Towards that end, they always look to offer new financial services, tangible and intangible goods to attract business. Consolidation and convergence facilitate this innovative process by creating a large and efficient organization from many smaller ones, which can bring together many smaller economies of scale, along with their technology and know-how. Consolidation and convergence can be achieved with mergers and acquisitions, which can bring economies of scale to the firm offering financial services, and to corporations that sell goods and services. As we know, economies of scale can be realized when a firm’s long-run average total cost is at the minimum. With that note, investment bankers could bring such efficiency to those organizations for a fee. Mergers and acquisitions could be in the form of vertical integration of smaller companies that produce various commodities or services. Further restructuring of the firm by the investment bank could be in the form of a horizontal merger, where many firms that produce homogenous commodities integrate into one. This allows a firm to expand its market to many other regions. For further information, please see Footnotes #18, #19, #20 and #21.

In the process of restructuring a company through merger and acquisition, investment banks can execute a friendly takeover, by which a firm acquires another firm in a friendly manner, which means the firm that is about to be acquired agrees to the acquisition. Conversely, an investment bank can choose a hostile takeover option, which occurs when a firm acquires another firm
against the wishes of its shareholders.  For further information, please see Footnotes #22, #23 and #24.

There is an understanding in the financial world that a hostile takeover is not the avenue that is favored by the interested parties. Furthermore, in the process of restructuring, the investment bank may take the responsibility of raising capital for the company that it is planning to acquire to help it become more efficient before purchasing it. This process is known as a leveraged buyout (LBO). This occurs when many investors come together and acquire a firm using borrowed funds to gain control of a large percentage of the acquired company’s assets. The loan’s collateral will be the assets of the firm that is being acquired. The purchasing firm’s objective is to make this venture a profitable one so they can use the profit gained from this transaction to pay back the loan used to purchase the firm. For further information, please see Footnote #25.

Financial engineering is another form of investment banks’ involvement in the financial market in trading securities known as derivatives. In this process, a new derivative is invented from being completely modified and offered as a new security. This process uses mathematical models for the creation of new financial services that can maximize the rate of return of the derivative.

The process of financial engineering could help diversify risk for the corporation and, to a certain extent, decrease the anticipated losses to the assets of the company that may occur due to fluctuation in macroeconomic variables. For further information, please see Footnotes #26 and #27. Two examples of derivatives are known as zero-coupon securities and mortgage-backed securities. Also known as a discount bond, the best feature that a zero-coupon bond offers is that it can be purchased at a lower price, and the full face value will be paid at the time of maturity. The shortcoming of this bond is that the holder of the bond does not receive interest payments in the interim. Another good feature of this type of security is that you can make provisions to hedge against inflation. For further information, please see Footnotes #28 and #29.

The financial market allows and facilities financial entities’ purchase of mortgages from various financial intermediaries and creation of a trust fund which allows them to issue securities against the trust fund for the purpose of raising capital. These securities are backed by mortgage installments and interest payments from the borrowers/homebuyers. These financial entities can be private or public. Ginnie Mae, Fannie Mae and Freddie Mac are a few examples of governmental entities that purchase mortgage-backed securities. Mortgage-backed securities have a favorable standing in the financial market, since the notion of not losing a home ensures that homeowners pay the principal and interest payments regularly. Economically, by purchasing mortgage-backed securities, the purchasing entities can lend more money to new homebuyers. In other words, if you purchase mortgage-backed securities, you are helping someone else to own a home. And since the capital raised is already backed by the previous mortgage installments as collateral, the new loans to new homebuyers need not have additional collateral. In this case, the new lender, let’s say a local bank, is a go-between the new homebuyer and the entity that originally purchased the pool of mortgages. For further information, please see Footnotes #30, #31.
The above mentioned process is also known as securitization, which means any receivables with collateral that is regularly paid by borrowers can be pooled into a trust fund and have securities issued against it for the purpose of raising capital that can be used to lend again to borrowers for home ownership in the secondary mortgage market. Since mortgage-backed securities are transacted in the capital market and, therefore, cannot be liquidated easily, this process facilitates assets that have long-term liquidity being transferred into liquid assets. For further information, please see Footnote #32.

Aside from the mentioned activities and functions of investment banks, they can provide services such as money market funds, venture capital and merchant banking. A money market fund is synonymous with investment in securities that are not risky. Like any other security, it pays dividends regularly. Money market funds are transacted in the financial market, so there is no collateral to provide security for such an investment. Therefore, fund managers use investors’ funds to purchase governmental securities with lower risk. For further information, please see Footnote #33.

Venture capitalists provide a financial opportunity to individuals for whom the future outlook for their innovation and inventions is great. Venture capitalists provide funds even though it is risky, but in case the venture becomes successful, they receive a much greater rate of return than the average investment offers. A venture capitalist’s involvement may also include managerial expertise and a limited partnership. By the way, Microsoft began as a venture capital entity. Now you know the rest of the story. For further information, please see Footnote #34.

The modern name for merchant banking is investment banking, but the history of merchant banking goes way back to the middle ages. Merchant banking was invented by Italian merchants who were trading grains. Another important banking family in Europe that was also known as merchant bankers was the Rothschilds. Like every other aspect of financial services provided by an intermediary, merchant banking also evolved significantly. Today, merchant bankers – now known as investment bankers – provide managerial advice to wealthy entities on managing their assets. They help corporations to diversify with mergers and acquisitions, and also help them to raise capital through IPOs, from issuance to their maturity. For further information, please see Footnote #35.

Conclusion

In this module, you learned how investment banks function and provide service to the corporate world. After reading this module, you should be able to articulate the process of an initial public offering. You also learned about the due diligence process, mergers and acquisitions, corporate finance, mortgage-backed securities, securitization, money market funds, and venture capital. And finally, you learned about merchant banking and its financial activity.


