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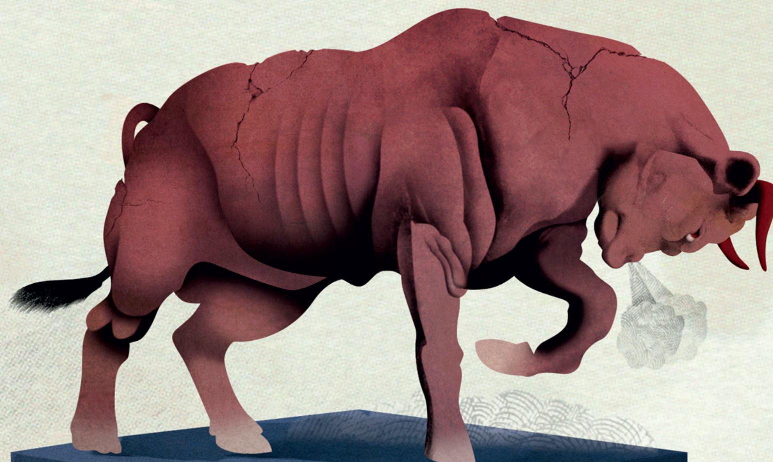
Twilight of the gods



Twilight of the gods

Investment banking faces a leaner, humbler future, says Jonathan Rosenthal, though a select few banks will emerge from the financial crisis even larger and more powerful

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FIFTY YEARS AGO this newspaper said that British banks were "the world's most respectable declining industry" and asked: "Has banking a future?" With hindsight, that analysis was spectacularly off the mark. Far from shrinking, banking across the rich world expanded prodigiously between 1963 and the financial crisis in 2008. By almost any measure it generated remarkable returns for shareholders and paid vast sums to its employees. Returns on equity (ROE), a standard measure of profitability, routinely ranged from 20% to 25% for the financial industry as a whole and often more for the most successful firms. Pay soared, too, not just for bankers but for most employees across the industry. Dylan Grice at Edelweiss, a fund manager, notes that last year 12 of the 50 richest Americans listed by *Forbes* magazine were financiers, asset managers or investors. In 1982 not one person on the list worked in finance.

Since the crisis, returns have collapsed. The Boston Consulting Group (BCG) reckons that ROEs for the world's biggest investment banks have halved, to about 10% in Europe and 13% in America. The outlook is even worse, with returns likely to fall to 6-9% as new regulations bite.

Views about growth and profitability in the financial sector are polarising. "From the outset there were two camps," says Brady Dougan, chief executive of Credit Suisse, a large Swiss bank. "One, probably the majority at first, that hoped and believed that this would all blow over, and another that figured the industry and regulatory landscape had changed permanently. We always believed that the changes would be far-reaching and permanent. As things have developed, more and more have realised that things are not going back to the old ways."

The extraordinary growth of finance before the crisis both fed on and fuelled a rapid rise in private-sector debt in rich countries, where banking assets increased from an average of about 50% of GDP in the 1960s to around 200% of GDP by the late 2000s (see chart, next page). In countries with large international banking sectors, such as Britain, bank assets swelled to about five times GDP. In Iceland and Switzerland they peaked at eight to ten times GDP. In America, where Main Street has been far bigger than Wall Street, the ratio of banking assets to GDP more than doubled in the 15 years leading up to the financial crisis, to 126%.

Balance-sheets expanded ever faster ahead of the financial crisis. Andy Haldane, the man in charge of financial stability at the Bank of England, notes that during the century up to 1970 bank assets in 14 big economies grew at a rather stately pace: on average just 0.6% a year faster than GDP. Yet after 1970 the ratio of assets to GDP increased by about 3 percentage points a year, doubling within a few decades.

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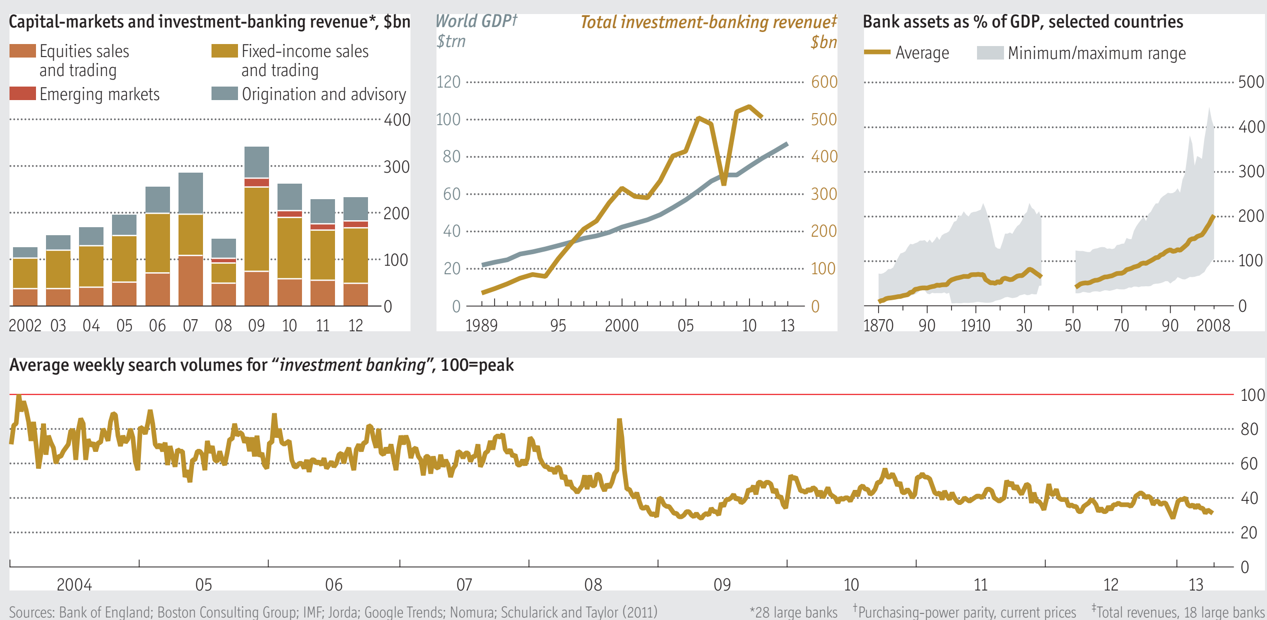


Sources: Bank of England; Boston Consulting Group; IMF; Jorda; Google Trends; Nomura; Schularick and Taylor (2011) *28 large banks †Purchasing-power parity, current prices ‡Total revenues, 18 large banks

Most of the reasons for this unusual growth were positive ones. As large companies started doing business in ever more countries, they needed large banks that could follow them across borders, financing factories, paying employees and hedging their exposure to currency movements or interest-rate changes. In the 12 years before the financial crisis, world trade increased from 22% to 33% of global GDP.

Deregulation of banks and markets and financial innovation played a part too. New ways of financing homes through the use of mortgage-backed securities lowered the cost of borrowing for millions of households in rich-world economies. Large sections of the population that had been unable to borrow found they could buy homes for the first time.

But there was excess, too. Of the millions of homes being financed, a worrying proportion was bought by people who had no hope or intention of repaying their loans. The slew of useful financial innovations also included some designed mainly to allow banks to sidestep regulation and take on more risk with their shareholders' (and taxpayers') money. Bankers should take most of the blame for these excesses, but central banks and regulators too were partly responsible for the waves of credit that rolled through the economy in the early 2000s, inflating banks' balance-sheets and bankers' pay. Loose monetary policy in rich economies encouraged risk-taking and pushed up leverage.

Perhaps the most pernicious influence came from an unexpected quarter: the elegant framework of capital rules known as Basel 2. Widely considered the pinnacle of effective bank regulation, these had aimed to calibrate precisely the amount of capital that banks had to hold against the probability of each loan defaulting. Yet they unwittingly encouraged banks to hold vast quantities of "risk-free" assets that turned out to be anything but.

Most of the finance the expanding banks provided, and the innovations they fostered, spurred economic growth, but a good chunk of it just inflated the size of the financial sector as banks created ever more securities to buy and sell from one another. McKinsey, a consultancy, reckons that about a third of the increase in the world's debt-to-GDP ratio in the years before the crisis came from banks increasing the size of their balance-sheets; bond issuance by banks during this period was about five times larger than by companies. This trend accelerated after 1995, with only a quarter of the increase in debt to GDP coming from households and companies, an "astonishingly small share, given that this is the fundamental purpose of finance", McKinsey says.

In an IMF paper published in June 2012, Jean-Louis Arcand, Enrico Berkes and Ugo Panizza find strong evidence for the conventional view that the expansion of bank balance-sheets (and private borrowing in general) helps drive economic growth. More surprisingly, though, they also note that once private borrowing gets close to 100% of GDP it starts to slow down growth. Another paper, by Stephen Cecchetti and Enisse Kharroubi at the Bank for International Settlements, reaches strikingly similar conclusions. "At low levels, a larger financial system goes hand in hand with higher productivity growth," the authors write. "But there comes a point—one that many advanced economies passed long ago—where more banking and more credit are associated with lower growth."

Too big to succeed

Most bankers bristle when asked whether the finance industry is already big enough (whether measured by the size of its balance-sheet or by the amount of business it does and the fees it generates) in relation to the rest of the economy. Yet that question is central to the industry's future. Last year the investment-banking industry generated total revenues of about $233 billion (see top left chart), about a third less than at its peak of $341 billion in 2009. The figures fluctuate a great deal, so too much should not be read into a single year's results. In 2008 the industry's revenue was only half the previous year's, but in 2009 it more than doubled from that low level, reaching a new record. However, it has remained depressed since 2010 and has had a weak start in the first quarter of this year, a season when banks usually make about a third of their annual revenues.

Bankers who think that the finance industry will continue to grow at least as fast as the underlying economy, or faster, argue

that increasing wealth in both rich and developing countries will create more financial assets that can be bought and sold. They also point out that increasing banking penetration and debt in developing countries as legal and financial systems mature will allow people to borrow against the value of their homes or land, and companies to sell bonds and shares to expand.

One of the optimists is Jamie Dimon, chairman and chief executive of JPMorgan Chase, America's biggest bank. "Investible assets are going up, they're not going down. Global trade is going up, it isn't going down…the underlying trend [for investment banking] is up," he recently told analysts on a conference call. "Over time it will grow." Mr Dimon is far from alone in forecasting healthy growth for the banking industry.

Glenn Schorr, an analyst at Nomura in New York, neatly summarises much of the thinking among senior investment bankers. He notes that financial-services revenues have generally been closely correlated with world GDP, and thus ought to do at least as well as that in the future. Michael Poulos of Oliver Wyman, a consulting firm, thinks that financial services are luxury goods, with demand growing faster as countries become richer.

The worst is yet to come

Ranged against these positive factors, though, are powerful forces that could hold back both the growth of the industry and its profitability. The first is the disappointing economic growth across much of the rich world. This is cyclical and will change in time, but the downturn is proving more protracted than most bankers expected. Record low interest rates across much of the rich world are also taking their toll, depressing returns on most assets and dampening the volatility that generates profits in many trading businesses. Michael Sherwood, vice-chairman of Goldman Sachs, says: "Investment-banking revenues are likely to remain static in the near term, so we are focusing on maintaining performance levels and identifying where there are opportunities for us to increase market share."

More enduring structural forces are also at work. The most immediate of these is a raft of regulation that will fundamentally change the business of investment banking. Higher capital standards that have already been agreed to but are not yet fully in place will force banks to shrink their balance-sheets and will make many of their businesses far less profitable. Regulations that are still largely on the drawing board will make investment banks easier to break up, less able to use cheap retail deposits to fund their trading business and to take risks and, as a consequence, less profitable (if safer).

Another threat facing banks is the march of progress. Just as competition has made cars, flights and computers cheaper and better over time, banking too is under pressure to offer more and charge less. Thanks to new technologies such as algorithmic trading systems, many of the jobs formerly done by bankers are now carried out by computers that do not up sticks to join rival firms or demand large bonuses. Moreover, many of these systems are being bought by banks' clients, allowing them to trade directly with one another or to demand keener foreign-exchange rates or cheaper interest-rate swaps.

Ken Moelis, a veteran banker who now runs his own firm, recalls that when he started in the industry in 1981 at Drexel Burnham Lambert, a firm that pioneered the high-yield bond market, "there wasn't another firm in the world that knew how to price a junk bond," so issuing and trading them was enormously profitable. These days, he says, they can be traded and their prices discovered electronically down to three decimal places. Commissions and spreads, the revenues that banks can make from trading, have already been relentlessly compressed in the simpler parts of their business such as trading shares or exchanging currencies. The squeeze on margins is now spreading to more complex businesses such as bond trading and derivatives.

This environment will create both winners and losers. The main beneficiaries are likely to be a handful of very big, global banks that, in the main, are able to reap the benefits of scale and combine investment banking and trading with corporate banking. Geography will favour banks with big home markets and friendly regulators. Among those that seem likely to do well will almost certainly be JPMorgan, which has managed to dominate most big capital markets. Another is Goldman Sachs, the investment bank that almost all rivals would like to emulate because of its dominance in equity trading and a reputation for smartness that have helped it attract many of the best minds in banking. Two less obvious candidates are Citigroup and HSBC, both of them big commercial banks that in the past have found it hard to compete in investment banking. They will benefit from their large global networks and their close relationships with corporate clients.

The future of Europe's main contenders seems more in flux. Switzerland's two biggest banks, UBS and Credit Suisse, have been forced by regulators to pare back and are faced with the difficult task of becoming both smaller and more profitable. Barclays and Deutsche Bank, the region's two "flow monsters" (with huge trading volumes based on clients' orders), have continued to expand through the crisis, but their home markets are suffering from anaemic growth and expansion abroad is becoming more difficult as new regional competitors pop up in fast-growing emerging markets. New regulations in America will also make life harder for domestic and foreign banks there.

At the risk of repeating this newspaper's mistake of 1963, this report will argue that investment banking's most profitable days are in the past. This is not to say that the industry's revenues will not bounce back from their current low levels. There is bound to be some growth as the banks' corporate clients regain their appetite for takeovers and start selling bonds and shares, and as rising equity markets lure investors back into trading more. Yet these revenues are unlikely to return to their recent peaks in the near future, and ROEs have almost no chance of getting back to their lavish pre-crisis levels of 25% or more. Indeed, even the banks' more modest goal of returning 15-20% to shareholders seems elusive in view of the sea of new regulations. ■

Regulation

The bite is worse than the bark

New regulation poses a threat to investment banks, and more is on the way

"THE MOOD AMONG investment banks that I talk to…is such that they expect that the regulation is over, they expect that they will be able to keep growing their balance-sheets, that they will be growing bigger than ever," says Axel Weber, chairman of UBS, Switzerland's biggest bank. As a former president of Germany's central bank, he is well placed to take the temperature of both bankers and their overseers. "The mood among the regulators I talk with is more like 'we haven't even started'."

Swiss banks such as UBS and Credit Suisse may have a particularly jaundiced view of regulation; after all, they have been subjected to some of the toughest capital rules in any rich country. Their central bank and regulator have made it clear that they would like the country's two big banks to shrink and to trim their investment-banking arms. Yet the Swiss capital requirements that seemed so shocking when they were first introduced in 2010 now seem much less outlandish as regulators the world over consider imposing similarly high capital standards or other draconian rules.

The new medicine comes in three flavours, none especially palatable to bankers. All regulators are set to administer at least one, but some insist on two or even all three. The choices are higher capital and liquidity rules; restrictions on activities such as trading for their own profit; and structural changes such as forcing banks to "ring-fence" their retail banks from their trading businesses or to reorganise global businesses into national subsidiaries.

Start with the capital cushions that banks everywhere are being forced to plump up under the new rules known as Basel 3. These will require all banks to have equity buffers about three times larger than the minimum under the old Basel 2 rules by 2019. The world's biggest banks, such as JPMorgan, Citibank and HSBC, which regulators consider to be the most systemically important (and thus capable of causing the most chaos if they were to fail) must have still thicker capital cushions.

The very biggest, most interconnected or complex of them must hold an extra 2.5% of equity capital on top of the 7% that is becoming mandatory for most other banks. This rule was designed to discourage banks from getting bigger or more complex and is likely to have a significant impact on their profitability. McKinsey reckons that the average return on equity for the world's 13 largest investment banks may fall to 6-9% by 2017. This is well below the cost of equity (the return that shareholders would expect for investing in banks, say, instead of brewers).

Get it over with

Two unintended consequences of the new rules are already emerging. First, banks are boosting their capital much more quickly than regulators had expected. This may be making the banking system safer that much sooner, but it is coming at a cost: instead of asking their shareholders for more equity to boost the ratio, many banks are shedding assets and cutting back on lending instead. Second, banks and their investors seem to be ignoring the carefully calibrated scale of capital charges, and all big banks are now promising to increase their capital to reassure their clients and creditors. "It's a race to 10% and beyond," says Anshu Jain, a co-chief executive of Deutsche Bank, Germany's biggest bank. "By 2014 we will all be Basel 3 compliant," almost five years ahead of schedule.

The new rules partly deal with an important flaw in the old Basel 2 regime: basing the amount of capital required only on the riskiness of a bank's assets. This seemed sensible enough when the rules were first drafted, but soon led to perverse outcomes and has not yet been resolved satisfactorily. If banks held assets that were judged to be risk-free, they could have as many of them as they liked without worrying about the overall size of their balance-sheets or the thinness of their capital cover. That generated an insatiable appetite for highly rated bonds, issued by the most creditworthy governments or companies. When the supply of these ran out, which it soon did, the finance industry quickly set about manufacturing new forms of AAA-rated securities such as collateralised debt obligations (CDOs) that bundled inferior assets together, sliced up the risks associated with them and packed them into different tranches so that losses would first hit those holding the riskiest slices. By combining loans that were thought unlikely to default simultaneously and concentrating the risks of defaults into the dodgiest slices, banks had supposedly created a whole new class of ultra-low-risk investments. Rating agencies were complicit in this, too, as they helped banks structure these securities to attract the highest ratings.

The average return on equity for the world's 13 largest investment banks may fall to 6-9% by 2017. This is well below the cost of equity

A second pernicious outcome of the old rules was that they turned investment banks from intermediaries to proprietary traders. Two decades ago investment banks were in the money-moving business. They used capital markets to shift funds from savers to borrowers and generally avoided taking too much risk onto their own balance-sheets. Investment bankers would quip that a long-term investment was a short-term one gone wrong.

Yet over the decade before the financial crisis investment banks switched from the moving business to the storage business. Take the growth in Goldman Sachs's balance-sheet between its IPO in 1999 and the financial crisis, which is fairly typical of what happened at investment banks at the time. The balance-sheet ballooned from $231 billion in 1999 to $1.1 trillion at the end of 2007. The bank's value at risk (VAR), a (deeply flawed) risk-management measure of how much it might lose in any given day if markets turned against it, increased from an average of $39m in 1999 to $138m by the end of 2007.

At the time investors, far from being alarmed, were egging banks on. In 2005 Credit Suisse, among other banks, was pressed by investors to increase its exposure to residential mortgages. It also increased the number of people it employed in proprietary trading by 20%. To be fair to the bank, it reduced its risk and leverage before the crisis (and earlier than most of its competitors), which helped it avoid losses. Most other banks did not. Total holdings of corporate bonds by investment banks that are primary dealers (a who's who of banks that are big in trading government bonds) increased from under $40 billion in 2001 to more than $230 billion just before the crisis.

To be sure, at least some of this increase may have been offset by undisclosed positions elsewhere, and some was because banks were building up holdings of bonds to facilitate trades by ▸▸

their clients. Mr Dimon says that if he were running a shoe shop, he would have to stock a range of different shoes. Since he runs a bond shop, he needs an inventory of bonds. Yet much of the increase in banks' holdings of securities was nothing more sophisticated than a massive "carry trade" in which banks borrowed cheaply using short-term money markets and put the money into riskier, longer-term and illiquid assets such as corporate bonds or mortgage-backed securities. This made the trading of bonds, currencies and commodities, usually known as FICC (fixed income, currencies and commodities), the biggest and most profitable part of investment banks' business, of which more later. The risks to this strategy became clear when banks' creditors stopped rolling over the cheap loans and banks could not sell their assets quickly enough to repay them. With the new regulations starting to bite, banks are now slimming down again.

Will Volcker rule?

The rules forcing limits on the businesses that banks can be in are generally less developed than those on capital, but they could have far-reaching consequences. Among these is America's Volcker rule (named after Paul Volcker, a former chairman of the Federal Reserve), which proposes to stop banks trading for their own profit. For now, many American banks are either ignoring the proposal or are thinking up clever ways to evade it. But even if banks find ways round it, it will still outlaw a range of activities that accounted for a good chunk of American investment banks' profits in recent years. It is affecting European banks, too, as their executives sniff the political wind and close down businesses before they are made to. The threat of litigation is also significant, particularly in America and Britain, where banks are paying billions in fines and compensation for sins of the past.

The main barrier to the adoption of a Volcker rule outside America is its fiendish complexity: it forces regulators to second-guess whether a bank has bought a bond with the aim of keeping it, or whether it was hoping to sell it on to a client immediately but could not find a buyer. Yet regulators in Britain have said they are watching the evolution of the rule closely, and if it works they might impose something similar.

Another threat comes from rules that will force banks to standardise many of the derivatives they offer and to push them onto clearing houses and exchanges. This, along with capital rules that penalise complicated and long-dated derivatives written by banks, will cut deeply into FICC revenues.

Higher capital requirements and a ban on proprietary trading will reduce banks' profits and force them out of businesses that they were never particularly good at, but they do not pose an existential threat to the future of big investment banks. The same cannot be said of two further sets of rules now on the drawing board which deeply worry European bankers. They could dash the hopes of Europe's remaining big investment-banking contenders, Barclays and Deutsche Bank, of being able to go on challenging the dominance of America's biggest banks.

The first of these is a proposal to separate investment banking from retail banking. In Britain the split will probably be a "ring-fence" in which the retail-banking arm is roped off, whereas continental Europe is debating variations of a plan by Erkki Liikanen, the governor of Finland's central bank, to separate banks' trading operations. Both proposals are meant to ensure that retail deposits cannot be used to finance investment-banking businesses. If implemented, both are likely to raise European banks' funding costs. "Potentially Britain falls away [as a home to internationally competitive investment banks] because it doesn't seem to want big global banks," says the boss of one large universal bank. "The Swiss have already fallen away and Germany is still making up its mind. America has made it clear it wants to be in the game."

Meanwhile in Washington, DC, another set of rules is taking shape that could have a serious impact on Europe's investment-banking industry. These would force big foreign banks operating in America to establish local holding companies for all their American subsidiaries. These would have to have their own capital and liquidity, whereas the current arrangements allow foreign banks to operate through thinly capitalised branches or subsidiaries backed by guarantees from their parent companies. The rules seem to point directly at the American operations of Deutsche Bank and Barclays, both of which have shuffled assets and deregistered their main American holding companies over the past two years to sidestep new capital requirements.

For American regulators the proposed rules are perfectly sensible: if a big European bank collapses on their doorstep, they do not want to have to ask its home country for money. Yet the rules will impose huge additional costs. Huw van Steenis at Morgan Stanley reckons that Deutsche Bank had a capital deficit of $20 billion in its American business before it deregistered its American holding company. This shortfall could probably be reduced to $7 billion-9 billion over the next few years, he says, but the new rules could still trap a significant share of Deutsche Bank's capital in America. And the worry is not simply about America. If other regulators were to follow its lead and force all foreign banks to hold capital and liquidity locally, the era of financial globalisation would be over. ■

Equity trading

Going broke in stocks

Trading equities is barely profitable these days, but many banks are carrying on regardless

IN APRIL 1859 a revolution of sorts swept through Paris, or at least its bourse. At the instigation of the market's regulated brokers, about 20 unlicensed stockbrokers (*coulissiers*) were arrested and had their papers seized. But the blue-blooded *agents de change* of the Paris Bourse found themselves under attack from their clients, who wanted to continue to do business with the unlicensed brokers. Not only were they cheaper, but they could take risk and make markets instead of simply matching buyers and sellers. "The affair caused such a commotion that the government got frightened," a correspondent reported at the time. Within days the unregulated brokers were freed.

Scraps between well-heeled established brokers and enterprising interlopers are as old as trading markets themselves, but competition in share trading has probably never been as fierce as it is today. Since 2007 the revenue generated by trading shares has fallen consistently in every year bar one. Equity trading, once a mainstay of investment banking, now makes up less than a fifth of the industry's revenue and an even smaller share of its profit. Its relegation is partly due to the spectacular rise of banks' FICC (fixed income, currencies and commodities) businesses, which have become their most profitable parts.

Yet equities are the canary in the coal mine. The fall in the sector's trading volumes and the relentless squeeze on margins, revenues and profitability augur badly for large parts of banks' debt businesses. Five years after the financial crisis, share trading is barely covering its cost of capital. Its investors would do better putting their money in the bank than buying shares in it.

Not buying, not selling

The global financial crisis, the recession in Europe and worries over the euro zone and America's fiscal cliff have greatly reduced companies' appetite for takeovers and mergers and for issuing debt or shares for expansion. Most institutional investors, too, have preferred to sit on their hands. Since the financial crisis average share volumes traded in America, still the world's biggest equity market, have fallen by about 37%. One reason is economic uncertainty; another is that investors are shifting their money from active fund managers, many of whom trade shares furiously in the hope of beating the market, to passive investments such as simple index trackers, which buy and hold an underlying basket of stocks to match the market's movements.

The most disruptive of these may be the humble exchange-traded fund (ETF), a kind of mutual fund that can itself be traded as a share. This has grown explosively over the past few years. McKinsey reckons that the value of assets in exchange-traded products (defined somewhat more widely than ETFs), which in 2010 was about $1.5 trillion, will more than triple by 2015.

Equities businesses are also facing strong pressure on margins. JPMorgan Chase's Mr Dimon notes that 30 years ago it cost an average of 15 cents to trade a share; in 2011 the same trade would have cost about 1.5 cents. The pace of change is accelerating as deregulation has allowed stocks to be traded across many different trading venues, as well as in secretive "dark pools" set up to allow the anonymous exchange of large blocks of shares. New technology, too, has played its part as trading has shifted from people to computers. Algorithmic trading and high-frequency trading (HFT), virtually unknown until about six years ago, now account for almost 70% of the flow of orders on the main exchanges.

The rise of HFT and algorithmic trading has improved liquidity in most big and highly traded stocks as well as in frequently traded currency pairs in foreign-exchange markets. Spreads between the buying and selling prices of a share have narrowed considerably (see chart 1). The advantage has shifted from brokers or banks with fast-talking salesmen and traders to those with the fastest computers and the best algorithms. "It's computer against computer," says Paco Ybarra, the global head of Citi's markets business. "It's basically an arms race."

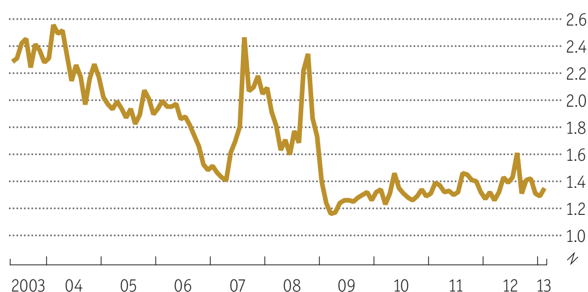
This war of the machines is fundamentally altering the distribution of profits and revenues within the industry. Under the old model of employing human traders, some would be excellent, some poor and most average, so they would generate average earnings. With algorithms and high-speed trading the stakes are higher because the fastest computer, or the one with the best algorithm, can take a disproportionate share of trading profits.

Technology has had a curiously contradictory effect on the trading of shares and derivatives. On the one hand it has lowered barriers to entry, allowing for the creation of new electronic entrants and market-makers such as America's Getco and Europe's Optiver. These have undoubtedly helped reduce spreads and increase the volume of shares traded. Yet not everyone is convinced that this liquidity is helpful to big institutional investors. BlackRock, a huge asset manager, frets that much of it is "phantom liquidity" that quickly evaporates when investors try to buy or sell significant numbers of shares, usually known as "blocks". Being able to trade big blocks is important for asset managers because they may want to raise or lower their stake in a company without affecting prices in the market or tipping off their competitors. In a recent report BlackRock said that trading in blocks consisting of 10,000 or more shares in a single company now makes up less than 7% of the total trading volume of S&P 500 companies, down from nearly 50% in the early 1990s.

Much of this decline is due to the widespread adoption of algorithmic trading. If specialist electronic market-makers and high-frequency traders can dice blocks of shares into hundreds of tiny trades that they scatter around the market, so can institutional investors. Yet part of the reduction is because most banks are allocating less capital to equity trading and are less willing to take on the risk of trying to move these big blocks. That reduces their opportunity to earn juicy spreads rather than modest commissions for carrying out the basic paperwork or trading. "Banks and brokers are our partners," says Richard Prager, global head of

Coming down in the world 1

S&P 500 median bid-ask spread, US cents



Source: Knight Capital Group

The greater a bank's market share, the better it is able to sense shifts in the mood of the market

trading at BlackRock. "We need their liquidity, their intellectual capital and their products, but if we have to take the execution risk, then the market tips to an agency model where we pay a commission and not a spread."

The challenge for investment banks, then, is to be able to take on execution risk from clients but without having to dedicate too much capital to it. Here again it helps to have a large share of the market. The greater a bank's market share, whether it is trading bonds or currencies, the better it is able to sense shifts in the mood of the market and the more easily it can match buyers and sellers. That gives it an advantage in working out how risky a bespoke transaction might be, for instance, if a fund manager asked it to sell or accumulate a large block of shares without tipping off the rest of the market. And the more trading a bank does, the more it is able to invest in better and faster systems. The share of equity trading controlled by the five leading banks (Goldman Sachs, Morgan Stanley, Credit Suisse, JPMorgan and Bank of America) has increased by about one percentage point each year for the past few years, reckons Matt Spick, an analyst at Deutsche Bank. Estimates of the total for the five vary somewhat: Mr Spick thinks it is at around 44% but Brad Hintz, an analyst at Bernstein Research in New York, puts it at about 49%.

Pity the bit players

Smaller banks are struggling to cover their fixed costs and are more likely to misjudge risk. "If you're a top three player you can probably achieve a cost-to-income ratio of 85%" (about the minimum to be profitable), says Kevin Buehler of McKinsey. "If you're not top three it is very hard to make a positive return given what you have to spend on technology to stay current."

Since few firms are making money trading equities, why are so many still in the business? Many heads of investment banking are hoping for a rebound in markets and think they can hold on without allocating huge amounts of regulatory capital to the business. If it bounces back it will offer high ROEs, and if not, well, that will be their successor's problem. Yet banks' reluctance to close down businesses that are not profitable "keeps decent industry-level returns as remote a prospect as ever", says Deutsche Bank's Mr Spick.

"How long are my competitors going to keep investing in businesses where they shouldn't because they still have an expectation of world domination?" asks the boss of one universal bank, suggesting, naturally enough, that others should be cutting back, not him. To be sure, cutting back is not without its risks. Some bankers say they want to keep their equities-trading businesses because they are intertwined with and complementary to other things they do, such as offering advice on mergers or helping firms raise debt and sell shares. They fear that if they start unpicking the loss-making parts, their entire operation might unravel. "If you go back in time, no one really exited anything," says Jamie Forese, the head of Citi's institutional-clients group. "People worried that if you limited your geographic reach or product spectrum you'd poison the rest of your ambitions."

UBS, for instance, has sharply scaled back the debt side of its business but is still determined to stay in equities, without which it would lose ground in wealth management. Even cutting costs within the equities business is difficult. Take the dilemma over what to do with equity analysts. Providing first-rate research on stocks is one of the few ways in which investment banks can gain big institutional investors' attention. Corporate clients are also more likely to turn to a bank for advice if they think its analysts understand their industry.

But good analysts are expensive, and large stocks may be followed by as many as 40 of them, so it is hard for them to stand out from the crowd. Their pay has come down as investors are trading less and squeezing commissions. Investment banks' research departments also face competition from boutiques such as Autonomous Research, which charges investors a subscription instead of getting paid through trading commissions.

So most brokers are quietly cutting down on the quantity or quality of the research they produce, perhaps by having fewer analysts and getting them to follow more companies. "Research analysts are probably working harder than they've ever worked, and are earning the least they've earned in at least the past 15 years," says Simon Hayes of Odgers Berndtson, a headhunting firm. Others are reducing the number of companies and industries they follow.

One way of making research pay is to combine it with providing investors with high-level access to companies. Yet the conferences and road shows at which fund managers can meet companies are becoming commoditised, and regulators frown upon them. Earlier this year Britain's Financial Services Authority said it would take action against asset managers that rewarded investment banks for arranging meetings with company executives. Many of the executives themselves are also disenchanted when they realise that they are the product the investment bank is selling. "They're no more than a high-end logistics service," says the head of investor relations at one large company. "They get me good rates on hotels and send a limo to the airport to collect me."

Some banks are now starting to question whether they want to stay in this business. "The days of having 20 firms all saying they wanted to be the top three are over," says Bob Gach of Accenture, a consulting firm. Royal Bank of Scotland closed its equities business in 2012, and Nomura, which had bought the Asian and European businesses of Lehman Brothers in the middle of the crisis, last year retreated from equities trading in some markets. Others are sharpening their focus. Barclays, which had bought the American bits of Lehman Brothers, is cutting back in several areas of its investment bank.

All this would be bearable if other parts of the industry were expanding. But investment bankers face an even steeper drop in revenues and returns in an area which in recent years has been the beating heart of their business: the trading of bonds, currencies and commodities. ■

Fixed income, currencies and commodities

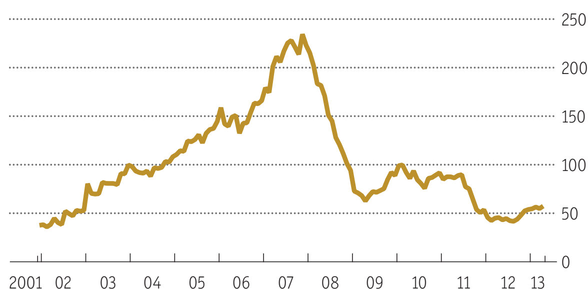
A FICC for your trouble

The beating heart of investment banking is ailing

"LOOK AT THAT," barks a senior executive at one of the world's biggest banks, stabbing his finger towards a blinking number on one of the six computer screens above his desk that shows the spread (or profit for banks) on trading dollars for yen. "We're already down to four decimal places. It can't get any narrower than that." If relentlessly declining margins are a serious concern for banks in the equities business, they are even more of a worry in fixed income, currencies and commodities (FICC), which has become the bread and butter of investment banking over the past decade.

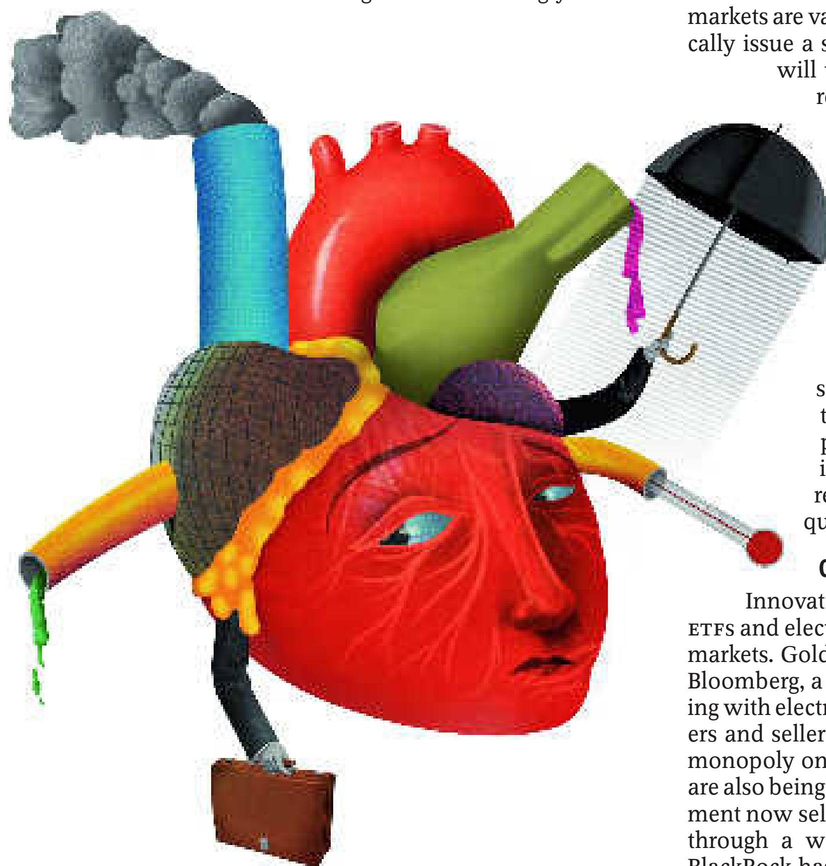
It is slightly misleading to think of FICC as a single business, since it consists of a disparate group of businesses ranging from trading low-risk government bonds to owning crude oil. What they all have in common is that they involve trading. For big banks, FICC revenues are dominated by trading government and corporate bonds and the currencies of the world's main economies. In this respect FICC is the oldest business line in investment banking. The Rothschild family had built the world's biggest bank in 1825 largely by lending money to governments.

Yet FICC's spectacular growth over the past two decades was fuelled mainly by the ballooning of bank balance-sheets that regulators unwittingly encouraged. An industry that as recently as 2000 earned twice as much revenue trading stocks as it did trading bonds ended the decade heavily dependent on FICC. Big capital-markets banks such as Citi, Deutsche Bank and Barclays now derive about two-thirds of their overall investment-banking income from this source. For Goldman Sachs, which is among the most respected banks in equities trading and advising on takeovers, FICC accounted for a mere 17% of its revenue in 1998, but a decade later it had become its largest and most profitable business, making up 35% of its revenues.



Source: Federal Reserve

Escalating debt and the expansion of bank balance-sheets have played a part in this, but so has complexity. Margins on the debt side of investment banking have generally held up much better than they have on the equities side mainly because debt markets are vastly more complicated. Large companies will typically issue a single class of shares, and any subsequent issues will usually be completely fungible with the ones already outstanding. Yet companies will often issue tens if not hundreds of different sorts of bonds, and even the simplest issue will differ from the previous one because interest rates will have changed and it will have a different maturity. This provides rich pickings for bond traders as buyers will often have to hunt around to find exactly the bond they want. Gaël de Boissard, the head of fixed income and Europe, Middle East and Africa at Credit Suisse, points out that there are 38,000 different corporate-debt securities in America alone, only a few of which trade every day of the year. But pressures for simplification are rising. Investors and issuers want it in order to lower costs and improve liquidity, and regulators want to make sure they can clean up quickly if a large bank fails.



Cutting out the humans

Innovations that have transformed equity markets, such as ETFS and electronic trading, are also making their way into debt markets. Goldman Sachs, UBS, Morgan Stanley, BlackRock and Bloomberg, a financial-data and news firm, are all experimenting with electronic bond-trading networks that try to match buyers and sellers. Primary dealers, who in the past had a virtual monopoly on the issue of new government bonds in America, are also being dislodged from their perch. The American government now sells about 20% of its debt through direct bids placed through a website according to calculations by Bloomberg. BlackRock has recently launched a series of fixed-income ETFS ▸▸

that will mature after a set number of years, like ordinary bonds. These will bundle together baskets of illiquid corporate bonds into liquid instruments that will pay out on a fixed date.

There is also pressure on the profitability of banks' derivatives businesses, another of FICC's traditional moneyspinners. The most far-reaching of these will be to force banks to move many of their derivative contracts with clients to central counterparties in a bid to reduce the systemic risk of a big bank blowing up. These rules threaten to erode the profitability of derivatives businesses as they make the cost of hedging clear for clients.

Together with the new rules on capital, liquidity and proprietary trading, these changes will hit banks' revenue as well as their profitability. Deutsche Bank's Mr Spick thinks revenue will drop by 6% this year and Mr Hintz at Bernstein reckons that the new rules may slash ROEs in trading businesses to 5-6% from their current level of 13-14%. Other analysts expect a more muted effect. Morgan Stanley and Oliver Wyman forecast in a recent report that the changes in derivatives markets will cause revenues to fall by just 3-5% in the period to 2015.

What banks do best

Not all of these changes will make lifer harder for banks. Centralised clearing and the simplification of derivatives may threaten to cut margins by as much as 40% in some of the most opaque parts of the business, but they may also increase trading volumes and will allow banks to shed much of the risk that they would previously have carried on their balance-sheets, freeing up capital.

That should enable many banks to turn back to their core role of intermediation and making markets for clients in illiquid securities, which they have neglected somewhat in the past few years. Corporate-bond inventories among primary dealers in America have fallen to below $60 billion, from $230 billion before the crisis, and almost all big European investment banks are shedding assets. As a result, hedge funds and other investors complain that they have found it more difficult to trade. "There is a lack of liquidity in stuff that used to trade like water," says a senior manager at a big hedge fund.

Investors' appetite for liquidity should benefit firms that are willing to offer a price for a security, even if there is no immediate buyer, and to guarantee to provide a security at a fixed price, even if there is no immediate seller. "There is a reason that market-making exists," says Citi's Mr Ybarra. "If it didn't and people sat down to invent something to make markets work better, the thing they would invent is banks."

Those banks that have capital should in time be able to benefit as weaker banks fall by the wayside. Yet there will also be increased competition from other financial players. Some of the task of providing liquidity has shifted to specialist market-makers and high-frequency traders. However, they generally take only intra-day risk and are unwilling to accept large blocks of securities that may be on their books for days or weeks. That may open up opportunities for hedge funds and other new providers of liquidity to step in if margins are attractive enough.

The advantages of scale are already evident in the growing dominance of the biggest banks. Concentration on the debt side of the business is increasing even more rapidly than in equities. Mr Spick reckons that within three years the five biggest banks will control more than 55% of total revenue, up from less than a third in 2008. "Trading is becoming a game of attrition as weaker players shrink capacity," says Mr Hintz. "Decisions to call it quits appear to be accelerating." Most banks are being forced to cut back and shut businesses in those areas where they do not have scale. That is offering ample opportunity for the biggest banks to grow bigger still. ■

Why scale matters

We happy few

Investment banking is increasingly becoming a game of winner-takes-all

MOST INVESTMENT BANKERS think a lot of themselves, but they seldom crow about their competitors' troubles in public. So it came as a surprise when Gary Cohn, the president of Goldman Sachs, told a press conference in Brazil in April that banks other than his and JPMorgan were "taking a pretty substantial step back from the markets" in a way that had not been seen "in the entire history of banking".

He was not exaggerating. Across the world the investment-banking industry is caught up in an unprecedented wave of deleveraging and deglobalisation. In large parts of the rich world most banks are shrinking their balance-sheets, retreating from foreign operations and closing businesses. This is dramatically reshaping the industry. In future it will increasingly be polarised into, on one hand, a handful of global "flow monsters" that stand astride global capital markets, and large numbers of much smaller regional and domestic banks on the other.

Patriotic deleveraging

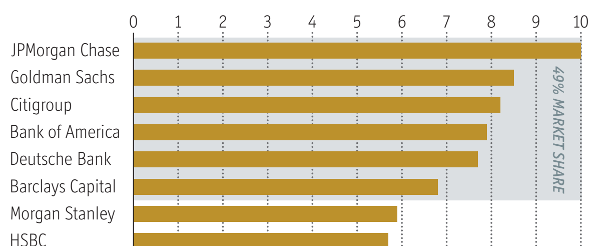
A report by McKinsey last year found that cross-border capital flows (including bank lending) collapsed to about $4.6 trillion last year from $11.8 trillion in 2007. This drop in cross-border banking is being encouraged by bank regulators, which are pressing banks to shrink but still supplying credit to their domestic markets. That is leading to what Morgan Stanley's Mr van Steenis has called "patriotic deleveraging". Of the $722 billion in assets and operations that commercial banks have sold off since 2007, almost half were in foreign operations.

This is being most keenly felt in Europe. Back in 2007 the biggest European banks (including Barclays, which bought the American operations of Lehman Brothers the following year) came close to rivalling America's banking giants, with a 22% share of global investment-banking revenues. Last year Europe's share of global revenues had slumped to 17%. Since the crisis European banks have cut their cross-border lending by some $3.7 trillion, and their retreat is far from over. In a recent report the IMF estimated that this year banks in Europe may cut their assets by about $2.8 trillion.

The most obvious reasons why European banks are having to pull back much faster than American ones are the region's ▸▸

The heavyweights 3

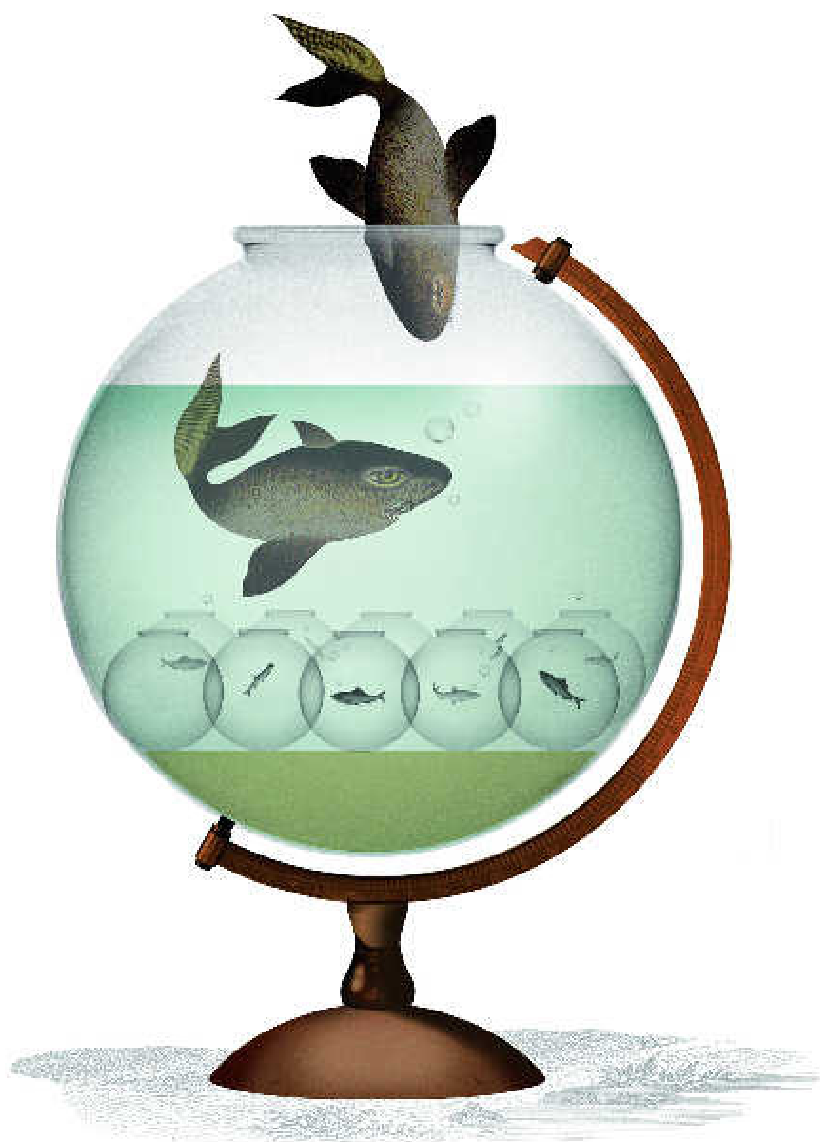
Investment banks' global market share by revenue*, 2014 forecast, %



Source: JPMorgan *FICC, equities and investment-banking division

economic slowdown and worries about the survival of the euro. Yet these have also brought to light an underlying structural disadvantage suffered by Europe's banks: the currencies in which they can take deposits and most easily raise funds are not the main currency of global trade. When American investors took fright at the euro crisis in early 2012 they stopped rolling over dollar-based money-market loans to European banks, forcing them into a sudden retreat from big markets such as providing trade finance in Asia and Africa.

European banks have also been quicker to implement the Basel 3 rules than their foreign competitors, so the consequences have hit them sooner. This will level out soon enough, but for the moment some American investment banks are able to expand their balance-sheets even as European ones are forced to contract theirs. "Every big bank in the world has a gun to its head," says Nomura's Mr Schorr of the new capital rules. "But the Europeans have the biggest guns."



Slimline in Switzerland

The banks that have retrenched most are Switzerland's two big investment banks. Previous bosses had hoped to build them up enough to join the world's five largest, but the current heads of both say they are happy with the more slimline versions. "It was time for UBS and its shareholders to consider different ways of doing investment banking, given the lack of success and the changing regulatory requirements we've had," says Sergio Ermotti, UBS's chief executive.

Credit Suisse changed strategy just before the onset of the financial crisis. It has cut its balance-sheet from almost SFr1.4 trillion ($1.1 trillion) in 2007 to little more than SFr900 billion now and plans to shrink it further still. Its main focus now is on "capital-light" businesses where it has scale. UBS has cut back dramatically in most of its FICC businesses and now hopes to make most of its money from wealth management. It will keep a foot in investment banking only in areas where it is strong and where the rules do not require huge allocations of regulatory capital, such as trading currencies and shares or advising on takeovers.

Both Swiss banks moved sooner and faster than rivals, not least because both have strong wealth-management businesses to fall back on, but many think that the rest of the investment-banking world will be going the same way. "The essence of what we are doing is not because we have a Swiss regulator, it is because we are applying Basel 3," says Mr Ermotti.

British banks have been forced on the retreat, too. Royal Bank of Scotland was once ranked among the world's ten biggest investment banks by revenue after an audacious (if ill-conceived) expansion before being felled by the crisis. Now majority-owned by a government unwilling to let it risk taxpayers' money in trading markets, it has had to draw back. Barclays, which had methodically built up a strong franchise in trading debt, saw the demise of Lehman Brothers as an opportunity to catapult itself into the ranks of the world's five largest investment banks. Yet a series of missteps, including its involvement in trying to rig LIBOR, a benchmark international interest rate, and the mis-selling of interest-rate swaps to small British businesses, have tarnished its reputation. Regulators are now clipping the wings of its investment bank.

The retreat of Europe's investment banks is interacting with two other trends. One is the growing power of the industry's biggest banks as the move to electronic trading favours those with the largest market shares. A second, subtler shift that may well determine which banks will dominate investment banking in the medium-term future is a gain in market share for big universal banks, which combine corporate and commercial banking with investment banking.

Mr Spick reckons that big universal banks have increased their share of FICC markets by about 12 percentage points since 2006, whereas traditional investment banks have lost out over the period. Part of this is simply because the financial crisis thinned out the field as almost all America's stand-alone investment banks collapsed or were bought up. Titans such as Lehman Brothers, Bear Stearns and Merrill Lynch all had to change their nameplates within a few months, leaving Goldman Sachs and Morgan Stanley as the last of their breed. Yet the biggest universal banks have continued to gain ground over the past five years, for several reasons.

One is that since the financial crisis almost all banks have become stingier about lending. When big corporations had almost unfettered access to credit, they could play one off against another for the cheapest loans. They could also shop around freely for takeover advice. Now that credit is scarce, banks with

big balance-sheets are in a stronger position to demand more of the juicy business if clients want to keep borrowing. One potential barrier to the continued rise of universal banks may be regulations such as those that will ring-fence banks' retail arms.

Credit ratings play their part too. Banks with a spread of businesses have generally been able to hold onto stronger credit ratings and enjoy more implicit government guarantees than those, like Morgan Stanley, that focus more narrowly on investment banking. This can make a huge difference not only to a bank's cost of borrowing but also its ability to write derivatives contracts and win investment-banking business.

Make it stick

Being a prime broker to hedge funds, for instance, is not in itself the most profitable of businesses, but it feeds a flow of trades into banks' equities and FICC businesses. It is also a sticky and concentrated business. Hedge funds typically enmesh their operations closely with those of their prime broker and will often do much of their trading with the firm. This is to reduce the amount they have to borrow and the collateral they have to post, since many of their trades may partly offset one another (buying shares in one firm, say, and shorting those of another).

Yet since the collapse of Lehman Brothers in 2008, itself a large prime broker, hedge funds have become pickier about which banks they get close to, often preferring to concentrate their trades with the strongest banks backed by their governments. "In the darkest days of the financial crisis, did anyone really believe that the Swiss government would stand behind the prime brokerages of Credit Suisse and UBS to bail out a bunch of foreign hedge funds?" says one hedgie. "Or the French, for that matter?"

Another reason for universal banks' new pre-eminence is that as big multinational companies have become ever more global, they have become more reliant on very large banks to help them manage cash and payments across many countries. At the same time, regulations such as Basel 3 are increasing the cost to banks of supplying trade finance and derivatives used for hedging. By getting many of these services from a single bank, companies can improve their liquidity by sweeping cash from foreign operations. "Companies are looking for simplicity," says James Cowles, Citi's head of Europe, Middle East and Africa. "Global banks are able to knit the world together for their clients."

Before the crisis this sort of banking, known as global transaction banking or transaction services, was looked down on by most investment banks and their managers, most of whom had built their careers on the hectic trading floors. "When I joined this business we were seen as second-rate bankers by the rest of the bank," says the head of transaction banking at one large bank. "They thought of us like plumbers," says another.

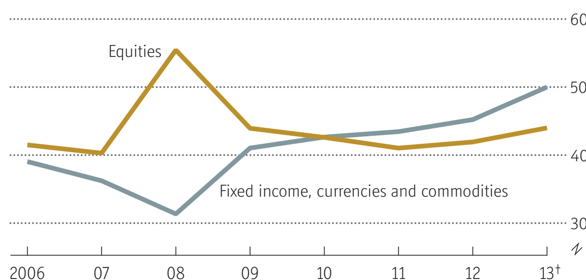
Now the plumbers are getting their revenge, with transaction banking seen as offering exciting growth prospects, good returns on equity and stable revenues. Total revenues in this business are probably worth about $200 billion a year, not much less than for investment banking and trading, though far more fragmented. They are also growing steadily. BCG forecasts that by 2020 revenues from global transaction banking will exceed $350 billion a year. More important than the size of the market, says Stefan Dab, a consultant at BCG, is that the business is "sticky". Big customers usually integrate their own accounting and payment systems with those of the bank, which makes them hesitant to switch. The stickier the business, the more opportunities the bank has to try to cross-sell more profitable business such as derivatives or bond issues. "Transaction banking is in the middle of a decade of love," says Satvinder Singh, the head of Deutsche Bank's trust and securities services business, part of its global transaction bank.

Unusually, pay for senior transaction bankers is also rising, whereas in most other areas of banking both pay and other costs are being cut at an unprecedented pace. ■

4

A cross to bear

Big investment banks*, market share by revenue, %



Source: Deutsche Bank

*Goldman Sachs, JPMorgan Chase, Bank of America, Citigroup, Morgan Stanley †Forecast

Costs

Leaner and meaner

Investment banks are struggling to trim fat without cutting muscle

FEW ISSUES RILE the public, and politicians, as much as bankers' pay, for obvious reasons. Investment banking is an industry that in the past seems to have been run mainly for the benefit of its employees rather than its shareholders or its customers. This is changing. New rules in Europe will limit the size of banks' bonuses relative to pay, reflecting a social consensus that bankers' rewards in recent years have been far bigger than justified. Grumpy shareholders are also exerting a downward push on pay as banks are forced to concentrate on profit rather than revenue.

Senior executives at most leading investment banks will agree privately that in the boom years they had their eyes mainly on revenue targets rather than profits or returns on equity. Anthony Salz, a London lawyer whom Barclays commissioned to look into its business culture, found that pay at the bank was "focused on revenues and not on other aspects of performance".

To be fair, most big banks did the same, and their managers had every incentive to do so. With profits soaring in the years before the crisis, banks' shareholders seemed to see themselves as buyers of lottery tickets rather than owners of businesses. They thought that allowing banks to expand as rapidly as possible in size, scope and geographic reach was a way of increasing their options for huge profits in the future.

Since the crisis, banks have had to start managing themselves as businesses rather than as expensive options for future growth. This has rippled through their cost and pay structures. Both the number of people employed in banking and the amount they are paid are falling fast. CEBR, an economics consultancy, expects the number of people employed in London's financial industry this year to tumble to around 237,000, its lowest level in 20 years, from a peak of 354,000 in 2007. In New York

and in Asia, too, numbers are dropping. In the first quarter of this year alone America's six largest banks announced plans to cut some 21,000 jobs, or almost 2% of their workforce. Analysts at JPMorgan reckon that American brokers have reduced their workforce by 10% since 2007-08, having already cut it sharply in the early 2000s (see chart 5).

Average pay has probably fallen by about 20% since the crisis, and many in the industry think that it has a lot further to fall over the next few years as banks struggle to get ROEs back up. A recent report by Morgan Stanley and Oliver Wyman estimated that European banks still need to cut costs by 10-25%. The same is probably true of America. Mr Hintz reckons that on banks' trading floors compensation costs will have to come down from about 50% of revenue to 40%. This will be achieved partly by cutting pay across the board, but partly also by promoting (or hiring) fewer people to highly paid positions on trading floors.

This will not be an easy thing to do. Simon Samuels, an analyst at Barclays, who has studied annual improvements in costs relative to income at Europe's main banks (not just its investment banks), thinks that banks are being ambitious by promising to improve the ratio by 3.3% a year over the next three years. He points out that in the 12 years before the crisis the average annual improvement was only 0.6%. And even if the proposed cuts are achievable, they may not be sufficient to restore returns.

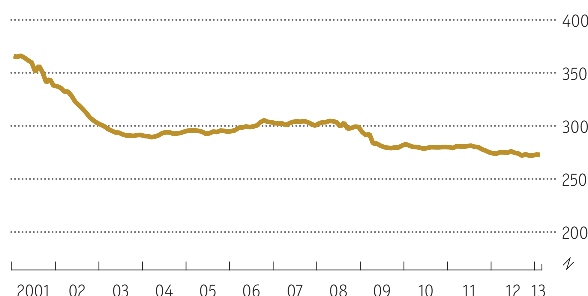
In most other industries these sorts of cost pressures would prompt a wave of consolidation. Yet regulators are unlikely to allow any of the world's biggest banks to buy rivals and grow bigger still. Smaller banks that might have wanted to band together are also affected: under the new Basel 3 rules, the bigger they get the more likely they are to attract a steeper capital charge. That may prompt some to combine forces in other ways: by setting up utilities to do their paperwork or to run their computer systems.

A standard answer

Marty Chavez, co-head of equities at Goldman Sachs, says that before the financial crisis each bank and its counterparties would negotiate bespoke legal agreements underpinning their derivative transactions, each of which was as individual as a snowflake. When the financial crisis struck and banks started worrying about the health of counterparties, they had to call in lawyers and trawl through thousands of such agreements to work out what collateral they were obliged to accept or post. Banks are now working towards standardising these agreements, which will not just bring down legal costs but also allow them to offset risks more precisely, using central clearing parties, which will reduce the capital they will have to hold.

The new standard agreements will be every bit as revolutionary for finance as the standardisation of grades of steel, rubber and bolts were to manufacturing industries in the middle of the 19th century, Mr Chavez thinks. The benefits to banks from being able to outsource parts of their businesses to specialist firms could be huge. BCG reckons that as firms gain sufficient scale in markets such as foreign exchange, the cost of each currency trade falls by almost a third. New technologies such as cloud computing may drive these costs down even further. Steve Vinnicombe of Capco, a technology consultancy, reckons that banks could save 40-60% of their cost base by adopting common infrastructure or switching to completely new IT systems.

Morgan Stanley and Oliver Wyman think that by clubbing together in this way, banks could save as much as $3 billion a year and improve their ROEs by 0.5%. But until that happens, the biggest investment banks with the largest market share will remain best placed to reap economies of scale. ■



Emerging markets

Lands of eternal promise

In emerging markets, local and regional banks are increasingly beating global ones

TO JOURNEY FROM the bustle of street-traders, minibus taxis, heat and dust of an African city centre to one of the pulsing arteries of global finance, all you need to do is walk a few steps, from the pavement to the towering coolness of the Johannesburg head office of Standard Bank, Africa's biggest bank. Before the financial crisis Standard Bank had global ambitions. Touting its skill in emerging markets and mining, it built outposts in Russia, Brazil, Turkey and London, among other places. For a time, the strategy seemed to be paying off as it won mandates to help local companies raise funds on international capital markets. "With the crisis, the competitive landscape changed dramatically," says Sim Tshabalala, co-chief executive of the bank. The cost of capital and funding for mid-sized investment banks shot up and domestic rivals in many of its markets began to flex their muscles. So Standard has shifted its focus to deploying capital across Africa, where it has a strong local presence and can see off competition from both global investment banks and newly emerging home-grown ones.

It may be tempting to dismiss Standard Bank's experience in far-flung markets as the price of an upstart emerging-market bank overextending itself. But big global banks are learning similar and equally expensive lessons. Fast-growing emerging markets may promise mouth-watering returns to global investment banks, but it is big local and regional banks that are proving most successful at garnering them.

A decade ago bankers from large American and European firms were descending on developing economies such

as Russia, Brazil and China with great fanfare. Champagne flowed as the chief executives from head office snipped ribbons to open the glitzy new outposts. The retreat has been more discreet as banks have announced plans to "optimise" their presence or "relocate coverage" of the market to places like London.

At first sight the growth in investment-banking fees in emerging markets looks enticing, or at least it did until last year, when total fees dropped significantly in parts of Asia and across the Middle East and Africa. But on closer examination the market turns out to be highly diverse. Investment banking in America generates about half the industry's global revenue and an even larger share of its profits because of massive benefits of scale. By contrast, Asia accounts for only about 20% of the industry's overall revenue and probably 10% of its profits because of the higher costs of working in such a fragmented market.

China, which once seemed the most alluring of all Asian markets, still remains largely closed to outsiders. Many of the big investments that foreign banks made in Chinese ones in the early 2000s have been reversed, albeit profitably, with the sale of their minority stakes, and hopes that they would lead to enduring partnerships and provide access to China's riches have mostly been dashed. Chinese banks have quickly learned to offer their own investment-banking services.

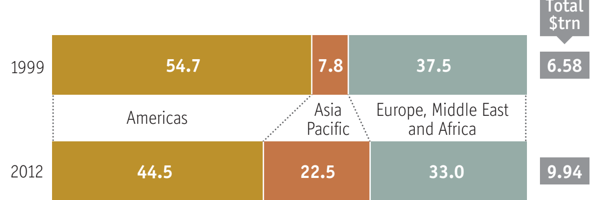
Local talent

Indeed, across most big emerging markets international banks are coming up against stiffer competition from domestic banks or new regional powerhouses than from their global competitors. In Brazil BTG Pactual, a bank set up in 1983, now dominates parts of its home market and is rapidly expanding through acquisitions in neighbouring countries. In India domestic banks dominate the market for helping local companies raise debt. "Internationals still hold sway in big-ticket, cross-border mergers and acquisitions," says Anup Bagchi, who runs ICICI Securities, the investment-banking arm of India's second-largest bank.

In Russia, too, state-owned Sberbank, the country's biggest bank, has recently emerged as a force in investment banking. A year ago it completed its acquisition of Troika Dialog, a scrappy local investment-banking boutique. Todd Berman, who heads that side of the business, thinks the balance is shifting in favour of home-grown banks in emerging markets because they are learning to combine new skills with a willingness to lend and finance deals in ways that capital-constrained international rivals cannot. "Three years ago big local banks would provide the credit and international banks would provide the research, the distribution," Mr Berman says. "Now in Brazil, China, Russia…large successful banks have hired world-class people. To play in these markets you have to be not only a provider of good ideas, you also have to provide the financial capital."

Thank heavens for Asia 6

Global investment banks, share of revenue by region, %



Source: Dealogic

Banks from different emerging markets are now starting to team up. Brazil's BTG has formed alliances with VTB, Russia's second-largest bank, and with Citic Securities, a Chinese investment bank. And the Industrial and Commercial Bank of China has become the largest shareholder in Standard Bank.

To be sure, some international banks are still making good money across emerging markets. UBS and Credit Suisse, for instance, retain strong positions in Asia, where their wealth-management arms have enviable franchises. Rich people who have already handed their assets to these banks to look after readily turn to them for advice when they are thinking of selling their family firms or raising debt to finance them. Banks such as JPMorgan, Citi, HSBC and Standard Chartered, with branches and commercial-banking networks across large parts of Asia, Africa or Latin America, are also doing well in those parts of the world where their reach is deepest. Banks that are able to serve local as well as multinational firms in emerging markets seem to be gaining an advantage. Having local operations allows them to lend to growing emerging-markets firms, while their global reach lets them finance their trade or help them raise money abroad.

That presents a challenge to the international model of many big investment banks. In the past many would fly "suitcase bankers" into emerging markets from regional hubs such as Singapore or London to do big deals. With just a few such hubs banks like Morgan Stanley or Goldman Sachs could cover the globe. Now all but the biggest international investment banks are being outfoxed by local banks in fast-growing economies. ■

The outlook

Down to Earth

The industry has been drastically downsized, but the biggest banks will still do well

INVESTMENT BANKERS ARE a bright and resourceful lot. Some of the best minds of this generation are in search of the next big innovation in credit markets or risk management that will bring back the heady days before the financial crisis. But the industry's voyage back to profitability will probably be slow, and not all banks will make it.

New and interesting markets or products are still being discovered. Among the biggest at the moment is "collateral management": helping financial institutions and companies manage the collateral that they are owed or that regulators want them to post with central counterparties on their derivative transactions. This may sound humdrum, but JPMorgan, for one, thinks its revenues from it could soon rise to perhaps $500m a year.

A racier proposition is the emerging business of "collateral transformation", in which banks hope to take clients' poor-quality assets such as junk bonds in exchange for cash or high-quality assets such as government bonds that can be posted as collateral elsewhere. Yet regulators are already casting a beady eye on the idea, mindful that it was just this kind of alchemy that blew up finance during the crisis.

Even if they come off, such opportunities do not begin to make up for the huge loss of revenue that investment banks are facing in their main trading businesses. A recent report by Morgan Stanley and Oliver Wyman concluded that collateral transformation will at best provide the banks with collective annual revenues of $5 billion-8 billion, yet since 2009 they have suffered a drop in income of almost $100 billion.

With little prospect of growth for the industry as a whole, each bank will try to get a larger slice of the existing pie. The trends are already clear. Very big banks with scale, or "flow", in their trading operations are likely to keep expanding their market share, as are big banks that enjoy economies of scope by combining investment banking with the corporate sort.

To be sure, there will be limits to consolidation. First, domestic banks in both rich and developing countries will probably hold on to a good chunk of their home markets. Their local companies will give them business so as to be able to borrow from them, and their governments may send bond sales and trading their way to keep their national champions afloat. Second, institutional investors will be keen to avoid too much consolidation in key markets such as the trading of bonds or shares, so they will probably give enough business to the fifth- or sixth-largest investment banks in each market to keep up the competitive pressure on the biggest.

Small specialist investment banks, too, are likely to thrive. Even as big banks and corporations draw closer to one another, there will still be a role for boutique investment banks and advisers. The relationship between a company and its transaction bank is usually centred on the chief financial officer or treasurer, but chief executives like to deal with trusted confidants whose loyalty is to them, not their CFOs. That may mean a growing role for specialist advisory firms such as Moelis & Co, Evercore, Rothschilds and Lazard.

To the victors

Even so, the handful of global banks that already bestride capital markets seem likely to increase their dominance even further. Kian Abouhossein, an analyst at JPMorgan, forecasts that in 2014 the six largest investment banks (currently JPMorgan, Goldman Sachs, Morgan Stanley, Barclays, Citi and Deutsche Bank) between them will control nearly half the industry's total revenue, whereas the ten smallest will have just 10% of the market between them. And even the list of industry giants is not immutable. At the moment it contains two pure investment banks, Goldman Sachs and Morgan Stanley. But Morgan Stanley's share of key markets has slipped in recent years and it pays more than its rivals for its funds. It may well be ousted from its position by a rising universal bank, HSBC, which has quietly doubled the size of its investment bank in recent years.

Banks such as Morgan Stanley and Europe's contenders, UBS, Credit Suisse and France's BNP Paribas and Société Générale, will not disappear, nor will they retreat entirely to their home turf. By concentrating on narrower markets and serving mainly domestic clients they should still be able to earn decent enough returns. Yet their aspirations to become big global investment banks have moved out of reach.

The handful of huge global banks seem likely to increase their dominance even further

As for the global titans, they will come under ever greater pressure to cut costs—and will respond by expanding even more to gain economies of scale and scope. Paradoxically, stricter regulation intended to tame banks that were thought too big to fail is leading to the creation of even bigger and more systemically important institutions. ■

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