

An Investment Banking Perspective on the Future of the Financial System

Rob Ferguson

1. Introduction

The forces which are shaping the financial markets of the future – globalisation, technology, regulation – are being widely discussed. In this paper I want to focus on some current institutional developments which will affect banking and investment banking over the next five to ten years.

2. Excess Capacity in Global Banking

It is well known that in the global banking industry there is an excess of capital in aggregate. Some banks recognise this and are reducing capital by share buy-backs. Others are doing what banks traditionally do with excess capital: use it to expand, even if these expansion moves are questionable. In particular, several of the large European universal banks have excess capital and substantial market capitalisation. Their aim is to use these attributes to convert their domestic strength into a global investment banking presence. This is happening at a time when there is also excess capacity in world investment banking.

Investment banks aspire to be leading participants in all or nearly all of the following activities: corporate finance, both public and private; mergers and acquisitions; sales, trading and research of equities, foreign exchange, fixed income securities and derivative products; and investment management and related operational services.

Increasingly, those aspiring to success in these activities are striving for a global reach which typically comes from being part of a global organisation. These organisations seek global reach because many of their customers are now involved in global competition and there is a strong conviction that to hold your customers you must offer them global skills.

Who are the aspirants in this game? A recent (April 1996) research paper by Rafael Soifer of Brown Bros Harriman and Co New York listed sixteen names:

US-based

Bankers Trust
Goldman Sachs
Lehman Bros
Merrill Lynch
J.P. Morgan
Morgan Stanley
Salomon Inc

European-based

ABN Amro
Barclays
CS Holdings
Deutsche Bank
Dresdner Bank
HSBC Holdings
NatWest Group
Swiss Bank Corp
Union Bank of Switzerland

On the European list all the aspirants are also large retail banks. In contrast, there are no retail banks on the US list. Bankers Trust used to be involved in retail but shed these activities long ago while J.P. Morgan historically operated as a wholesale bank. The other US names are non-banks with a background in either equity or fixed-interest sales, trading and research.

This lack of retail banks on the US list largely reflects regulation. Commercial and investment banking were legally separated in the US between 1933 and 1990. In Europe on the other hand, commercial banks have dominated the investment banking and broking business for generations and this is where the model for the universal bank – the bank involved in retail and wholesale banking, investment banking, insurance and funds management – evolved.

At present, many of the European aspirants are cross-subsidising their thrust into global investment banking from their entrenched domestic retail or wholesale banking oligopolies. The European firms are very large in terms of market capitalisation and seem prepared to accept lower returns on equity than their US counterparts. For example, HSBC Holdings is currently valued in terms of market capitalisation at five times that of Morgan Stanley, six times that of Bankers Trust and ten times that of Salomon Inc.

The obvious way to establish a position in global corporate finance would be to buy one of the leading US houses. However, this is prohibitively expensive because market prices reflect the high profits which those houses have been earning from the long equity bull market in the United States.

As an alternative strategy, to get a foot in the door, the European banks have been aggressively buying staff out of the US investment banks – individuals and whole groups – in some cases doubling or tripling already high remuneration. This thrust comes in spite of the fact that of the 16 aspirants for an enduring role as a global investment bank, less than half are likely to make the cut. That is because there is excess capacity in investment banking. It has been a booming business for many years, thriving on the turbulent financial environment which has been with us for two decades. Investment banks have grown and added capacity, but the environment in which they prospered may have changed.

I believe February 1994 may have marked the end of an era of transition from regulated finance to deregulated finance. That transition required changes in the attitudes and behaviour of investors, institutions, market-makers and regulatory authorities and as they all felt their way, they had to cope with sharp changes in fiscal and monetary policies, inflation, surges of speculation, and the like.

In February 1994 the bond bull market collapsed and triggered the end of the speculative use of derivatives and Latin America and South East Asia bull markets. The fact that the bond bear market was largely unconnected to fundamentals, just like the 1987 equity crash, showed that it was a phenomenon largely due to too many players getting on board. Even the supposedly smart players were hurt. So perhaps the markets have come to understand the rules of the new deregulated game and what happens when everyone runs in one direction against a background of steadier fiscal and monetary policies.

So where does all this lead? There is a sense in which the players are right to see a future in global investment banking. The corporate finance/underwriting/equity business

is becoming globalised, in tandem with its globalising corporate clients. The business was once predominantly domestically based with funding and merger and acquisition technique as its products. These have now been commoditised and the business is increasingly about the provision of industry-specific global strategic advice; for example, Goldman Sachs can deal with Telstra because they follow telecommunications worldwide. This means they can talk the dynamics of the technology as well as the changing commercial issues of the business.

At the same time as this global future is realised, excess capacity will be squeezed out – a rationalisation that may be assisted, after the 1996 US election, by reform of the Glass-Steagall Act, prompting European investment banking aspirants to acquire US investment banks. European banks seeking to acquire US banks may be joined by large US banks of the size of Bank of America, Chase and Nations Bank with aspirations to be universal banks. Eventually there may be six or eight ‘winners’ in the global investment banking race.

In the meantime, there will be upheaval. The US players will be weakened by loss of staff and by more mercenary attitudes in those who remain. There are questions about how effective ‘bought’ staff will be as they may have cultural differences with other ‘buy-ins’ and the buyer, and they may have short time horizons.

At the end of the day, the firms that survive this battle will be those with strong cultures and a coherent business strategy. Those who use the cheque book to grow will find, as many banks have in the past, that growth in investment banking tends to be organic, given the fragile nature of investment banking cultures.

3. Impact on Australia: Non-Funds Management

How will these developments affect Australia? First let’s look at the non-funds management parts of investment banking, where the changes caused by global rationalisation are very likely to be of the ‘tail wagging the dog’ variety, that is, consequences of other more fundamental international strategic moves. A recent example was the Swiss Bank acquisition of Warburgs, leading to SBC in Australia merging with Potter Warburgs. Fortuitously, this created a very strong Australian investment banking arm for SBC Warburgs due to a complementary set of skills in businesses in the two merged firms. Future local mergers driven by overseas developments are unlikely to be so complementary.

More interesting are the parallels in Australian banking and investment banking. Just as European banks, who have, as universal banks, always strived to be all things to all people, Australian commercial banks, given the same opportunity, have tended to have similar aspirations. This reflects the oligopolistic origins of both industries and the cosy regulated environment that preceded them.

In Europe, commercial banks are much more firmly entrenched across the retail, wholesale, investment banking and funds management horizon. No doubt there are enormous cross-subsidies with retail banking providing the bulk of this. But the cross-subsidisation is not solely driven by excess returns in one area of their business. Several of these banks earn returns at or below 10 per cent return on equity (on undervalued assets). So the subsidy also comes from the past to the present.

By contrast, Australian commercial banks' aspirations to universal bank activity may have passed their peak. One particular manifestation of this is a reduced desire to be involved in stockbroking and other forms of wholesale/retail research and securities sales and distribution activities. On the other hand, Australia's major banks continue to aggressively pursue corporate business even though for many years most large corporates with good credit ratings have been able to bypass banks and go directly to the securities markets.

Why do Australian banks continue to pursue this type of corporate business? Again, the answer is cross-subsidisation – mainly from the home mortgage business. However, this source of cross-subsidisation is being rapidly eliminated and this will force our big banks to price each business properly. As this trend unfolds, our big banks will be forced to focus on what they do well. Corporate activity at the creditworthy end of the market may not be amongst those activities.

For Australian investment banks, once the big banks focus on their areas of expertise, opportunities should emerge to service corporate borrowers with unique non-standard credit needs. These borrowers will be of the type who need a combination of debt and equity raised for them by their investment bank. It is at the point of intersection of debt and equity that investment banks have a special capability but heretofore this skill has been blunted by big bank cross-subsidisation of corporate businesses.

Investment banks have amongst their core competencies sales and trading of securities, in particular debt and derivative securities in a trading-room environment. The big banks compete in these areas but again heavily cross-subsidise. As cross-subsidisation declines, the big banks will review and reduce these activities and create opportunities for investment banks.

On the other hand, the likely rationalisation of global aspirants into six to eight major players will mean reduced activities in Australia by those who miss the cut. Already we have seen a major trend for international banks and investment banks to rationalise their trading-room activities in the one time zone. In South East Asia, representation in Singapore, Sydney, Tokyo and Auckland is giving way to an approach that chooses one location. Sydney has tended to lose out to Singapore in this process.

So far the withdrawals from Sydney have been by players outside the 16 aspirants but as the list of aspirants reduces, we will see further withdrawals from Australia. For global products like foreign exchange, the liquidity consequences of these withdrawals will be minimal, but for more domestically based products, like Australian dollar securities, the impact will be more severe.

The obvious question raised by the likely exit of Australian capacity to other parts of the region is, why? It seems Singapore and Hong Kong are seen as both 'closer to the action' but also much more business-friendly, not so much in terms of taxation, but in terms of the lack of complexity in setting up operations compared to Sydney. Ironically, Australia has become a substantially lower-cost location for these activities, but this message does not seem to have got through Australia's other perceived disadvantages.

4. Impact on Australia: Funds Management

In Europe, funds management was part of the universal banking model and so most European aspirants to global investment management have substantial, albeit old-fashioned, funds-management businesses primarily operating out of their domestic market.

In the United States, funds management and investment banking tended to be separate historically at the wholesale level, so firms like Goldmans, Salomons and even Morgan Stanley downplayed these funds-management activities mainly because of the concern that other institutional clients would not like to see them competing as funds managers when they were also brokers. The end of fixed-rate commissions on Wall Street ended the need for this concern but it has taken a long time for the US investment banks to build their own funds-management capability. On the other hand, Bankers Trust has always been in the funds-management business; Merrill Lynch, as a retail broker, felt less constrained on the competitive issue and so built a huge retail or mutual funds business; and J.P. Morgan as a non-equity broker was traditionally a funds manager.

So the field of global investment banking aspirants is presently very uneven in terms of funds-management capability but almost universally there is a view that this should be a core business. Morgan Stanley has a declared aim of 50 per cent of revenue to come from funds management (currently 30 per cent) and most other competitors would agree with such an objective. Funds-management income is seen as higher quality (the stockmarket puts a higher premium on it) and less volatile (usually associated with higher quality) and so there is a world-wide scramble on at present for global investment banking contenders to build this aspect of their business. This scramble coincides with generational changes at many individually owned funds-management businesses that blossomed in the early 1970s and now are huge businesses with great value and complexity, and that are seen by some to fit better into global organisations.

The merger trend in funds management has some parallels to the desire of European banks, after London's 'Big Bang', to buy into the stockbroking business. The cultural differences between funds management and banking are as wide as they are between banking and stockbroking. Investment banks with their equity sales and distribution backgrounds may be more successful acquirers of funds-management businesses than banks, but stockbroking and funds-management cultures are also very different so it will be interesting to see if firms manage to turn the huge goodwill payments their acquisitions will cost into durable earnings streams.

In Australia, the big four banks, as universal banks, have long been involved in funds management but have struggled with the cultural divides, especially over the last decade or so. One of the issues that the banks in Australia will have to decide is what part of the funds-management business they want to operate in. If pressure from the demise of cross-subsidisation forces them to focus on core competencies, they will have to ask which part of the business suits them.

Put simply, funds management is really three sub-businesses. First, manufacturing – the creation of products and the achievement of investment returns; second, distribution of product to clients; and, third, the processing of all of the transactions involved in product sales and product management.

Product creation is, not surprisingly, a ‘creative’ business and the culture that fits in such a business often doesn’t fit in a bank. Retail banks are basically giant distribution systems with large client lists that can be sold multiple products. Inherent in the sales of these products are big transaction-processing jobs that a bank can do well if it develops this core competency.

I believe banks will ultimately decide that they can add value primarily at the distribution sector of the chain, rather than product manufacture. If they can manufacture a good product to put through their own distribution, all the better. But given that distribution is the retail bank’s greatest strength, they are unlikely to want to jeopardise it by selling their own product at the expense of other products that could satisfy customers more. Just as retail stores stock many products, including their own, I believe retail banks will also move this way. Already some have recognised this. On the processing front, while banks can be competitive here, there may be other specialist providers who offer an outsourcing product that establishes industry-wide standards of service and price that all players, including banks, will have difficulty matching.

Undoubtedly the most significant development in the funds-management industry for many years is the Superannuation Guarantee Levy (SGL). Interestingly, this and the associated consequences – in particular the move from defined-benefit to defined-contribution superannuation schemes – have not been really closely analysed by government or the industry in terms of their impact on the industry’s future structure. However, the impact of the accelerated move to defined-contribution superannuation is profound. It will fundamentally change the savings landscape from one where individual savers via superannuation relied on others to guarantee their retirement income, to one where savers will now invest their own retirement income. Put simply, savers who in the past either chose a banking system or an employer to take away their investment risk will now become at-risk investors.

There are three types of competitors trying to win market share in the new superannuation business that has arisen out of the SGL:

- banks which traditionally looked after savings on their own balance sheet;
- insurance companies which used a combination of balance sheet and agency relationships to manage money; and
- funds managers which manage money on an agency basis.

Each group has strengths and weaknesses in the battle for market share. Banks have huge client lists but high-cost distribution. If they can lower their distribution costs, their client lists can allow them to build powerful distribution profits based on fee income rather than balance sheet returns.

The SGL by its compulsory nature has led to the Retirement Savings Account (RSA) debate which, if successful, should give the banks a very useful way of gaining new long-term clients. RSAs in themselves may not be very profitable, just like money boxes were presumably unprofitable, but they will give banks a chance to cross-sell other products to RSA holders once they get a sufficient balance to warrant the resort to a balanced portfolio of equities, debt and property. Certainly this will mean low returns for some years for banks on these accounts, but ultimately it should help them build a loyal client base that will have an appetite for cross-selling of products.

The problems the banks will have to overcome in optimising this business are numerous, and in addition to moving away from their costly bricks-and-mortar distribution there are the cultural problems involved in having sales forces selling with a commission agent mentality in a culture that presently finds that approach alien.

For insurance companies, their culture long ago adjusted to the commission approach but the high cost of their commission sales forces is a problem. Insurance companies have long been involved in the superannuation industry and are advantaged in that they have been able to quickly capitalise on the potential to sell SGL-related products through their sales forces. Once again these products may be low return in the initial stages, be they to individuals or to small companies wanting the convenience of record-keeping and simplicity. Over the medium term insurance companies, as with the banks, will develop loyal customers who can be cross-sold other higher-margin products as they accumulate assets.

Funds managers' origins in Australia tend to be from wholesale sources. Accordingly they do not have the huge but expensive distribution systems and instead rely on third-party providers of distribution channels. This is both a strength and weakness. Funds managers, like banks and insurance companies, will have to ask themselves what are they good at in the list of manufacture, distribution and processing. Some may do all of them well – but they will be few and far between.

For funds managers who have been in the mutual fund business since it blossomed in 1982, there will be a need to change the structure of the business to one that is oriented towards long-term saving rather than retirement lump sums. The mutual fund industry blossomed in 1982 because of the 1982 recession and the need of those made redundant in the recession to invest lump sums. The retail funds-management industry has continued to emphasise this market but must now shift to a much different long-term savings market where banks and insurance companies are more formidable competitors. Equally, third-party distributors of mutual funds will need to make a similar transition.

It is apparent then that whatever changes arise from technological advance or regulatory review, they will impact on a system that is already undergoing significant upheaval, with investment banks adjusting to the post-1994 environment and with banks restructuring in the face of declining cross-subsidisation.

5. Competition

Before concluding, I would like to comment briefly on the competitive debate that will be an important part of the Financial System Inquiry chaired by Stan Wallis.

The big event of recent times is the break in mortgage rate pricing which has underwritten a lot of low-return activities of the banks. Now that the genie is out of the bottle it will be very hard for the banks to avoid pricing each business to produce an adequate stand-alone return. This will mean, as I have said, expansion in some areas and shedding of activities in others. In the absence of Trade Practices constraint, the flow-through of these forces would be achieved by merger amongst the big banks leading to the emergence of two big banks. However, while this would undoubtedly allow for greater efficiency via rationalisation of a bloated branch network that has been paid for by mortgage margins, the question is where will the competition come from once these economies have been realised.

It is worth noting that banks acquiring insurance companies, the so-called bancassurance route, is far less likely to be the rational route. Merging the antiquated distribution systems of two hierarchical organisations that need dramatic change will be a very challenging exercise. Insurance and banking mergers would be exercises of scope rather than of scale and rationalisation, at a time when the market is telling all of us to narrow our scope to what we are really good at.

It is also worth asking why, when deregulation brought competition to many areas of banking, it did not see effective competition in the mortgage business? There are many reasons, but the main reason seems to be that the existing banks could see that if one broke ranks they would all break ranks, and there was no one bank that could benefit by upsetting the applecart. In other words, they all had a lot to lose as it funded the rest of the business. Typically you would have expected the innovative small players, in this case the regional banks, to bring price competition. But they had more to lose than the big banks because of their building society origins and the dependency they had on housing loans. In the end, the competition came from outside the banking system. This competition took an offshore idea that required a sophisticated capital market to provide an effective alternative to the banks. Deregulation delivered the sophisticated capital market and ultimately (but slowly) the alternative developed and forced the banks to respond.

Given the above, one is tempted to argue that future competition will also tend to come from outside the banking system and therefore the acceleration of concentration inside the banking system will be offset by continuing competitive forces from outside.

One area where external competition is less likely to be effective in the short term is lending to small and medium-sized businesses: those businesses that are not big enough to access the capital markets. Such businesses could be vulnerable to oligopolistic pricing behaviour, but here the conundrum is that at present the margins on this sort of business are well below those charged in other, more open, banking markets. The reason is that these customers are currently also enjoying the benefit of the mortgage margin umbrella, but this umbrella is coming down.

As indicated above, further concentration in banking may not necessarily be bad news for investment banks. If concentration allows a more rapid move to rational pricing, that could lead to increased opportunities for investment banks in some areas. On the other hand, concentration in funds-management distribution, if that were to occur, would not be advisable. This central question – how to balance the efficiency of a concentrated banking sector with the competition needed to keep the industry honest – is one for the Wallis Inquiry to ponder.