The Role of Investment Banking in the Global Financial Crisis: Taking Goldman Sachs as an Example

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Abstract. Being one of the most critical crisis in the economic world, the financial crisis during 2008 has seriously influenced commercial activities on a global level. The impact includes but not limited to individuals, small corporations, and entire enterprises. Experiences from the crisis is valuable since the financial field was severely traumatized during the pandemic. In analyzing the arising phenomenon, the relationship between financial crisis and investment banks are especially worth of addressing, as investment bank is a form of business that is heavily dependent on commercial activities and capital stability. Those commercial activities covers range from stocks to mortgages. Given all the factors mentioned above, this research aims to illustrate the role of investment banking through literature review and critical analysis of data related to financial crisis. In hope of comprehensive insight of the issue, the thesis mainly addresses Goldman Sachs, which is ranked as one of top 5 international investment banks for the last decade.

Keywords: Investment banking; Goldman Sachs; Financial crisis.

1. Introduction

Prior to the global financial crisis occurred between 2008 and 2010, the globalization process has enabled rapid development of investment banking industry in terms of expansion in scale, opening up new markets in other sectors, and providing streamlined services to those businesses seeking equity and debt securities during mergers and acquisitions [1]. Hence, the significance of investment banking activities has become increasingly important for global financial system. However, as the financial crisis begins to influence global economy, the investors are switching their attitudes towards market from profit-seeking to risk adverse, which resulted in an overall decrease in financing activities. As the financing activities decline, the business for investment banking has dropped significantly. Therefore, in order to gain a deep understanding of the issue, this research aims to identify how investment banking industry is correlated with financial crisis and how does financial crisis affect investment banking activities. This could mainly be associated with the changes in revenue level of investment banking, changes in governmental regulative policies, and changes in investment portfolios. For financial crisis, investment banking activities are part of the commercial process, and could also influence the severeness of financial crisis in various aspects. Based on previous researches and using Goldman Sachs as an example, this thesis aims to provide a perspective that could reflex the correlation between investment banking and financial crisis, which will be elaborated in the following sectors of literature review, critical analysis, and reflection of issues related to financial crisis.

2. Literature Review

2.1 Definition and Features of Investment Banks

Differ from the conventional banking activities, investment banking offers services in relation to advisory services of merger and acquisition activities, trading, securities, merchant banking, and investment management [1]. By acting as an intermediate, investment banks could provide investors and capital seekers with the advice in complex financial transactions such as IPO, mergers and acquisition, and other capital activities [2]. Different from commercial banks, who receives interest from loans and other financial instruments, the main income of an investment bank lies within the fee they charge from those clients seeking professional service.

This corporate structure is developed from closely held private firms partnerships in the 1970s. As New York Stock Exchange changed its rules towards allowing banks to expand their work towards including investment banking activities in the mid-1980s, investment banks have been adopted by wholesale banks and bloomed as a promising business [3]. Therefore, the form of investment banks have changed from partnership companies to public companies.

The case of Goldman Sachs offers a similar development process, for it used to be a bank with partnerships and has changed into a large group company with a variety of operations. Nowadays, Goldman Sachs is a leading investment banking and securities firm operating on a global level that provides products such as investment banking, trading and principal investments, and asset management.

2.2 Overview of Financial Crisis in Relation to Investment Banking Activities

The influence of financial crisis towards investment banking activities could be further classified into different aspects of influence on profitability, influence on policy and regulations, and influence on business contents.

As it is mentioned in the article of Mamatzakis & Bermpei (2014), before the financial crisis, investment banking activities have been increasing rapidly on a global level [1]. This fact could be proven through data of profitability. In 2006, the earnings of investment banking contributed to 62% out of the total banking activities income in US, which could explain the significance of investment banking activities and its significance. Meanwhile, in UK, investment banking contributed to 30% of the total exporting activities income. However, as financial crisis hits, there has been a dramatic decline in business activities. US contributed to over 60% of the investment banking activities decline around the globe, while European countries contributed to 30% of the activities decline [4]. This could reflect the decline in profitability and activity level of investment banking during the financial crisis.

In addition, despite the great importance of investment banking activities for business activities, some countries have imposed strict regulations that limits the application of investment banking activities while reducing the risk in operation. For example, US has imposed regulatory act of the Dodd-Frank Act, which requires investment banks to raise their capital ratio in face of the credit decline. In this way, the risk of operation could be limited, while requirements for capital would also increase significantly. The act also banns investment banks from being merged with commercial banks through disallowing banking entities to engage in proprietary trading or owning the partnership of a private equity fund.

Not only has the financial crisis influenced profitability and policies of different governments towards investment banking, but it has also changed the social attitude towards investment banks and the service of investment banking activities. According to a survey performed by World Public Opinion that is quoted by Davies (2010), 79% respondents in UK has considered International bankers’ risk attitude towards the risk in their financial activities to be at fault [5]. In addition, 89% respondents in UK blame the risk seeking bankers in their own country for the initiation financial crisis. With this social attitude, activities surrounding investment banking would be perceived as more risky and more likely to result in failure. Hence, the irrational perception towards investment banking is more likely to result in cautious actions and reduction in investment banking activities [6].

2.3 Previous Studies on Investment Banking Activities and Financial Crisis

In previous studies, a variety of analysis have been laid out in relation to viewing the issue of financial crisis through different aspects. A majority of research has focused on how investment banks are being influenced under financial crisis. In the research of Mamatzakis & Bermpei (2014), they have attributed the decrease in investment banking activities to increase in risk adverse investment strategies and stricter policies [1]. In addition, it specifically pointed out how fees, liquidation, and risk could drive the performance of investment banks. Hence, it limits the ability for investment banks to expand their portfolio and engage in risk diversification managements.

Another aspects taken by researchers is how investment banks work as part of the elements in initiating financial crisis through implementing risky capital structure. In Davies's research (2010), not only does the book addressed how the general public consider investment banking to be one of the factors that leads to financial crisis, but the book also considers risky investment to be a triggering cause that resulted in the collapse of the economic world [5].

Last but not least, some researches have focused on how investment banking activities should aim for in the future after the financial crisis. In the research of Wójcik et al. (2019), it discussed how the investment banking centers on a geographical sector has changed after the financial crisis [4]. In their research, the changes in trends of investment banking activities has been identified after the financial crisis. When forming a new financial center, despite the fact that the leading center is still US with a significant distance from the rest of the financial centers, the ranking of other financial centers have changed, where countries such as Canada and China has increased their ranking of importance in investment banking activities. Meanwhile, previous leading centers such as Germany and Netherlands have dropped in ranking. The research attributed these changes to attitudes towards investment banking of these local businesses. In terms of Canada, the increase in ranking is attributable to their open and beneficial regulations that could boost performance.

3. Analysis of the Role of Investment Banking in the Global Financial Crisis

Based on the research provided above, the role of investment banking during global financial crisis could be described as follows.

3.1 Influence of Investment Banks on Debt Management and Equity Management

In accordance with the nature of investment banking, the shock on credit would influence their performance in terms of advisory for investors and corporations. After the financial crisis take place, one obvious trend is that demands for goods have decreased dramatically. Following the decline in consumption, entity economy has declined significantly in 2008, resulting in a preceding decline in monetary economy. Hence, capital expenditures in a variety of industries have declined. This in turn negatively affects the amount of corporations in need of an equity security or merger and acquisition advisory. It is argued by Kahle & Stulz (2013) that such changes influenced both companies that rely on credit and companies that do not rely on credit [7]. For those who seek funds from capital investment or debt, the loss of credit borrowing method has led to severe influence on commercial bank crunch. Not being able to obtain trustworthy information from the distorted market would result in the negative outcome in spending more than a company should on acquiring a debt finance [8]. In this way, the position of a investment bank would be challenged and distorted. For those firms that expect to rely on credit in operation, they are forced to reduce capital expenditures under the high uncertainty from financial crisis. Under a conventional situation, the healthy cash flow of a corporation would aid it in paying up credit borrowings and ensure the circulation in the financial system. However, with the rising uncertainty, corporations are more likely to hoard cash and hold on tight to the cash income the corporations have gained. This may increase the difficulty in credit circulation, which in turn affects the demands for monetary market, hence resulting in a decline in business for investment banks.

From the case of Goldman Sachs, it could be noted that failures related to financial crisis anticipation could influence the reputation and performance of an investment bank significantly. In previous history of the founding process of Goldman Sachs, it had encountered a decline in investment outcome of the Goldman Sachs Trading Corp due to risky investment on high leverage trusts due to stock market collapse in the 1920s. In the previous event, the reputation of Goldman Sachs has been severely influenced, which resulted in a negative image of the company and downturn in business. This failure was later altered by cautious management of the new CEO in 1950s. The managers of Goldman Sachs have commented that in order to ensure “long lasting greed”, it is essential for the corporation to value reputation by approaching investment opportunities with cautious actions [9]. However, during the financial crisis, Goldman Sachs’ attitude towards risk in financial instruments has given rise to moral and ethical considerations of how it might be suggestive to questioning outcomes. In the case proposed by Lartey (2020), it argued that Goldman Sachs has caused conflicts of interests between the investment bank and its clients through participating in insurance activities [9]. The case proposed in the article is Abacus 2007-AC1, where the deal enables policy holders to obtain insurance returns upon investment failure of their bet. If the bet was successful, the policy holders could gain high reward. If the bet failed, the policy holders may still get repayment. Such financial instruments would ensure the earning ability of investment banks such as Goldman Sachs, while creating conflicts of interests, since investment banks could earn from the deal in either way, it would not be as much interested in the positive outcome for their clients as the situation where it do not participate in such insurance schemes. In addition, such actions would increase risks in investment, and resulting in market failure in debt and equity investment.

3.2 Influence of Investment Banks on International Business

In addition, as a part of the international business, trade surrounding investment banks has also shifted in terms of influencing import and export, and influencing the dynamics between different financial centers and different nations. For key players in financial centers, they have a significant dependent on the active market as part of their foreign trade economics [10]. When the market is being influenced by financial instability, such export and import balance would be broken, leading to a change in export portfolio.

In addition, the performance of international banks would also influence national affairs. In the case of Goldman Sachs, its relationship with the Greek government has resulted in a masking of the true debt ratio of the government. The process is described as a way of pushing current liabilities partially to the future, which could result in a lower debt ratio than the actual figure. However, for the health of the financial system, this false image of the government financial situation would lead to misjudgments and more severe credit risks. As a member of the European Union, the Greek government is supposed to follow the Maastricht rules and control the budget deficit to at most three percent of their gross domestic product, and have a government debt ratio below 60%. However, Greece has failed to meet the requirements in the 2000s, with higher debt ratio and a 12% deficit [6]. Therefore, trade from the US bankers to Greece regarding their debt in swap deals could result in a more severe financial situation in the future. Despite the action’s legitimacy, this behavior is criticized for its risky nature and the difficulty imposed on global dynamics.

4. Issues Surrounding Investment Banking Frameworks

Therefore, in order to ensure the stability of investment banking activities and the stability of economic activities as a whole, the following issues and countermeasures are being addressed.

4.1 Government Regulations and Performance of Investment Banks

During the financial crisis, many governments have issued strict rules on debt ratio and credit sales. This has restricted the global and domestic performance of investment banks. However, after the crisis, with the slow recovery of financial activities, those regions with open policies are more beneficial under the recovery by receiving higher financial income. Therefore, despite the cautious procedures required for the financial system to avoid disruptions, a normal level of policy strict level should be identified for better ensuring the health of the financial stability.

4.2 Changes in the Operation of Goldman Sachs and Ethical Considerations

In the past, Goldman Sachs have overcome a sharp decline in investment outcome through employing stable operation methods.

Through the previous arguments, it could be seen that not only does the reputation of Goldman Sachs suffer from the financial risks imposed by risky deals, but the monetary market would also suffer from such actions. Hence, it has been proposed that investment banks should adhere to certain ethical regulations rather than solely pursuing profitability. For example, Davidoff et al. (2011) suggested that the top priority of an investment bank should be ensuring its trust with its counter parties [3]. In order to ensure the legitimacy of their action, the minimum action is that they should adhere to anti-fraud rules. In addition, it should adhere to the risks in trading and the nature of different financial situations to avoid taking aggressive moves towards financial decisions such as the Greek government debt scheme.

5. Conclusion

To conclude, investment banking activities are being severely influenced during the financial crisis by the long-lasting changes in policy and regulations and changes in risk attitudes in the market. Before the 2008–2010 global financial crisis, the globalization process enabled the investment banking industry to rapidly develop in scale, opening up new markets in other sectors and providing streamlined services to businesses seeking equity and debt securities during mergers and acquisitions. The impact of the financial crisis on investment banking activities can be divided into three categories: impact on profitability, impact on policy and regulations, and impact on business content. Many governments imposed strict debt ratios and credit sales rules during the financial crisis. This has hampered investment banks' global and domestic performance. Furthermore, as part of international trade, trade surrounding investment banks has shifted in terms of influencing import and export and the dynamics between different financial centers and nations. As a result, investment banking activities have taken a different approach after the financial crisis. In the future aspects, it is essential for investment banking regulators and managers to be cautious about their scope of operation as well as use high ethical standards during operation to ensure that their business can be performed with less risk.

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