



Dominika Hempel (*University of Gdańsk*)

AMERICAN INVESTMENT BANKING IN THE CONTEXT OF GREAT ECONOMIC CRISES

The bankruptcy of Lehman Brothers had a strong impact on the whole financial system and started the worst recession since the Great Depression. However, it was not the first crisis in the history of the USA. The purpose of this article is to present the history of investment banking during the main crises in the US history and their impact on the American economy. The article presents the following: a definition of investment banking, theoretical aspects of crises, changes in banking system regulations, and the history of the most important American investment banks, including the infamous Lehman Brothers.

Key words: *economic crisis, investment banking, Lehman Brothers*

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INTRODUCTION

From time to time the economy is hit by economic crises. The 1930s were marked by the Great Depression that shook the global economy to its core. In the years 2007–2008 the world once again had to face an economic breakdown. The American economy collapsed as a result of the crash in the real estate market. The culminating point of the crisis was the bankruptcy of the Lehman Brothers bank. For the rest of the world, this was the beginning rather than the end of the crisis – it caused a domino effect that disturbed the global economy on an unprecedented scale. However, this was not the first financial crisis in the history of the United States to affect American investment banking.

This article aims at presenting the impact of economic crises on transformations of investment banking in the USA. It focuses on great econom-

ic crises, including the Great Depression and the crisis of 2007–2008, but also on the 19th century origins of investment banking in the USA.

THE DEFINITION OF AN INVESTMENT BANK

The word “bank” is most commonly used to refer to an institution whose activity involves taking deposits, lending money, and managing payment operations. Such banks are the core of the financial system and are also the most common banks. In English literature, they are referred to as “commercial banks”.

Investment banks, on the other hand, belong to a completely different group of financial institutions, as the scope of their operation is far from that commonly associated with banks. Investment banks, as opposed to commercial banks, are not involved with taking deposits or lending money.

What do they do then? By definition, an investment bank is an institution which secures sources of financing for its clients in capital markets [Kosiński B., Nowak A. 2011: 24–25]. Investors use the services of investment banks, rather than commercial banks, in order to locate resources in the securities market [Jaworski W, Zawadzka Z. 2002: 41]. One might say that investment banks act as brokers between people (entities) with financial resources which they want to invest and profit from, and those who need these resources to finance their activity. Most clients of investment banks are enterprises, wealthy investors, and governments. It is worth noting that the terms “investment bank” and “investment banking” are not synonymous. “Investment banking” refers to an area of financial services and products mainly associated with processing transactions in securities market, while an “investment bank” is a financial institution that performs these services.

THE HISTORY OF INVESTMENT BANKING

The history of investment banking in the USA dates back to the 19th century, which was a time of increased governmental demand for capital and rapid industrial development. Private companies were established, such as Riggs & Co., Clark Dodge & Co., Alex and Brown & Co, which act-

ed as stock brokers [Geisst Ch. R. 2009: 228]. These were the early days of investment banking, and its role significantly grew during the American Civil War, when the government needed more financial resources.

After the Civil War, investment banking was strongly connected with the development of railways. The 19th century in the USA was a time of large-scale development in rail transport [Szelągowska A. 2009: 22]. The construction of railroads, particularly long-distance ones, was a huge investment and required much financial resources. Many investment companies at the time underwrote securities for railway companies. One of the greatest bankers of his times, John Pierpont Morgan, largely contributed to financing rail investments. He assisted railway companies struggling with financial problems, which is why he had his share in the construction of 1/6 of all railways built at that time. When the railway boom came to an end, Morgan moved on to financing other enterprises, such as General Electric or U.S. Steel.

Early days of even the greatest investment banks were modest, as exemplified by the famous Lehman Brothers. In September 1844, Henry Lehman, a German migrant of Jewish origin, came to Ellis Island in New York, just like most people coming to the USA back then. From there, he set off inland. Shortly afterwards, he opened a small shop in Montgomery, Alabama, where he sold and bought various commodities. In 1850, his two younger brothers, Mayer and Emanuel, joined him. This is also when the family company started to operate under the name "Lehman Brothers".

In 1855, Henry went on a business trip to New Orleans, but he never made it there. On his way, he fell victim to the yellow fever epidemic and died.

His two brothers continued their joint enterprise. Shortly after, the company started its brokering activity in the cotton market, cotton being the main crop of the Southern states. This turned out to be a lucrative move. The company started to grow and shortly after the brothers opened their first office in New York. In 1869, Lehman Brothers and other cotton traders established the New York Cotton Exchange.

Cotton was not the only commodity that the Lehman brothers sold. They were also involved in sugar and coffee trade. Lehman Brothers was also a member of the Coffee Exchange and the New York Fuel Exchange. In 1887, the company started to operate in the New York Stock Exchange, and gradually explored the world of investment banking. In 1906, the company underwrote an issue of securities for the first time [*A centennial: Lehman Brothers*, 1950: 1-25].

At that time, Lehman Brothers entered into an alliance with a famous banker of the time, Henry Goldman, to broker the sales of commercial companies' securities, such as Sears and Roebuck. The company helped finance the quickly developing railway and mining industries, as well as the film and television industry in Hollywood.

Reviewing the history of particular investment banks, one is struck by the fact that the first ones were established as partnerships. A "partnership" can be seen as a company in which the partners jointly own the company and share the generated profit. That is why personal skills and characteristics of entrepreneurs (building relations with partners, advisory and negotiating skills, as well as the ability to analyze the market), their network of contacts, and the reputation they enjoyed were of crucial importance [Morrison A. D., Wilhelm W. D. 2008: 311]. This is how most investment banks functioned in the beginning. The case of the so-called Bulge Bracket (a group of five largest and most influential American investment banks) was no different. The group included:

- Bear Stearns: established in 1923 by Joseph Bear and Robert Stearns.
- Goldman Sachs: established by Marcus Goldman in 1869. Later the company was joined by Samuel Sachs and transformed into Goldman Sachs & Company.
- Lehman Brothers: established in 1850 by Henry, Emanuel, and Mayer Lehman.
- Merrill Lynch: established in 1914 by Charles E. Merrill. In 1915, he was joined by Edmund C. Lynch, and the company changed its name to Merrill Lynch.
- Morgan Stanley: established in 1935 by Henry S. Morgan and Harold Stanley.

The first thing one notices about these enterprises is the fact that the bank names are at the same time the names of their founders. In the early days of banking, there were no separate risk management units, so the partners managed the company together and were personally liable. Therefore, they were not too inclined to take out loans and preferred to rely on their own capital, which limited the options for expanding their business. In the 1970s, investment banks started to move away from this form of organization. At first, the investment banking sector was very fragmented, with numerous small companies. Over time, they started to merge, creating larger and larger organizations. The largest investment banks that transformed into joint-stock companies were: Merrill Lynch (1971),

Morgan Stanley (1986), Bear Stearns (1985), and Lehman Brothers (1994). The last of the Bulge Bracket companies to take this step was Goldman Sachs (1999). This allowed the companies to gain more capital, which in turn enabled them to enter new markets and expand their scope of operation. On the other hand, since they no longer relied on the owners' capital, they were more willing to take risks.

WHAT IS A CRISIS?

According to economists Charles Kindleberger, Hyman Minsky [Iwanicz-Drozdowska M. 2002: 35], and Frederic Mishkin [Mishkin F. S. 1992: 118], an economic crisis is a situation where disruptions occur in the financial market (including decreases in asset prices), the government must intervene in financial markets, people lose trust in the financial system, and banks and other financial institutions file for bankruptcy.

Hyman Minsky created a model of crisis comprising five stages [Iwanicz-Drozdowska M. 2002: 40]: displacement, boom, over-trading, revulsion, and tranquility. Displacement is the first stage involving an element of "shock". It leads to the expansion of the economy and increased optimism among investors – the "boom". Banks start to expand their loan offer, and investors want to make a profit, so they keep investing in the given sector. Excess of investment leads to over-trading on the market and the emergence of a "speculative bubble". At some point – referred to as the "Minsky moment" – the bubble bursts. This is when the prices of the assets (which earlier had been very profitable) start to decrease. Minsky calls this phase a "financial revulsion". This is when financial institutions go bankrupt.

Economic crises are as old as humanity, but with the development of financial markets and their globalization, they have recently become more frequent and more severe. The following countries suffered what are considered the most serious crises after the Second World War: Spain (beginning in 1977), Norway (1987), Finland (1991), Sweden (1991), Japan (1992), Russia (1998) and Argentina (1999).

Why, despite the existence of such advanced theories on financial crises, was it not possible to foresee the events of 2007 and 2008?

Since the 1960s, interest rates in the USA grew and in 1982, they reached their historic high. The period between 1965 and 1982 is called

The Great Inflation, characterized by large instability of financial markets. The Federal Reserve System (FED), which is a central banking system in the USA, enforced a very strict policy and maintained high interest rates. In 1979, Paul A. Volcker became the president of the FED Board of Governors, and his aim was to stabilize prices. He managed to decrease both inflation and interest rates.

The period that started in 1982 went down in history as the Great Moderation, a time when prices lowered and the economy started to rapidly develop. Neoliberal concepts had a significant impact on the economic policy, as they called for limiting the role of the state in the economy and loosening restrictions and regulations. This is the policy that the Reagan administration pursued in the years 1981–1989. In the USA and other developed countries, restrictions previously imposed on financial institutions were lifted. The Great Moderation was a time of economic prosperity and optimism, which lasted until 2007.

Neoliberal economic theories, which dominated during the period of the Great Moderation, were based on the assumption that the economy and financial markets were naturally stable, and did not predict the disaster that occurred in the 2000s. One of the popular economic theories of the time was the efficient-market hypothesis (EMH), formulated by Eugene Fama from the University of Chicago. According to EMH, the prices of securities always reflect all the relevant information [Fama E. F. 1970: 417], and that markets are rational. Therefore, it is impossible for any investor to buy low-value securities or sell them at an excessive price. The second theory was Robert Lucas's theory of rational expectations, which assumes that people make rational economic decisions, taking into consideration all the available information and historical data, which enables them to predict future events.

At that time, no serious crises occurred that would undermine the validity of these theories. Therefore, Minsky with his "speculative bubble" and other similar theories were not treated very seriously.

INVESTMENT BANKING AND ECONOMIC CRISES

In 1873, the American government decided to limit money supply, which resulted with lack of sufficient funding for the development of railways. As a consequence, many railway companies went bankrupt. During the "panic" (as crises were termed back then), one of the bankrupt banks

was Jay Cooke & Co, which financed the construction of Northern Pacific Railroad. The panic of 1873 was one of the first global crises. It started with problems regarding excessive, risky development of railroads, and specifically, with the bankruptcy of the Philadelphia and Reading Railroad. Deposit holders were concerned about the poor condition of the American economy and started to withdraw their deposits on a large scale. A bank run started, which caused many banks to go bankrupt. After the crisis, the economy only stabilized due to the intervention of J. P. Morgan [Morgenson G. 2011: 185–207].

In 1907, the so-called Bank Panic of 1907 started, generally considered to have been caused by the collapse of the New York-based Knickerbocker trust. As a consequence, people started to believe that other trusts can crash as well. Furthermore, clients of banks became concerned about their deposits and began to rapidly withdraw them, starting a bank run. As a result, many banks and trusts suffered, mainly those based in New York [Hafer R. W. 2005: 294]. This is when the famous American banker, J. P. Morgan, helped save several trusts and the New York Stock Exchange. Along with other bankers and financial institutions, he provided financial support to the affected banks and trusts. In early 1908, the situation was finally brought under control. The Panic of 1907 was short, but took its toll on the whole American financial system. In 1908, the Aldrich-Vreeland Act was adopted, which, among other provisions, established the Monetary Commission, entrusted with controlling the banking system and solving problems within it.

In 1912, Arsene Pujo became the president of a congressional committee for establishing the so-called money-trust – a group of powerful Wall Street bankers meant to control the American banking and financial sector. This group was to include J. P. Morgan. It is worth noting that the USA, one of the leading global economies and a country with an advanced financial system, did not have a central bank at the time.

As a result of the committee's investigation, the Federal Reserve Act was adopted to establish the FED. One year later, the Clayton Antitrust Act was adopted, which e.g. forbade directors from taking positions in two or more competing companies.

At the turn of the 20th century, investment and commercial banking started to come closer together. The large-scale economic development of the time resulted in increased demand for additional capital. The investment banking market was dominated by large companies, such as J. P. Morgan & Co., Kuhn, or Loeb & Co. In 1929, the Great Depression put

an end to this boom. As a result of the recession, production decreased in the USA, and unemployment started to soar – reaching 90% in some regions. The crisis did not spare the banking sector. It is estimated that several thousand banks went bankrupt at this time. The newly elected president, Franklin Delano Roosevelt, wanted to save the recession-hit country, and in 1933 introduced a program of reforms called the New Deal.

One of his first moves was to introduce a one-time, four-day bank holiday, during which all banks, including the FED, were closed. Right after that, the US government adopted the Emergency Banking Relief Act, which gave the government the right to restore, reorganize, and reopen solvent banks.

The Roosevelt administration sought ways to limit risks in banking. Their efforts resulted with the Banking Act of 1933 (commonly referred to as the Glass-Steagall Act or the GS Act, from the names of its authors – senator Carter Glass and representative Henry Steagall). Among other things, this act increased the liability of the federal government for the banking system, authorized the FED to set maximum interest that banks can pay on deposits and investments, introduced restrictions concerning loan speculation, and created the Federal Deposit Insurance Corporation (FDIC). More importantly, this act separated commercial banking from investment banking. The foundation for this act was provided by hearings held at the US Senate Commission called the “Pecora commission”, which investigated the causes of the American stock exchange crash. According to the commission’s report, the combination of standard banking activity (taking deposits and granting loans) and underwriting of securities leads to a conflict of interests, which resulted in promoting investments in low-quality securities [Kroszner R. S., Rajan R. G. 1994: 810].

Before the act was introduced, banks had been able to run both commercial and investment banking activities. Excessive involvement of these institutions in speculative transactions could threaten deposits placed in those banks. This was actually considered one of the reasons of the crash of 1929. Banks sometimes used deposits to back their investment activity.

The Glass-Steagall Act was meant to restore trust in the banking system. The act forbade commercial banks from underwriting, holding or trading securities, directly or indirectly. At the same time, investment banks were prohibited from taking deposits and granting loans.

Once the act had been adopted, financial institutions had to decide within a year whether they wanted to continue their operation as investment or commercial banks. For instance, J. P. Morgan & Co. continued as

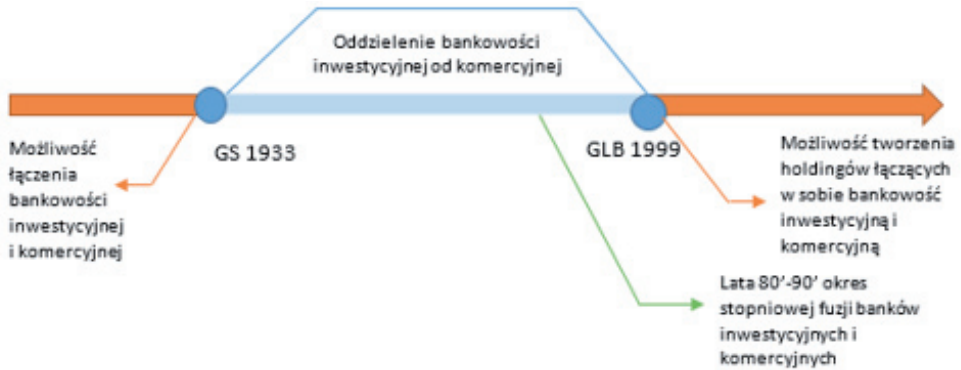


Figure 1. The process of separating investment and commercial banking

a commercial bank, but some of its employees, e.g. Henry S. Morgan (J. P. Morgan's grandson) and Harold Stanley decided to establish an investment bank – Morgan Stanley. The Glass-Steagall Act remained in force in an unchanged form in subsequent years, though at first, it was criticized by American banking circles. The law led to the separation of financial institutions involved in investment banking alone.¹ The Bulge Bracket banks focused on investment banking, as this had been their main area of operation.

The 1980s and 1990s in the USA were a time when commercial banks gradually started to engage in investment banking activity. In 1987, the first legislation change was introduced – commercial banks could create the so-called “section 20 subsidiaries” and generate up to 5% of their gross income from trading in specific securities. In 1989, this limit was increased to 10%, and in 1996, to 25% [Heffernan S. 2007: 29].

Finally, in 1999, the Gramm Leach Bliley Act (GLB Act) was adopted, which enabled the creation of financial holding companies (FHC) that could combine commercial and investment banking activities (Figure 1). The adoption of the new act was, on the one hand, supposed to provide

¹ In Anglo-Saxon countries (Great Britain, and later USA), a model was developed where specialized investment banks were separated from commercial banks, while in the main countries of continental Europe, the model of universal banking dominated. The most important European universal banks offering investment banking services include Deutsche Bank (Germany), Credit Suisse Group (Switzerland), and BNP Paribas (France). In Poland, the banking law allows banks to also trade in securities, and does not define the term “investment bank”. The largest Polish bank providing investment banking services is PKO BP.

a more stable business model for American banks, while on the other, it gave them a chance to compete with universal banks (such as the German Deutsche Bank) from countries where the two forms of banking were not separated [Stowell D. P. 2010: 32]. Some banks, for instance Goldman Sachs or Lehman Brothers, decided to hold on to investment banking as their main area of operation. At the same time, financial holdings involved in both commercial and investment activities emerged. These were for instance: City Group, J. P. Morgan, or Bank of America. The 1980s and the early 1990s were a time when modern investment banking was shaped.

No particularly severe crises struck in the years 1980–2000. The few that did occur were e.g. the crisis of the late 1980, the S&L crisis,² the “dot-com crash”,³ or the disturbances and insecurity in financial markets caused by the World Trade Center terrorist attack in New York. Incidentally, Lehman Brothers had their office in the WTC.

The above-mentioned US crises were often caused by a sudden withdrawal of client deposits, which was further intensified by the fear of insolvency of a given financial institution. People lost trust in the banking system and were concerned about their money, hence the bank runs. However, the crisis of 2007–2008 was more complex, caused by multiple factors, and, in contrast to previous crises, was not caused by a bank run and sudden withdrawal of deposits by clients. Nor was it a single event, but a series of crises that shook the whole financial system to its core. It was the most severe recession since the Great Depression.

THE CRISIS OF 2007–2008 AND AMERICAN INVESTMENT BANKING

According to the “Financial crisis inquiry commission report”, the crisis of 2007–2008 could have been prevented. It was not the result of uncontrollable natural forces or systemic flaws, but only of human ac-

² Savings and Loan institutions (S&L) were savings cooperatives which had existed in the USA since the 19th century. In the mid-1980s, due to less restrictive regulations, the number of S&L companies started to grow. Furthermore, they started to invest in risky businesses and commercial loans. As a result, over 1000 (more than half) of such institutions went bankrupt.

³ With the rapid development of the IT sector in the 1990s, the so-called “dot-com bubble” appeared. In 2001, the market of Internet companies collapsed. Some companies from this sector went bankrupt, and many investors lost money.

tions and negligence [The Financial Crisis, Inquiry Report... 2011: XVII]. Previous crises were often caused by increasing speculation in some assets. In this case, the “boom” stage in Minsky’s theory involved real estate. It is thought that the crisis was triggered by the speculative bubble burst in the US real estate market. In 2001, the FED gradually decreased interest rates. This encouraged Americans to take out low-interest mortgages, which produced a boom in the real estate market. Due to the low interest rates, many Americans thought it made more financial sense to buy their own house or flat rather than pay rent. The demand for houses grew, and so did their prices. Furthermore, mortgages were also granted to people with poor credit scores, who would not have been eligible under regular circumstances. These were the so-called “subprime” mortgages [Markham J. W. 2011: 391]. Furthermore, the American government wanted to enable less well-off people with worse credit scores to have their own houses [Lastra R. M., Wood G. 2010: 540]. Banks started to fuel the boom by giving mortgages, also high-risk ones. Additionally, modern financial instruments became more common. One thing was not taken into account, though – that for the first time in 50 years, real estate prices would go down.

Apart from that, a number of other factors contributed to the crisis: flaws in the regulatory and supervisory system for the financial sector, amendment of the Glass-Steagall Act allowing for combining investment and commercial banking and insurance funds again, as well as the existence of the “shadow banking system” that fell out of the scope of regulations [Friedman J. 2011: 18]⁴, globalization and excessive consolidation of the banking system, poor risk management, the “too big to fail”⁵ doctrine, greed, euphoria, lust for profit, and the subsequent shock and panic that only intensified the crisis.

This financial crisis changed American investment banking forever. Bear Stearns was the smallest of the five largest investment banks. As early as January 2008, the financial standing of Bear Stearns started to rapidly worsen. On March 14, 2008, J. P. Morgan Chase & Co. announced the

⁴ The shadow banking system included institutions that operated in the capital market beyond the scope of appropriate regulations [Friedman J. 2011: 18].

⁵ The doctrine stating that large financial institutions could not go bankrupt, as that their collapse would have major repercussions for the whole financial system. Therefore, their managers believed that, in case of trouble, the government would be forced to help them.

purchase of Bear Stearns. The FED played a large role in the conclusion of this transaction.

On September 15, Lehman Brothers announced its bankruptcy [Steward P. E. 2014]. This event was very controversial, and there are various theories concerning the combination of factors that caused Lehman Brothers to be treated differently than other institutions. First of all, no one wanted to purchase Lehman Brothers – this resulted e.g. from the lack of certainty regarding its financial situation and losses [Craig S. 2010: B8; *Report of Anton R. Valukas...* 2010: 620]. Talks with potential private investors, conducted until the last days and hours, did not bring a positive result. The case of Lehman Brothers turned out to confirm the “too big to fail” theory, as its collapse (contrary to expectations) did have massive repercussions for the whole financial system. Its bankruptcy initiated the worst stage of the crisis. Lehman Brothers became not only the largest financial institution to go bankrupt during this crisis, but also the largest financial institution to ever go bankrupt in the whole American history. The value of Lehman Brothers assets exceeded 2013 GDP of Poland, and amounted to 530 billion dollars. This enormous financial institution, with more than 150 years of history, will forever remain the symbol of the crisis of 2007–2008. On September 14, 2008, Bank of America announced its purchase of Merrill Lynch for more than 50 billion dollars. Merrill Lynch, one of the greatest investment banks in the USA, lost more than 45 billion dollars due to its mortgage-related operations [Story L. 2008: A1]. Merrill Lynch was involved in issuing subprime mortgage-backed securities. The same month, two other investment banks, Goldman Sachs and Morgan Stanley, announced their transformation into financial holdings.

CONCLUSION

The history of investment banking shows how vulnerable this sector is to any economic changes. Investment banking significantly affects the economy. Lack of appropriate regulations and their timely introduction can lead to crises that may affect the entire world. After the Great Depression, supervision over the banking sector became stricter, however, the loosening of regulations over time prompted financial institutions to pursue profits by taking excessive risks. Though the crisis of 2007–2008 started in the USA, its consequences spread all over the world due to globalization and international economic relations.

The crisis was finally resolved by the intervention of the authorities. The FED intervened directly in monetary markets to ensure their liquidity, and the American government provided capital injections to key financial institutions in order to alleviate concerns regarding their solvency. The consequences of the crisis still affect many people, and many governments and international organizations started to change their regulations to make sure it never happens again.

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Dominika Hempel – PhD candidate at the University of Gdańsk. Graduated from the University of Gdańsk (MA in History) and from Gdańsk University of Technology (MS in Management – Banking and Finances). Scientific interests include: history of Latin America (Chile), USA-Latin America relations, history of economy and banking.