What do investment banks do?

By Laurence Knight Business reporter, BBC News

Investment bankers make enormous profits from financial information - but what does it all mean?

Barclays' change of leadership shows the bank sees its future in investment banking.

Bob Diamond, the bank's new US-born head, made his name by growing its Barclays Capital division into a major global investment banking player.

But what is investment banking, why is it so controversial and why does it make so much money?

Adviser or dealer

Investment banks carry out two very different - and sometimes conflicting - functions in the financial markets.

Traditional "investment banking" refers to financial advisory work.

For example, a big corporation might ask for the bank's help if it wants to borrow money in the bond markets, or float itself on the stock market, or buy up another company.

In this capacity, the investment bank acts as an impartial adviser - like a solicitor or an accountant - using its expertise to help its client in return for a fee.

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But investment banks also do something else quite different - they deal directly in financial markets for their own account.

An investment bank's "markets" division makes money by buying financial assets from one client, and then selling them to another - often with a hefty markup.

Profit and loss

It is banks' capital markets whizz-kids who were behind the last decade's boom in "derivatives" - complex contracts that allow clients to speculate on financial markets.

For example, the investment bank may know a pension fund in London who wants to buy Russian mortgage debt, while its Moscow office may know a local home loans company.

The bank may offer to buy the Russian client's loans, and then sell them on to the London client through a derivative contract, but at a much higher price.

The profits on these kinds of transactions were enormous during the boom years - and have become enormous again during the recovery.

These transactions are supposed to be risk-free for the investment banks - it is the buyer who should end up with all the risk.

But as the demise of Lehman Brothers and others demonstrated, the business can contain many hidden risks that only come to light during a financial crisis.

Conflicts of interest

Goldman boss Lloyd Blankfein got a grilling from US politicians over his firm's behaviour unlike their colleagues in the advisory division, the salespeople and traders of the markets division do not have any obligation to take their supposedly sophisticated clients' interests into account.

This creates a well-known conflict of interest - the risk that confidential "inside" information given by clients to the investment bank's advisory people may be abused by the bank's traders.

For this reason, all investment banks are required by law to have a "Chinese Wall" that prevents information passing from the advisory division to the markets division.

However, the financial crisis revealed a new source of controversy - the US financial watchdog found investment banking supremo Goldman Sachs had misled clients into buying dud investments.

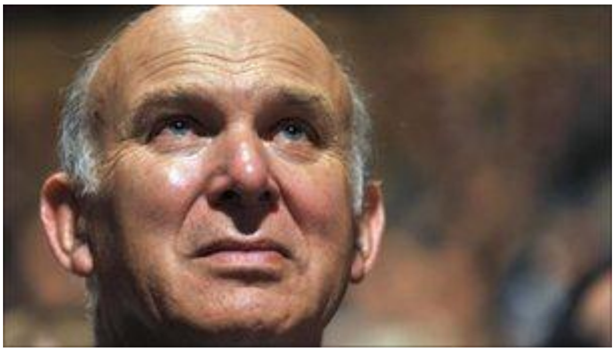
The case has led to calls by some US politicians for new rules that will ban traders at investment banks from exploiting their clients' gullibility.

Splitting up

Strictly speaking, what investment banks do not do is "traditional" banking - taking deposits from ordinary folk and making loans to local companies.

But that has not stopped most investment banks teaming up with a big retail bank.

Warburgs, Salomon Brothers, JP Morgan, Merrill Lynch, Bear Stearns are all big investment banks that have been bought up by High Street banks.



Business Secretary Vince Cable campaigned during the UK's elections for the banks to be broken up

Deutsche Bank and Barclays grew their own investment banks from scratch. Only Goldman Sachs and Morgan Stanley remain as pure investment banks.

By teaming up in "universal" banks like this, the investment banks can put all those retail deposits to much more profitable use.

But since the crisis, there have been calls on both sides of the Atlantic to split these banks up again.

In the US, former central banker Paul Volcker argued successfully that the government should ban these universal banks from their more risky activities that gambled depositors' money on global markets.

In the UK, the independent banking committee has been tasked among other things to look at the complete split-up called for by Liberal Democrat Vince Cable.

But some query the logic of the move. Lehman Brothers was a pure investment bank, not a universal bank, but that did not stop its collapse from nearly sinking the entire financial system.

Just deserts?

The level of profits and pay earned by investment banks far exceeds that at most other industries. Many wonder why.

Hard work and talent play a part. Bankers - particularly juniors working in corporate finance - are famous for working 12-plus hours a day, including weekends.

Bankers will argue that the high pay reflects the importance of their work. By channelling money from those who have it spare, to those who can put it to good use, Wall Street and the City help drive the investment that underpins economic growth.

But some may ask why - if investment banks make so much - other banks do not enter the market and undercut their profits.

Part of the answer is that very few firms have the necessary global reach. To make money, an investment bank must be able to match all kinds of investors and borrowers from all parts of the world.

Lehman Brothers' demise showed that the profits come with risks attached

The most profitable transactions usually come when a bank spots an opportunity to match buyers and sellers that nobody else has seen.

But others argue that much of the investment banks' reported profits are not real.

Because bankers are paid such big bonuses, they seek clever ways to report higher profits while concealing the true risks from their own management or shareholders.

And some may also ask whether a business that makes money through the creation of ever more debts has already reached the limits of its social usefulness.

Who's who?

- **Barclays**: Known in the UK as a staple high street name, the British bank makes most of its money in international finance these days. The bank had a "good" crisis, famously refusing bailout money from the UK government, then picking over the bones of Lehman Brothers.
- **Deutsche Bank**: Like Barclays, the German retail bank grew its massive markets division from scratch. Although headquartered in Frankfurt, the real centre of power and profits is London.
- **UBS**: The Swiss bank bought up Anglo-American investment firm Warburg, Dillon Read in the 1990s. But it took heavy losses during the financial crisis, which it was forced to explain by the Swiss government.
- **Credit Suisse**: UBS's big rival, the Swiss private bank's reputation was badly tarnished when the dotcom bubble burst, but it has come out of the 2008 crisis much stronger.
- **JP Morgan**: The blue blood US brokerage, which was bought up by retail bank Chase Manhattan during the credit boom, has weathered the financial crisis and its political fallout better than most.
- **Bank of America**: This big commercial bank came to the rescue of Wall Street firm Merrill Lynch during the financial crisis in a deal that turned controversial due to the scale of Merrill Lynch's losses, revealed only after the deal was sealed.

- **Citigroup**: Once heralded as the future model of universal banking, the US giant needed a special rescue package to avoid bankruptcy in 2008. Now it is widely criticised for being too big and unwieldy to manage.
- **Goldman Sachs**: Often credited with being the smartest investment bank, the Wall Street firm became a lightning rod for criticism in the US in the aftermath of the financial crisis.
- **Morgan Stanley**: Along with Goldman, the only pure investment bank to survive the financial crisis intact, although both firms converted into traditional "bank holding companies" in order to qualify for a financial lifeline from the US authorities.