A Brief Summary of the Demise of Drexel Burnham & How Investment Banks Have Changed

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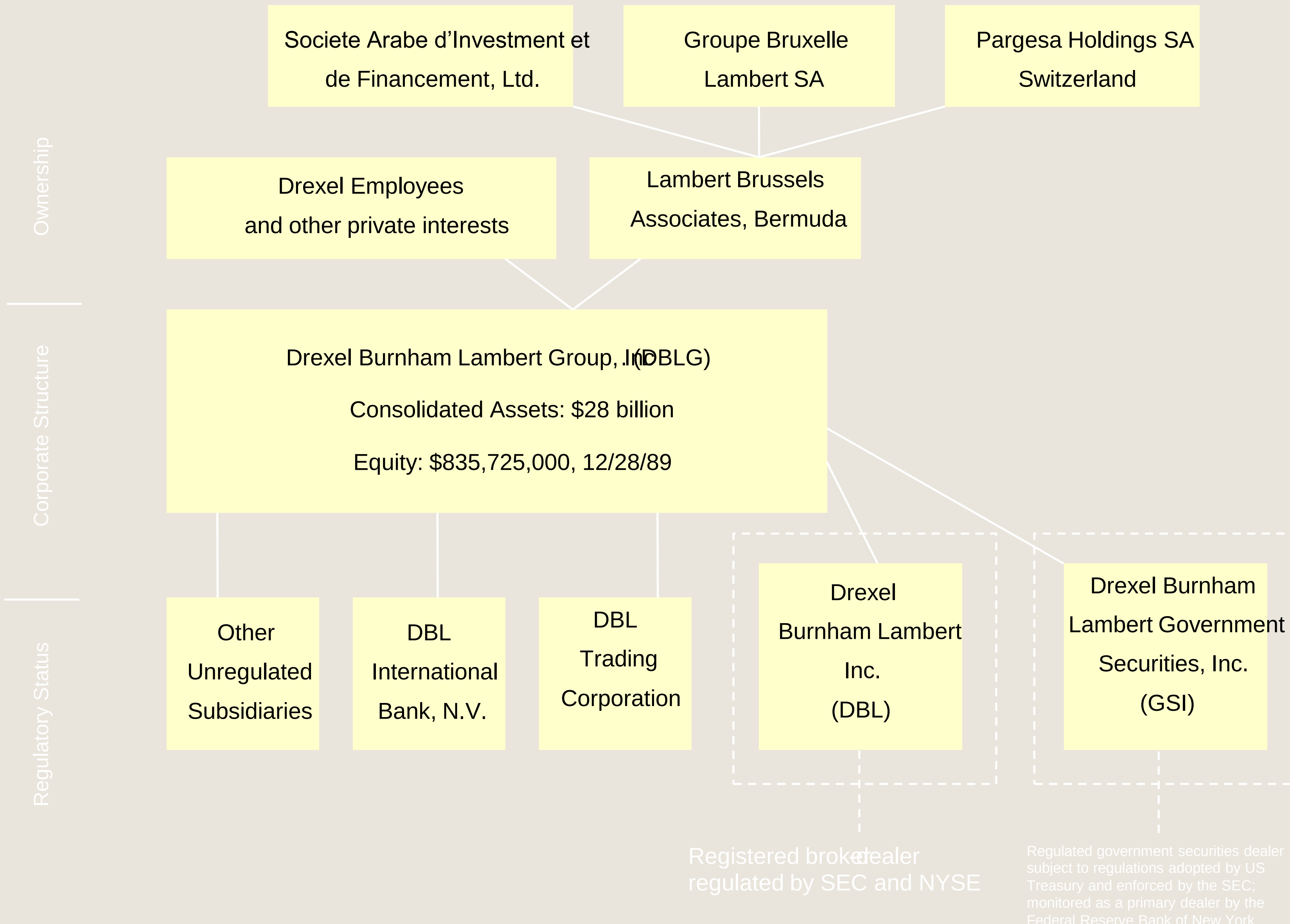
Drexel Burnham Lambert

- ✓ DBL was the most profitable investment bank on Wall St. during the mid 80s
- ✓ Main contribution: extended range of risk priced in primary bond markets
- ✓ Innovation made possible by development of active secondary market in junk bonds
- ✓ DBL mortally wounded 3/89 when pled guilty to 6 felony charges and agreed to pay $650 million in fines.

The Structure of Drexel Burnham Lambert Group, Inc.



The Collapse of DBL

- DBL financial structure became unsustainable
  - Junk bonds and bridge loans illiquid
  - Unable to roll over commercial paper
  - Like commercial bank without a safety net
- Prohibited from upstreaming excess capital in regulated subs
- DBL filed for protection under Chapter 11 bankruptcy procedures

Officials did not roll out the safety net

- ✓ Authorities protected the regulated subsidiaries
- ✓ Ready to counteract spillover effects
- ✓ Bank of England and Fed intervened to sustain clearing and settlement and facilitate unwinding of positions at DBL trading
  - Did not risk public funds
  - Did not attempt to support prices at which securities sold
  - Acted solely to prevent gridlock in the clearing and settlement mechanism

It could have been worse…

- ✓ Subsidiaries were transparently solvent
- ✓ Traders were not under suspicion & agreed to wind down positions
- ✓ Bank of England & Fed were trusted as an honest brokers

Disposition of DBLG

- A largely successful application of functional regulation
  - Customers of regulated subs protected
  - No serious contagion, even though entire group collapsed, even solvent subsidiaries
  - Dow Jones average finished above previous close on the day DBLG filed for bankruptcy

Traditional US view: investment banks do not pose systemic risk

1. Unlikely to be subject to a run, since customer funds not comingled with those of firm
2. They hold mainly marketable securities and should be able to deleverage rapidly without suffering illiquidity costs in the event of a funding shock
3. Access to systemically important large-value clearing and settlement systems was through large banks
   - Thus could rely on indirect regulation

The EU has long held contrary view

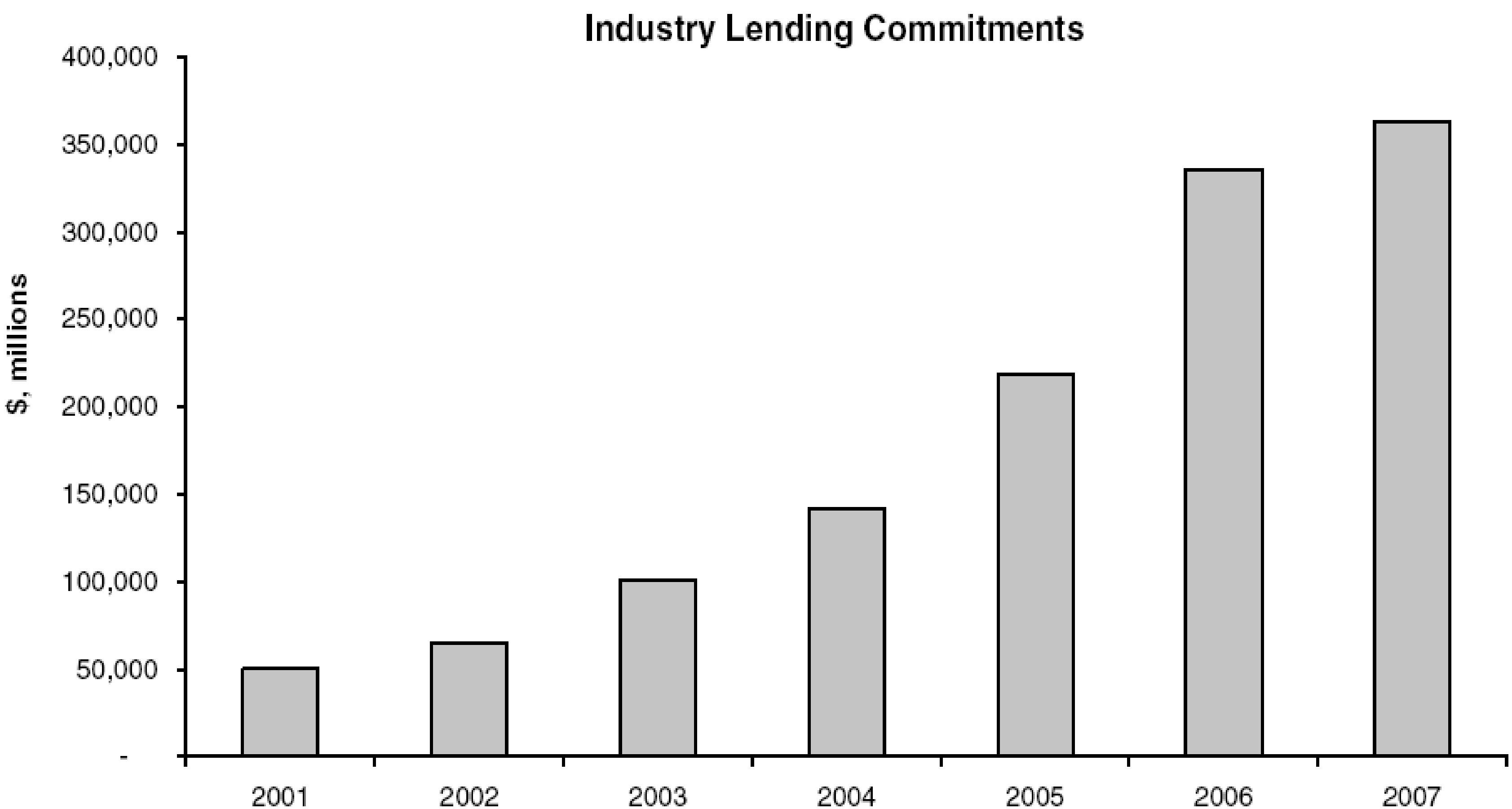
EU perspective

- ✓ Most of the largest European banks have long had full range of securities powers
- ✓ The largest US investment banks have established banking operations in the EU
- ✓ The EU has insisted that they be subject to consolidated prudential oversight comparable to that applied to large US banks
  - 5 leading investment banks agreed to be Consolidated Supervised Entities subject to Basel II like capital standards at the holding company level

What's changed?

Portfolios have shifted in favor of lower quality, less liquid assets

- ✓ More difficult to deleverage when funding shock

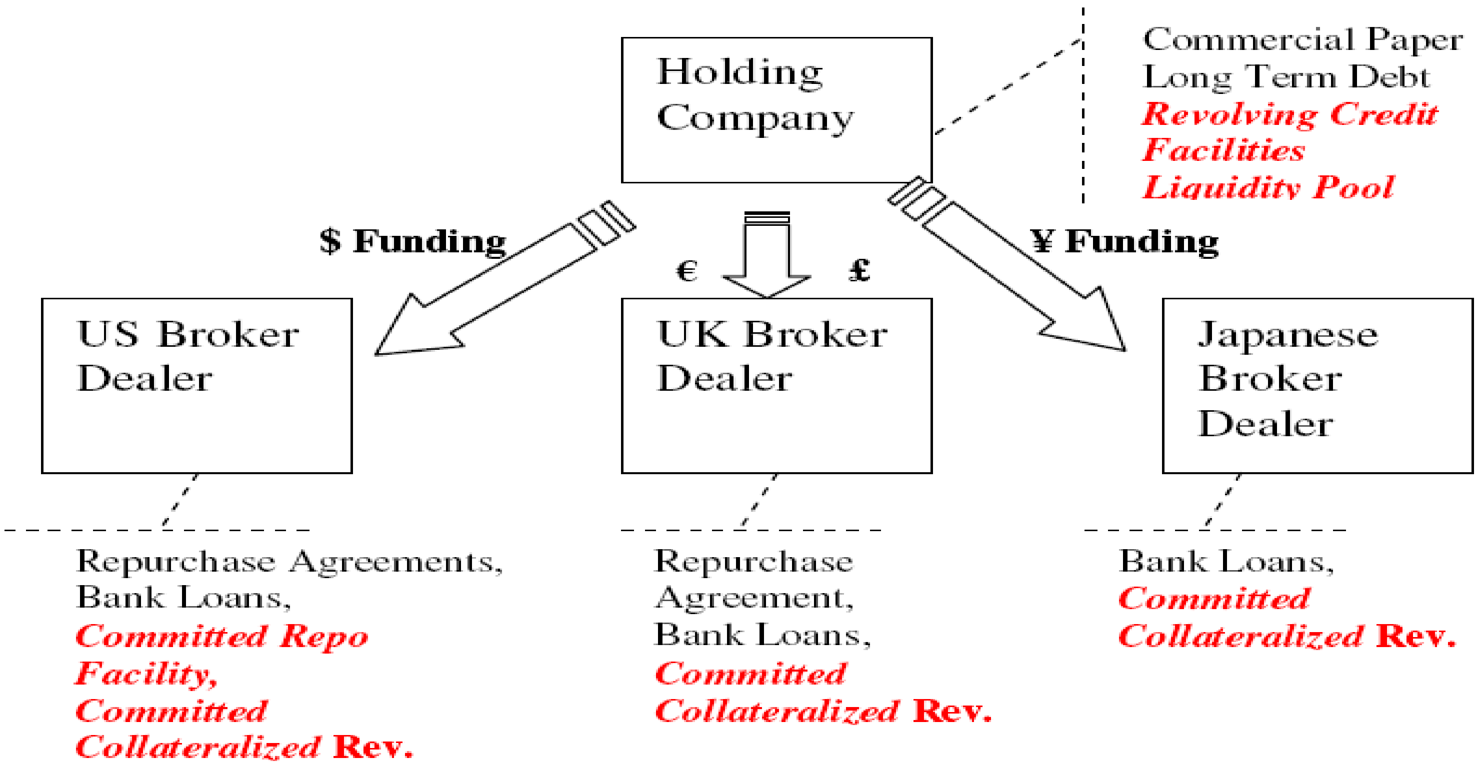


Source: Corporate Disclosures, Bernstein Analysis

Growing internationalization

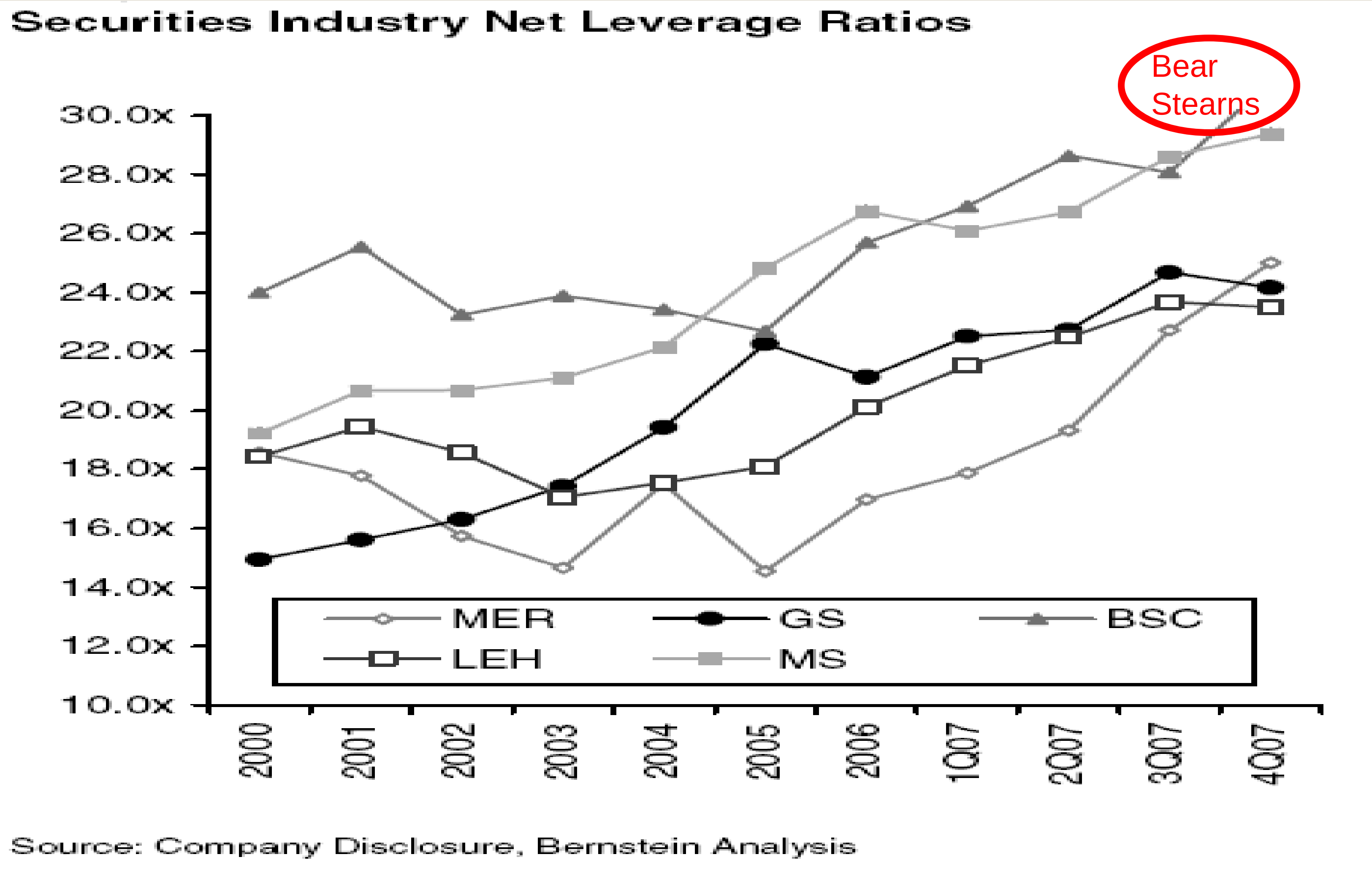
- ✓ Diversifies funding
- ✓ But increases coordination costs in event of a shock

Simplified Securities Industry Funding Diagram



Source: Bernstein Research

Increasing Net leverage



Growing reliance on 3rd party repos to fund b/s

- ✓ Remarkable growth in repo market since 1990
  - In 1990 secured repo credit was 13% of federally insured deposits
  - In 2007, secured repo credit was 60% of federally insured deposits
  - 2/3rd s of repos mature or must be rolled over o/n
- ✓ For 3rd Party term repos in broader range of securities must have confidence counterparty can provide additional margin when necessary