Management of Financial Institutions

**Role of Investment Banks**

**Investment banks**

It helps companies and governments (or their agencies) raise money by issuing and selling securities in the capital markets (both equity and debt).

Almost all investment banks also offer strategic advisory services for mergers, acquisitions, divestiture, or other financial services for clients, such as the trading of derivatives, fixed income, and foreign exchange, commodity, and equity securities.

Trading securities for cash or securities (i.e., facilitating transactions, market-making), or the promotion of securities (i.e., underwriting, research, etc.) is referred to as "sell side."

The "buy side" constitutes the pension funds, mutual funds, hedge funds, and the investing public who consume the products and services of the sell-side in order to maximize their return on investment. Many firms have both buy and sell side components.

**Organizational structure of an investment bank**

**The main activities and units**

The primary function of an investment bank is buying and selling products both on behalf of the bank's clients and also for the bank itself. Banks undertake risk through proprietary trading, done by a special set of traders who do not interface with clients and through Principal Risk, risk undertaken by a trader after he or she buys or sells a product to a client and does not hedge his or her total exposure. Banks seek to maximize profitability for a given amount of risk on their balance sheet.

An investment bank is split into the so-called **Front Office**, **Middle Office** and **Back**

**Office. Front Office**

* **Investment Banking** is the traditional aspect of investment banks which involveshelping customers raise funds in the Capital Markets and advising on mergers and acquisitions. Investment banking may involve subscribing investors to a security issuance, coordinating with bidders, or negotiating with a merger target. Other terms for the Investment Banking Division include Mergers & Acquisitions (M&A) and Corporate Finance (often pronounced "corpfin").
* **Investment management** is the professional management of various securities(shares, bonds, etc.) and other assets (e.g. real estate), to meet specified investment goals for the benefit of the investors. Investors may be institutions (insurance companies, pension funds, corporations etc.) or private investors (both directly via investment contracts and more commonly via collective investment schemes eg. mutual funds) .
* **Sales and Trading** is often the most profitable area of an investment bank,responsible for the majority of revenue of most investment banks In the process of market making, traders will buy and sell financial products with the goal of making an incremental amount of money on each trade. Sales is the term for the investment banks sales force, whose primary job is to call on institutional and high-net-worth investors to suggest trading ideas (on caveat emptor basis) and take orders. Sales desks then communicate their clients' orders to the appropriate trading desks, who can price and execute trades, or structure new products that fit a specific need.
* **Research** is the division which reviews companies and writes reports about theirprospects, often with "buy" or "sell" ratings. While the research division generates no revenue, its resources are used to assist traders in trading, the sales force in suggesting ideas to customers, and investment bankers by covering their clients. In recent years the relationship between investment banking and research has become highly regulated, reducing its importance to the investment bank.
* **Structuring** has been a relatively recent division as derivatives have come into play,with highly technical and numerate employees working on creating complex structured products which typically offer much greater margins and returns than underlying cash securities.

**Middle Office**

* **Risk Management** involves analyzing the market and credit risk that traders aretaking onto the balance sheet in conducting their daily trades, and setting limits on the amount of capital that they are able to trade in order to prevent 'bad' trades having a detrimental effect to a desk overall. Another key Middle Office role is to ensure that the above mentioned economic risks are captured accurately (as per agreement of commercial terms with the counterparty), correctly (as per standardized booking models in the most appropriate systems) and on time (typically within 30 minutes of trade execution). In recent years the risk of errors has become known as "operational risk" and the assurance Middle Offices provide now includes measures to address this risk. When this assurance is not in place, market and credit risk analysis can be unreliable and open to deliberate manipulation.

**Back Office**

* **Operations** involve data-checking trades that have been conducted, ensuring thatthey are not erroneous, and transacting the required transfers. While some believe it provides the greatest job security with the bleakest career prospects of the divisions within an investment bank, many have outsourced operations. It is however a critical part of the bank that involves managing the financial information of the bank and ensures efficient capital markets through the financial reporting functions. In recent years due to increased competition in finance related careers, college degrees are now mandatory at most Tier 1 investment banks. A finance degree has proved significant in understanding the depth of the deals and transactions that occur across all the divisions of the bank.
* **Technology:** every major investment bank has considerable amounts of in-housesoftware, created by the Technology team, who are also responsible for Computer and Telecommunications-based support. Technology has changed considerably in the last few years as more sales and trading desks are using electronic trading platforms. These platforms can serve as auto-executed hedging to complex model driven algorithms.

**Size of industry**

Global investment banking revenue increased for the third year running in 2005, to $52.8bn. This was up 14% on the previous year, but 7% below the 2000 peak. The recovery in the global economy and capital markets resulted in an increase in M&A activity, which has been the primary source of investment banking revenue in recent years. Credit spreads are tightening and intense competition within the field has ensured that the banking industry is on its toes.

The US was the primary source of investment banking income in 2005, with 51% of the total, a proportion which has fallen somewhat during the past decade. Europe (with Middle East and Africa) generated 31% of the total, slightly up on its 30% share a decade ago. Asian countries generated the remaining 18%. Between 2002 and 2005, fee income from Asia increased by 98%. This compares with a 55% increase in Europe, and a 46% increase in the US, during this time period.

**Recent evolution of the business**

**New products**

Investment banking is one of the most global industries and is hence continuously challenged to respond to new developments and innovation in the global financial markets. Throughout the history of investment banking, many have theorized that all investment banking products and services would be commoditized. New products with higher margins are constantly invented and manufactured by bankers in hopes of winning over clients and developing trading know-how in new markets.

However, since these can usually not be patented or copyrighted, they are very often copied quickly by competing banks, pushing down trading margins.

For example, trading bonds and equities for customers is now a commodity business but structuring and trading derivatives is highly profitable. Each OTC contract has to be uniquely structured and could involve complex pay- off and risk profiles. Listed option contracts are traded through major exchanges, such as the CBOE, and are almost as commoditized as general equity securities.

In addition, while many products have been commoditized, an increasing amount of profit within investment banks has come from proprietary trading, where size creates a positive network benefit (since the more trades an investment bank does, the more it knows about the market flow, allowing it to theoretically make better trades and pass on better guidance to clients).

**Vertical Integration**

In the US, the Glass-Steagall Act, initially created in the wake of the Stock Market Crash of 1929, prohibited banks from both accepting deposits and underwriting securities which led to segregation of Investment Banks from Commercial Banks. Glass-Steagall was repealed by the Gramm-Leach-Bliley Act in 1999.

Another development in recent years has been the vertical integration of debt securitization. Previously, investment banks had assisted lenders in raising more lending funds and having the ability to offer longer term fixed interest rates by converting the lenders' outstanding loans into bonds. For example, a mortgage lender would make a house loan, and then use the investment bank to sell bonds to fund the debt, the money from the sale of the bonds can be used to make new loans, while the lender accepts loan payments and passes the payments on to the bondholders. This process is called securitization. However, lenders have begun to securitize loans themselves especially in the areas of mortgage loans. Because of this, and because of the fear that this will continue, many Investment Banks have focused on becoming lenders themselves making loans with the goal of securitizing them. In fact, in the areas of commercial mortgages, many Investment Banks lend at loss leader interest rates in order to make money securitizing the loans, causing them to be a very popular financing option for commercial property investors and developers.

**Possible conflicts of interest**

Potential conflicts of interest may arise between different parts of a bank, creating the potential for financial movements that could be market manipulation. Authorities that regulate investment banking (the FSA in the United Kingdom and the SEC in the United States) require that banks impose a Chinese wall which prohibits communication between investment banking on one side and research and equities on the other.

Some of the conflicts of interest that can be found in investment banking are listed here:

* Historically, equity research firms were founded and owned by investment banks. One common practice is for equity analysts to initiate coverage on a company in order to develop relationships that lead to highly profitable investment banking business. In the 1990s, many equity researchers allegedly traded positive stock ratings directly for investment banking business. On the flip side of the coin: companies would threaten to divert investment banking business to competitors unless their stock was rated favorably. Politicians acted to pass laws to criminalize such acts. Increased pressure from regulators and a series of lawsuits, settlements, and prosecutions curbed this business to a large extent following the 2001 stock market tumble.
* Many investment banks also own retail brokerages. Also during the 1990s, some retail brokerages sold consumers securities which did not meet their stated risk profile. This behavior may have led to investment banking business or even sales of surplus shares during a public offering to keep public perception of the stock favorable.
* Since investment banks engage heavily in trading for their own account, there is always the temptation or possibility that they might engage in some form of front running. Front running is the illegal practice of a stock broker executing orders on a security for their own account (and thus affecting prices) before filling orders previously submitted by their customers.

**Letter of Credit**

**Commercial Letter of Credit**

Commercial letters of credit have been used for centuries to facilitate payment in international trade. Their use will continue to increase as the global economy evolves.

Letters of credit used in international transactions are governed by the International Chamber of Commerce Uniform Customs and Practice for Documentary Credits. The general provisions and definitions of the International Chamber of Commerce are binding on all parties. Domestic collections in the United States are governed by the Uniform Commercial Code.

A commercial letter of credit is a contractual agreement between banks, known as the issuing bank, on behalf of one of its customers, authorizing another bank, known as the advising or confirming bank, to make payment to the beneficiary. The issuing bank, on the request of its customer, opens the letter of credit. The issuing bank makes a commitment to honor drawings made under the credit. The beneficiary is normally the provider of goods and/or services. Essentially, the issuing bank replaces the bank's customer as the payee.

**Elements of a Letter of Credit**

* A payment undertaking given by a bank (issuing bank)
* On behalf of a buyer (applicant)
* To pay a seller (beneficiary) for a given amount of money
* On presentation of specified documents representing the supply of goods
* Within specified time limits
* Documents must conform to terms and conditions set out in the letter of credit
* Documents to be presented at a specified place

**Beneficiary**

The beneficiary is entitled to payment as long as he can provide the documentary evidence required by the letter of credit. The letter of credit is a distinct and separate transaction from the contract on which it is based. All parties deal in documents and not in goods. The issuing bank is not liable for performance of the underlying contract between the customer and beneficiary.

The issuing bank's obligation to the buyer, is to examine all documents to insure that they meet all the terms and conditions of the credit. Upon requesting demand for payment the beneficiary warrants that all conditions of the agreement have been complied with. If the beneficiary (seller) conforms to the letter of credit, the seller must be paid by the bank.

**Issuing Bank**

The issuing bank's liability to pay and to be reimbursed from its customer becomes absolute upon the completion of the terms and conditions of the letter of credit. Under the provisions of the Uniform Customs and Practice for Documentary Credits, the bank is given a reasonable amount of time after receipt of the documents to honor the draft.

The issuing banks' role is to provide a guarantee to the seller that if compliant documents are presented, the bank will pay the seller the amount due and to examine the documents, and only pay if these documents comply with the terms and conditions set out in the letter of credit.

Typically the documents requested will include a commercial invoice, a transport document such as a bill of lading or airway bill and an insurance document; but there are many others. Letters of credit deal in documents, not goods.

**Advising Bank**

An advising bank, usually a foreign correspondent bank of the issuing bank will advise the beneficiary. Generally, the beneficiary would want to use a local bank to insure that the letter of credit is valid. In addition, the advising bank would be responsible for sending the documents to the issuing bank. The advising bank has no other obligation under the letter of credit. If the issuing bank does not pay the beneficiary, the advising bank is not obligated to pay.

**Confirming Bank**

The correspondent bank may confirm the letter of credit for the beneficiary. At the request of the issuing bank, the correspondent obligates itself to insure payment under the letter of credit. The confirming bank would not confirm the credit until it evaluated the country and bank where the letter of credit originates. The confirming bank is usually the advising bank.

**Letter of Credit Characteristics**

• **Negotiability**

Letters of credit are usually negotiable. The issuing bank is obligated to pay not only the beneficiary, but also any bank nominated by the beneficiary. Negotiable instruments are passed freely from one party to another almost in the same way as money. To be negotiable, the letter of credit must include an unconditional promise to pay, on demand or at a definite time. The nominated bank becomes a holder in due course. As a holder in due course, the holder takes the letter of credit for value, in good faith, without notice of any claims against it. A holder in due course is treated favorably under the UCC.

The transaction is considered a straight negotiation if the issuing bank's payment obligation extends only to the beneficiary of the credit. If a letter of credit is a straight negotiation it is referenced on its face by "we engage with you" or "available with ourselves". Under these conditions the promise does not pass to a purchaser of the draft as a holder in due course.

• **Revocability**

Letters of credit may be either revocable or irrevocable. A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. A revocable letter of credit cannot be confirmed. If a correspondent bank is engaged in a transaction that involves a revocable letter of credit, it serves as the advising bank.

Once the documents have been presented and meet the terms and conditions in the letter of credit, and the draft is honored, the letter of credit cannot be revoked. The revocable letter of credit is not a commonly used instrument. It is generally used to provide guidelines for shipment. If a letter of credit is revocable it would be referenced on its face.

The irrevocable letter of credit may not be revoked or amended without the agreement of the issuing bank, the confirming bank, and the beneficiary. An irrevocable letter of credit from the issuing bank insures the beneficiary that if the required documents are presented and the terms and conditions are complied with, payment will be made. If a letter of credit is irrevocable it is referenced on its face.

• **Transfer and Assignment**

The beneficiary has the right to transfer or assign the right to draw, under a credit only when the credit states that it is transferable or assignable. Credits governed by the Uniform Commercial Code (Domestic) maybe transferred an unlimited number of times. Under the Uniform Customs Practice for Documentary Credits (International) the credit may be transferred only once. However, even if the credit specifies that it is nontransferable or no assignable, the beneficiary may transfer their rights prior to performance of conditions of the credit.

• **Sight and Time Drafts**

All letters of credit require the beneficiary to present a draft and specified documents in order to receive payment. A draft is a written order by which the party creating it, orders another party to pay money to a third party. A draft is also called a bill of exchange.

There are two types of drafts: sight and time. A sight draft is payable as soon as it is presented for payment. The bank is allowed a reasonable time to review the documents before making payment.

A time draft is not payable until the lapse of a particular time period stated on the draft. The bank is required to accept the draft as soon as the documents comply with credit terms. The issuing bank has a reasonable time to examine those documents. The issuing bank is obligated to accept drafts and pay them at maturity.

• **Standby Letter of Credit**

The standby letter of credit serves a different function than the commercial letter of credit. The commercial letter of credit is the primary payment mechanism for a transaction. The standby letter of credit serves as a secondary payment mechanism. A bank will issue a standby letter of credit on behalf of a customer to provide assurances of his ability to perform under the terms of a contract between the beneficiaries. The parties involved with the transaction do not expect that the letter of credit will ever be drawn upon.

The standby letter of credit assures the beneficiary of the performance of the customer's obligation. The beneficiary is able to draw under the credit by presenting a draft, copies of invoices, with evidence that the customer has not performed its obligation. The bank is obligated to make payment if the documents presented comply with the terms of the letter of credit.

Standby letters of credit are issued by banks to stand behind monetary obligations, to insure the refund of advance payment, to support performance and bid obligations, and to insure the completion of a sales contract. The credit has an expiration date.

The standby letter of credit is often used to guarantee performance or to strengthen the credit worthiness of a customer. In the above example, the letter of credit is issued by the bank and held by the supplier. The customer is provided open account terms. If payments are made in accordance with the suppliers' terms, the letter of credit would not be drawn on. The seller pursues the customer for payment directly. If the customer is unable to pay, the seller presents a draft and copies of invoices to the bank for payment.

The domestic standby letter of credit is governed by the Uniform Commercial Code. Under these provisions, the bank is given until the close of the third banking day after receipt of the documents to honor the draft.

**Procedures for Using the Tool**

The following procedures include a flow of events that follow the decision to use a Commercial Letter of Credit. Procedures required to execute a Standby Letter of Credit are less rigorous. The standby credit is a domestic transaction. It does not require a correspondent bank (advising or confirming). The documentation requirements are also less tedious.

**Step-by-step process:**

Buyer and seller agree to conduct business. The seller wants a letter of credit to guarantee payment.

Buyer applies to his bank for a letter of credit in favor of the seller.

Buyer's bank approves the credit risk of the buyer, issues and forwards the credit to its correspondent bank (advising or confirming). The correspondent bank is usually located in the same geographical location as the seller (beneficiary).

* Advising bank will authenticate the credit and forward the original credit to the seller (beneficiary).
* Seller (beneficiary) ships the goods, then verifies and develops the documentary requirements to support the letter of credit. Documentary requirements may vary greatly depending on the perceived risk involved in dealing with a particular company.
* Seller presents the required documents to the advising or confirming bank to be processed for payment.
* Advising or confirming bank examines the documents for compliance with the terms and conditions of the letter of credit.
* If the documents are correct, the advising or confirming bank will claim the funds by:

o Debiting the account of the issuing bank.

o Waiting until the issuing bank remits, after receiving the documents.

* 1. Reimburse on another bank as required in the credit.
* Advising or confirming bank will forward the documents to the issuing bank.
* Issuing bank will examine the documents for compliance. If they are in order, the issuing bank will debit the buyer's account.
* Issuing bank then forwards the documents to the buyer.

**Standard Forms of Documentation**

When making payment for product on behalf of its customer, the issuing bank must verify that all documents and drafts conform precisely to the terms and conditions of the letter of credit. Although the credit can require an array of documents, the most common documents that must accompany the draft include:

**Commercial Invoice**

The bill for the goods and services is called. It includes a description of merchandise, price, FOB origin, and name and address of buyer and seller. The buyer and seller information must correspond exactly to the description in the letter of credit. Unless the letter of credit specifically states otherwise, a generic description of the merchandise is usually acceptable in the other accompanying documents.

**Bill of Lading**

A document evidencing the receipt of goods for shipment and issued by a freight carrier engaged in the business of forwarding or transporting goods. The documents evidence control of goods. They also serve as a receipt for the merchandise shipped and as evidence of the carrier's obligation to transport the goods to their proper destination.

**Warranty of Title**

A warranty given by a seller to a buyer of goods that states that the title being conveyed is good and that the transfer is rightful. This is a method of certifying clear title to product transfer. It is generally issued to the purchaser and issuing bank expressing an agreement to indemnify and hold both parties harmless.

**Letter of Indemnity**

Specifically indemnifies the purchaser against a certain stated circumstance. Indemnification is generally used to guaranty that shipping documents will be provided in good order when available.

**Common Defects in Documentation**

About half of all drawings presented contain discrepancies. A discrepancy is an irregularity in the documents that causes them to be in non-compliance to the letter of credit. Requirements set forth in the letter of credit cannot be waived or altered by the issuing bank without the express consent of the customer. The beneficiary should prepare and examine all documents carefully before presentation to the paying bank to avoid any delay in receipt of payment. Commonly found discrepancies between the letter of credit and supporting documents include:

* Letter of Credit has expired prior to presentation of draft.
* Bill of Lading evidences delivery prior to or after the date range stated in the credit.
* Stale dated documents.
* Changes included in the invoice not authorized in the credit.
* Inconsistent description of goods.
* Insurance document errors.
* Invoice amount not equal to draft amount.
* Ports of loading and destination not as specified in the credit.
* Description of merchandise is not as stated in credit.
* A document required by the credit is not presented.
* Documents are inconsistent as to general information such as volume, quality, etc.
* Names of documents not exact as described in the credit. Beneficiary information must be exact.
* Invoice or statement is not signed as stipulated in the letter of credit.

When a discrepancy is detected by the negotiating bank, a correction to the document may be allowed if it can be done quickly while remaining in the control of the bank. If time is not a factor, the exporter should request that the negotiating bank return the documents for corrections.

If there is not enough time to make corrections, the exporter should request that the negotiating bank send the documents to the issuing bank on an approval basis or notify the issuing bank by wire, outline the discrepancies, and request authority to pay. Payment cannot be made until all parties have agreed to jointly waive the discrepancy.

**Tips for Exporter**

* Communicate with your customers in detail before they apply for letters of credit.
* Consider whether a confirmed letter of credit is needed.
* Ask for a copy of the application to be fax to you, so you can check for terms or conditions that may cause you problems in compliance.
* Upon first advice of the letter of credit, check that all its terms and conditions can be complied with within the prescribed time limits.
* Many presentations of documents run into problems with time-limits. You must be aware of at least three time constraints - the expiration date of the credit, the latest shipping date and the maximum time allowed between dispatch and presentation.
* If the letter of credit calls for documents supplied by third parties, make reasonable allowance for the time this may take to complete.
* After dispatch of the goods, check all the documents both against the terms of the credit and against each other for internal consistency.