

US investment banks : the capital markets limited risk and diminished opportunity

Over the last few weeks, equity and bond market dynamics have conjured up flashbacks to the fall of 1998 when a liquidity crisis gripped the global capital markets precipitating a grinding deceleration. In the subsequent weeks of that crisis, US securities firms experienced, in varying degrees of intensity, trading losses and highly compressed market making revenues as underwriting business vanished and demand for expanding inventories of emerging market and high yield securities dried-up.

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■ While the crisis largely stemmed from over capacity and aggressive investing in the emerging markets, particularly in Southeast Asia and Russia, the parallels between then and now are in some respects, uncanny. Recent over capacity and aggressiveness in the technology, internet and telecommunications sectors, have led to a general sell-off, repositioning and flight to quality as investors attempt to cherry-pick winners and define losers. At the same time, however, it should be emphasized that a type of confusion has settled into the

to be weeded from the system. As such, the general sell-off has caused substantial revaluation within the equity markets, which has been accompanied by widening credit spreads in the bond markets underscoring creditors heightened concern that many of these companies will eventually demonstrate increasing difficulties servicing their debt.

Fitch believes however, that potential rating consequences resulting from the current situation are negligible given the material differences between the broker dealers of today versus 1998.

This difference is largely reflected in their general financial condition and the complexion of their balance sheets. Following the losses experienced in late 1998, the firms have substantially reduced balance sheet inventories particularly those

of emerging market and other high yield inventories given what it perceived as a substantial imbalance between risk and return. Additionally, while contingencies for liquidity were also severely strained by the crisis, the industry enhanced its flexibility by reconfiguring both its

asset and liability structure – largely through a reduction in proprietary risk exposures, increased cash positions and increased long-term debt financing with an emphasis on lengthened maturity profiles. Losses were offset by the strength and diversifying nature of revenue streams. This axiom has in most respects held ever since.

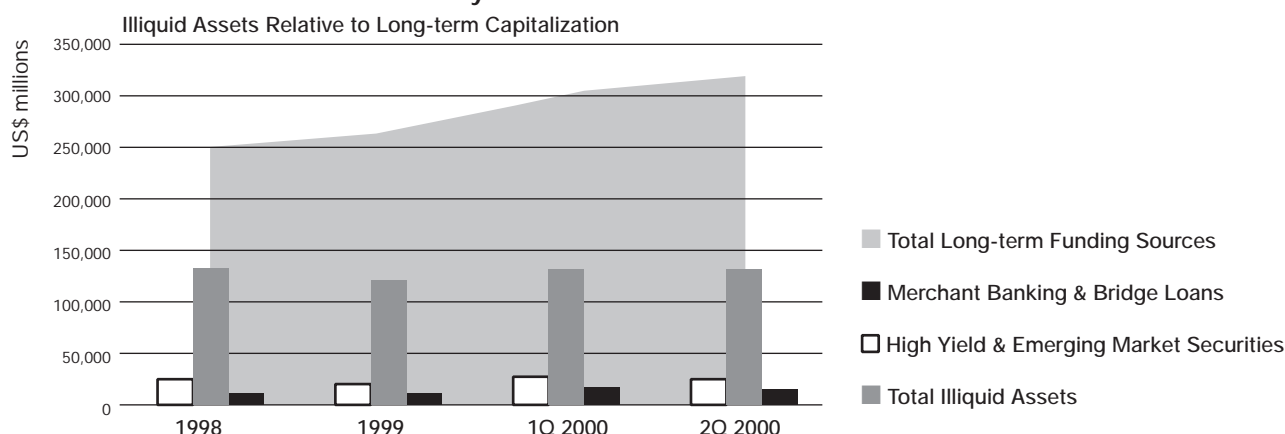
Lessons learned from 1998

Business strategy. In particular, an industry-wide focus on the expansion of distribution capabilities and increased scale in asset management has led to broader more diversified brokerage and wealth management networks. Opportunities abroad-Europe in particular have expanded the availability of advisory and underwriting business as well as the industry's base of available clients for wealth management. The integration of this strategy with traditional US-based investment banking and trading operations in conjunction with the strength of the economy and subsequent expansion of wealth, has broadened the diversity of both business and geographic spread producing both superior and more stable performance measures for the industry as a whole. As such, diversification of the industry's business

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markets. At the heart of this confusion is an unrealistic expectation that «real» earnings growth can be maintained at recent levels. This is coupled with a proclivity to punish viable firms that are settling into a mature phase of the growth cycle along with those that need

Table 1 - US securities industry



profile has in many ways better positioned it to manage through the uncertainties posed by market turmoil.

Financial strategy. In conjunction with a general diminution of exposures, industry-wide risk management models were also restructured to incorporate emphasis on stress-testing, credit standards were augmented and Value at Risk (VaR) trading volatility levels expanded to better reflect the potential consequence on revenues. While market trends have shifted focus away from the emerging markets, the industry's penchant for seeking out leading edge lucrative deals has not abated. This has been underscored recently by the rapid expansion of high yield bond underwriting and merchant banking equity investments in technology and telecommunication sector deals. The difference however has been the controlled nature of growth in on balance sheet illiquid assets since 1998 – particularly the positions of both the high yield and merchant banking portfolios. Fitch tracks levels of less liquid and illiquid as-

sets on a quarterly and annual basis. These include on balance sheet exposures to positions in high yield and emerging market debt, bank loans, merchant bank investments, goodwill and other assets, which are assumed illiquid (*see table 1 for more detail*).

The potential volatility that illiquid asset positions are famous for has been further mitigated by the Industry's reinforced capital base. Securities firms were active debt issuers during the lower rate environment – strategy that continued through the crisis of 1998. This materially increased levels of long-term debt and reduces rollover risk in the near term. Concurrently, they have maintained measures limiting the use of commercial paper and other market sensitive funding and expanded use of bank subsidiaries to issue deposits, and sweep money market funds into insured deposit products. The effect has been to further diversify and stabilize funding from rollover risk. It should also be noted that cash positions have been maintained at somewhat loftier levels than the pre-fall 1998 period (*see table 2 for more detail*).

The recent market environment has also raised concerns regarding credit quality and participation in shared national credits or syndicated loans in particular. Pressures within the syndicated loan portfolios have indeed materialized in recent quarters for both the investment and commercial banking sectors. However, any difficulties continue to remain isolated, are minor relative to capital and do not appear to be reflective of a large-scale deteriorating trend. Moreover, while very active in this business, the US securities firms have largely controlled exposure through the active sell-down of positions.

Gaining perspective

Given investor motives driving recent capital market volatility, it is understandable that concerns over the security industry's role and exposure have increased. That said, the industry's potential vulnerability to liquidity pressures needs to be analyzed in the context of both its business strategy and its overall financial condition.

The core business strategy that defines this industry is its role in seeking out new markets/industries in need of capital for growth. As these markets develop and expand their need for capital, the landscape to facilitate this burgeoning need becomes increasingly more competitive. As such, its function as an intermediary places the industry in a position of risk. Therefore, it becomes increasingly more difficult to sustain momentum in attracting lucrative transactions without expanding market share and taking on more risk. As such, it is expected that the investment banking community will continue to place

Table 2

Ratio of long-term funding sources as a percentage of illiquid assets

	1998	1999	May 2000	Aug. 2000
Bear Stearns Companies	238.81	435.35	486.07	392.70
Goldman Sachs Group	297.83	259.61	203.02	249.17
Lehman Brothers Holdings	116.77	235.70	417.96	427.12
Morgan Stanley Dean Witter	180.12	187.38	202.58	240.61
	1998	1999	1Q 2000	2 Q 2000
Donaldson Lufkin & Jenrette	111.45	93.62	96.95	107.11
JP Morgan	204.53	188.22	176.15	175.28
Paine Webber Group	230.79	348.18	319.74	241.88
Merrill Lynch & Co	216.00	249.34	278.09	306.61
Salomon Smith Barney Holdings	201.44	218.56	362.30	310.19

itself at the leading edge of this risk-taking tradition. While recognizing these risks, it is important to balance this with overall business strategy and financial condition. Fitch believes the industry to be well situated to defend against volatility and one-off pressures. While a general economic slowdown may be on the

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horizon, it does not by itself indicate a wholesale deterioration of credit. Recent quarterly financial performance remains fundamentally strong with some indication that the peak was reached in the second quarter of 2000. For the future, Fitch will be looking for signs indicating the presence of a blurred strategy that focuses more on aggressive/defensive positioning, as well as for signals that performance, with respect to financial management, asset quality and profitability, has fallen off-track. In the event competitive pressures are met with irrational strategies and weakened financial profiles, Fitch's outlook on the credit quality of the industry and its individual players will be revised to negative. But until such events occur our outlook will remain stable.

Limited risk diminished opportunity

Together with the ongoing strength of the general economy, the industry's strategy to expand its wealth management capabilities and stabilize its sources of recurring revenue is sound and is complimentary to traditional investment banking and trading businesses. This enhances financial flexibility. Viewed in conjunction with controlled exposure levels, it remains Fitch's opinion that the industry has limited the downside risk posed by the current market environment. Nevertheless, it should also be noted that current

market conditions indicate a return to normalized growth. This, for the time being, will have a humbling effect on the ability of the securities industry to generate underwriting and advisory volumes similar to those experienced through the current cycle. Fitch expects that increased competition will result and potentially lead to more consolidation. Whether it targets the energy sector, financial services (more consolidation) or concentrates on specific geographic regions such as the European continent, Fitch will be watching for changes in risk appetite and profile.

Other areas to watch

While in our opinion the events of the last few weeks pose limited risk to the sector, they are noteworthy and warrant continued monitoring. Those issues notwithstanding, Fitch is presently monitoring other factors, which pressure the credit ratings of the US securities industry. Of primary interest are the following:

- The expanded reliance on and continued evolution of the industry's risk management systems. Fitch will continue to review and critique the models utilized to measure capital exposure to market volatility, as well as pinpoint strengths or weaknesses in risk management systems measuring vulnerability to interest rate movements, market shocks and spread compression or widening;
- Increasing competitive pressures emanating from the commoditization of financial services. While securities firms appear to be in the cat-bird seat regarding movement of corporations from bank-dependent loans to capital markets, the increased competition from its commercial brethren has resulted in declining underwriting margins- particularly on the fixed income side;
- Lastly, Fitch sees the potential for rating actions from the restructuring of both the equity and fixed income markets. Emphasis will move away from transactions to customer service in the form of execution and access to research and risk monitoring tools. We suspect that this will result in ongoing capital expenditures for technological innovation and increased personnel, as well as the potential for increased risk-appetite in order to retain and meet the ever-expanding demands of clients. ●