

Piggy banks slim down

Old investment banks will expand more slowly or even shrink, leaving room for BRICs to grow their own



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Returns on equity at some of the big investment banks have crashed to single figures and in some cases less than zero, from 30-50 per cent in 2007. 'Piggy banks' is one phrase the occupants of the little tent village, set up in the city of London by anti-capitalist campers, are using to describe their new neighbours. Is this metaphor of the overfed omnivore already out of date?

In the 25 years since investment banking became a powerful global industry, each big market crash (1987, 1998, 2008, then August 2011) was followed by a sudden loss of confidence, profitability and jobs. And in each case until now, headcount and capital deployed in the industry shot back up as markets recovered. The same relief rally can be expected when we get through the worst uncertainty about the euro, but this time will be different. Adjusting for the lurch from boom to bust, the investment banking industry is going to grow more slowly or even start shrinking gradually, and its centre of gravity will shift further towards parts of the world that are growing faster.

A long-term decline in returns on capital invested in the industry will be a stronger constraint than the regulatory fences that are gradually being put in place. Before investment banking began its 25-year phase of excessive and ultimately dangerous growth, the business was based on fee and commission income. As agents, investment banks did not need much capital, but there were limits to the expansion of the business. There were no such limits once banks began taking much bigger principal positions and financing them with a growing equity base, leveraged to a crazy degree in inter-bank markets. Even before allowing for the effects of the market downturn, the subsequent decline in leverage made this business model, if it can be called that, unworkable.

In a slow and messy process, regulators are also going to get their way by putting sand in the gears of 'financialisation', whether in the US through caps on commodity positions, or the implementation of the Volcker rule on proprietary trading, or in Europe with policies like banning the issuance of credit default swaps that are not linked to an underlying

long position in the bonds concerned.

Lower returns and regulatory constraints will make investment banks relatively smaller, and less of a systemic threat, than they would otherwise have been, but advising on and arranging financial transactions will remain a huge business. Bloomberg counted more than 20,000 M&A transactions in the first nine months of 2011, up by 16 per cent at the same time last year, worth a total of nearly \$1.8 trillion. McKinsey's annual tally of the value of securities and loans outstanding worldwide, made most recently in August, put the global number at \$212 trillion at the end of 2010, a recovery over the previous peak in 2007. Cross-border capital flows were estimated by McKinsey at \$4.4 trillion last year, also a recovery on the prior two years' decline.

While the cost of capital and regulation will push back on principal risk-taking by banks, there is not going to be a return to the old model of agency-only business. Merger and acquisition advice on larger deals will still be linked with bridge loans and long-term financing. Trading for large clients like institutional investors and hedge funds can only be done competitively by committing capital to holding inventories of stocks and bonds. Investment banks will have to go on assuming risk. But if costlier capital and tighter regulation have the right effect, banks' exposure will become more focused on risk taken on to do business for clients, and not for the bank.

A more direct relation between what investment banks do, and what their clients want, is also going to tie the prospects for the industry more closely to areas of the world that are growing fastest. A clever and entrepreneurial investment bank such as BTG Pactual in Brazil was able to combine the strengths derived from Brazil's expansion with the weaknesses of old world banking to make a decisive breakthrough, with its buyout from UBS. Renaissance Capital built a large emerging market business based on its success in the early days of Russia's capital markets, when the big established investment banks simply could not understand how to assess local risk. It can't be long before India produces its own version too. ♦

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