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Down, But Not Out: The Current State of Investment Banking

Investment banking has had a difficult decade. Tight new post-crisis rules decimated trading revenues and a sluggish global economy sent advisory arms into a slump. At the same time, evolving technologies have placed a strain on business models and changing staffing needs have made finding the right talent increasingly challenging. Yet, despite the many issues facing the industry, it nevertheless has many important strengths. Talented young workers from top schools still dream of investment banking careers and the industry still performs innumerable vital capital markets functions. Investment banking may be down, but it is far from out.

Despite its glamorous image, investment banking has struggled to recover from the devastation of the global financial crisis. In its aftermath, revenues from traditional investment banking activities steadily declined for a decade and then, after briefly stabilizing in 2018, resumed their downward momentum in 2019.

Today, Deloitte reports that combined revenues at the top banks are at their lowest level since 2006. As a result, many industry leaders are asking hard questions about the future of investment banking.

Downturn

There are many reasons for the slump in investment banking revenues.

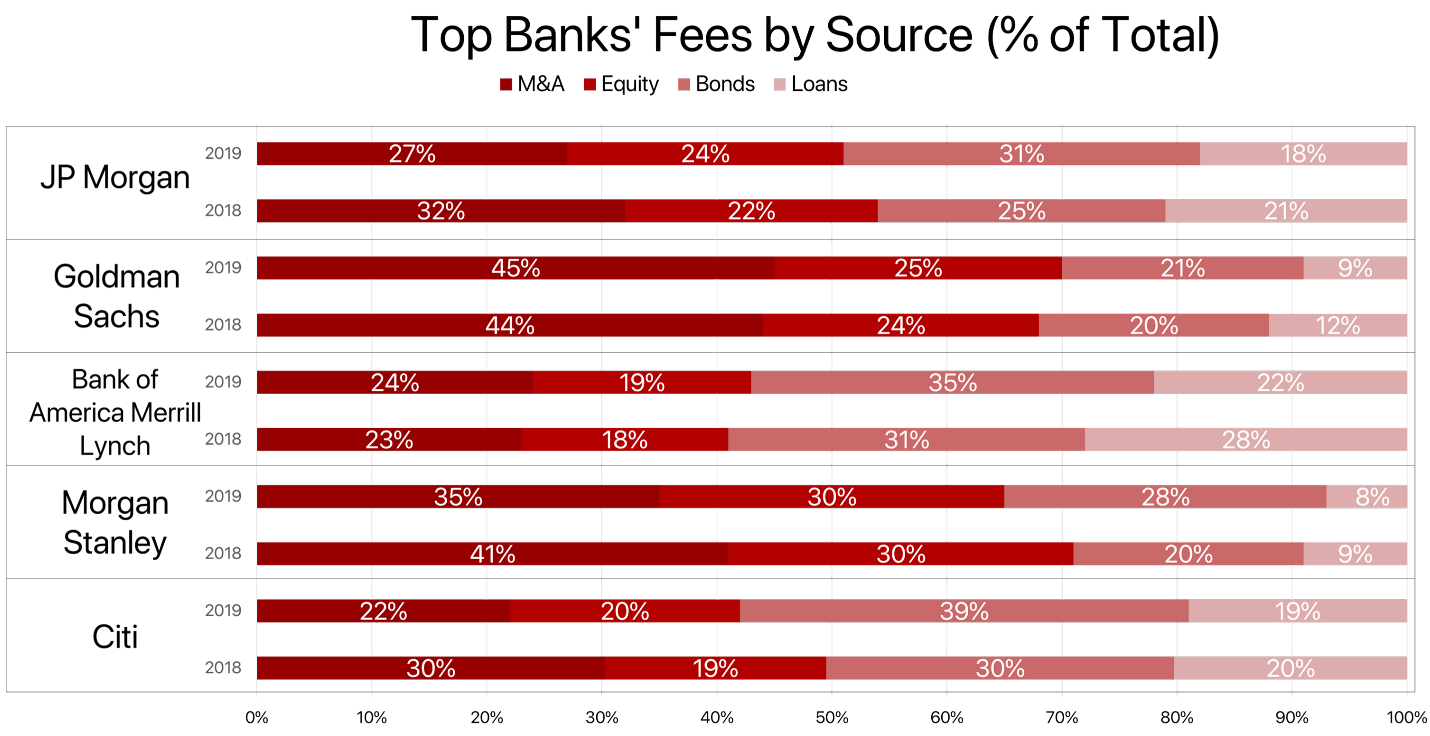
Trading & Underwriting

After the financial crisis exposed serious gaps in risk management models, regulators imposed many new restrictions on banks. In particular, they targeted banks' proprietary trading operations, which were viewed as a key source of systemic financial risk. New rules – such as the Volker Rule, introduced in the US by the Dodd-Frank Act – broadly prohibited banks from trading on their own account. Once a major source of revenue, trading desks at bulge-bracket banks were decimated by the new regulations.

At the same time, aggregate market volatility declined during the long bull market that began in March 2009. As volatility declined, overall trading volumes fell. High frequency trading (HFT) outfits have seen their profits plummet, as have investment banks with large trading operations, which have seen reduced trading appetite among clients.

In addition to tightening rules on trading, regulators also increased regulatory capital limits. This raised the cost of investment banks' traditionally sizeable underwriting operations – underwriting is a process by which banks take on a certain amount of financial risk in exchange for a fee, generally by agreeing to buy certain securities under particular circumstances. Rather than increasing their capital reserves, many big banks chose to shrink their underwriting businesses along with their trading arms. The process has been exacerbated by a growing number of companies raising capital directly from loan funds, without using underwriters.

With trading and underwriting volumes in retreat due to cyclical, structural, and regulatory factors, investment banks' advisory services have become their key revenue source. There too, however, there are challenges.



Source: Financial Times.

Technology & Competition

Changes in technology are having a disruptive effect on the advisory operations of the investment banking industry. AI is taking on a greater role in assessing market opportunities. Sophisticated AI systems are now able to identify potential M&A targets, for example, and many middle- and back-office functions can be outsourced to smart systems thanks to robotic process automation (RPA). Technology is also making it easier for clients to negotiate and trade directly, making investment banks' traditional intermediary function increasingly obsolete.

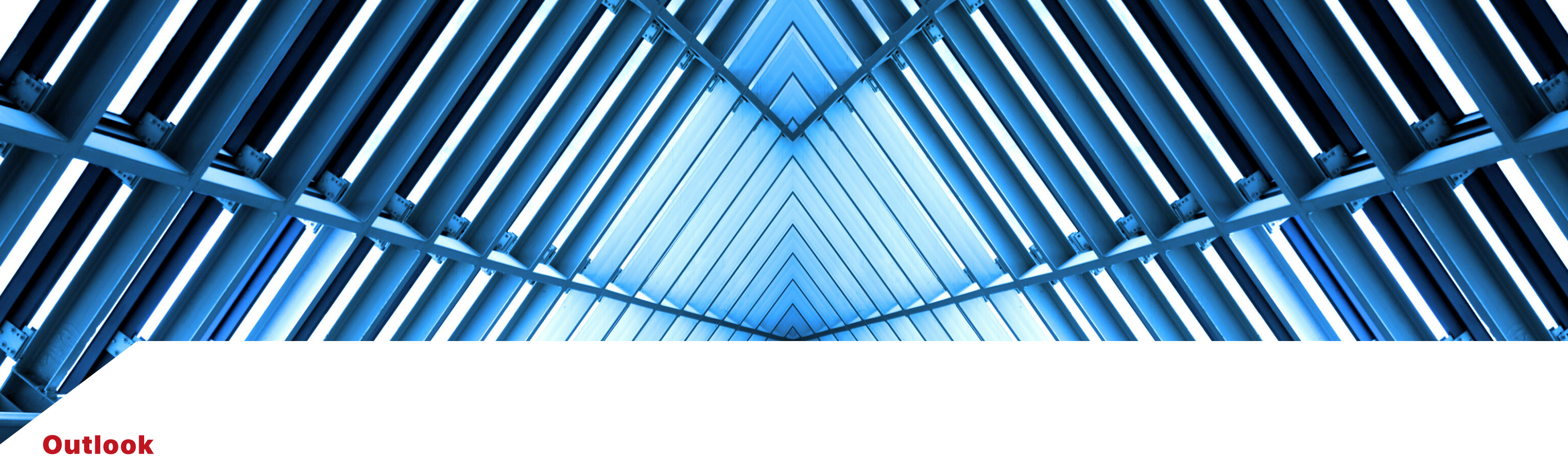
Technological improvements in access to market data and cheaper computing power mean that new competitors are being attracted to the investment banking industry. For example, a growing number of small, even one-person firms – often founded by former employees of top banks – are competing for and winning advisory business, such as structuring complex derivatives.

These problems in the advisory business are being exacerbated by changes in financial markets. Thanks to abundant private equity and venture capital, companies are remaining private for longer, hitting banks' initial public offering (IPO) business. Furthermore, a growing number of companies are opting for direct listings, which bypass investment banker underwriters to list directly on public markets. Banks' advisory revenues are thus being squeezed on all sides.

Talent

In response to the challenging environment, investment banks have been forced to cut costs and realign their business models, which meant major layoffs at many large institutions. This has been particularly true of European banks, which have been losing ground to their US peers and struggling to find a business model that works.

Yet, even as banks have been forced to cut staff, they have also been struggling to find new talent. In today's technologically sophisticated environment, banks need staff with both technical programming skills and traditional financial skills – as well as the interpersonal skills that are important for nurturing client relations. Finding talent with the right mix of skills is a challenge, particularly given the stiff competition for those with software skills from large tech companies and, increasingly, FinTech startups.



Outlook

Despite these many challenges, investment banks continue to enjoy certain advantages. New technologies offer the potential for significant costs savings at the middle- and back-office level, which could enable banks to lower the cost of their services for clients. Their deep and long-lasting relationships with corporations, asset managers, and wealthy individuals remain a core strength, helping banks to attract business and close deals.

US banks have benefited from the weakness of their European competitors and today, they claim the majority of global investment banking revenues. This puts them in a strong position to fend off new competitors and to attract the talent they need to compete in today's changing – and challenging – environment.

Intuition Know-How has a number of tutorials that are relevant to the challenges facing the investment banking industry today:

- Business of Investment Banking
- Corporate Finance – An Introduction
- Corporate Finance – Raising Capital·
- Mergers & Acquisitions (M&A) – An Introduction
- Mergers & Acquisitions (M&A) – Analysis
- Business of Investment Banking
- Corporate Finance – An Introduction
- Corporate Finance – Raising Capital
- Mergers & Acquisitions (M&A) – An Introduction
- Mergers & Acquisitions (M&A) – Analysis
- Equity Markets – Issuing
- Private Equity – An Introduction
- Artificial Intelligence (AI)
- Robotic Process Automation (RPA)

Banks & Regulators Disagree On The Cost Of The Final Basel III Framework

Banks have begun to grapple with the costs of implementing the Final Basel III Framework. European banks' estimates put the price tag of meeting increased capital requirements at around €400 billion and they warn that the rules could shrink lending by as much as €2.9 trillion. In contrast, the European Banking Authority (EBA) estimates that the new capital requirements will cost just €135 billion. As European authorities prepare to develop implementing regulations, industry voices are warning that handled poorly, Basel III could cost Europe 0.5% of its GDP growth. There are lessons aplenty to be drawn from Europe's experience as the rest of the world prepares to tackle the new rules.

When the Basel Committee on Banking Supervision (BCBS) finalized its revised banking industry rules in late 2017, the Final Basel III Framework – sometimes colloquially referred to as Basel IV – was immediately controversial. Banks warned that the new rules would increase capital requirements and reduce lending – and could potentially lead to increased risk as banks clustered into certain lending sectors

In Europe, regulators have begun work on developing regulations to implement the Final Framework across the EU. As they do, the banking industry is sounding ever-louder warning bells.

Conflicting estimates

In August 2019, the EBA published advice on the implementation of Basel III in the EU. Its quantitative assessment found that the new rules would increase banks' minimum capital requirement (MRC) by an average of 24.4%. Based on current bank capitalization levels, the EBA estimated that the increased MRCs would create a capital shortfall of €135.1 billion, of which €58.7 billion would materialize in 2027 (when the last of the requirements must be fully implemented).

However, a November 2019 report by Copenhagen Economics (CE), conducted on behalf of the European Banking Federation (EBF) and UK Finance, argued that the EBA's assessment underestimates the amount of capital involved. According to the report, banks typically hold capital buffers in addition to the required minimums and, if these buffers are kept at current levels, the actual capital shortfall would be between €300 and €400 billion – a far more substantial funding burden.

The report also argued that the new rules may disadvantage European banks relative to their US peers – in CE's analysis, US capital requirements will not increase in line with European ones, increasing European banks' capital costs compared to US banks. In addition, the report claims that the increased capital requirements, as well as new constraints on modeling credit risk and various other changes, could significantly reduce bank lending.

Basel III & Brexit

While the UK will, post-Brexit, have leeway to steer its own course on Basel III implementation, it will be constrained by the rulings of the BCBS, which maintains a register of countries it considers to be non-compliant with global banking standards. It may also come under pressure to align its rules with EU legislation to maintain market access.

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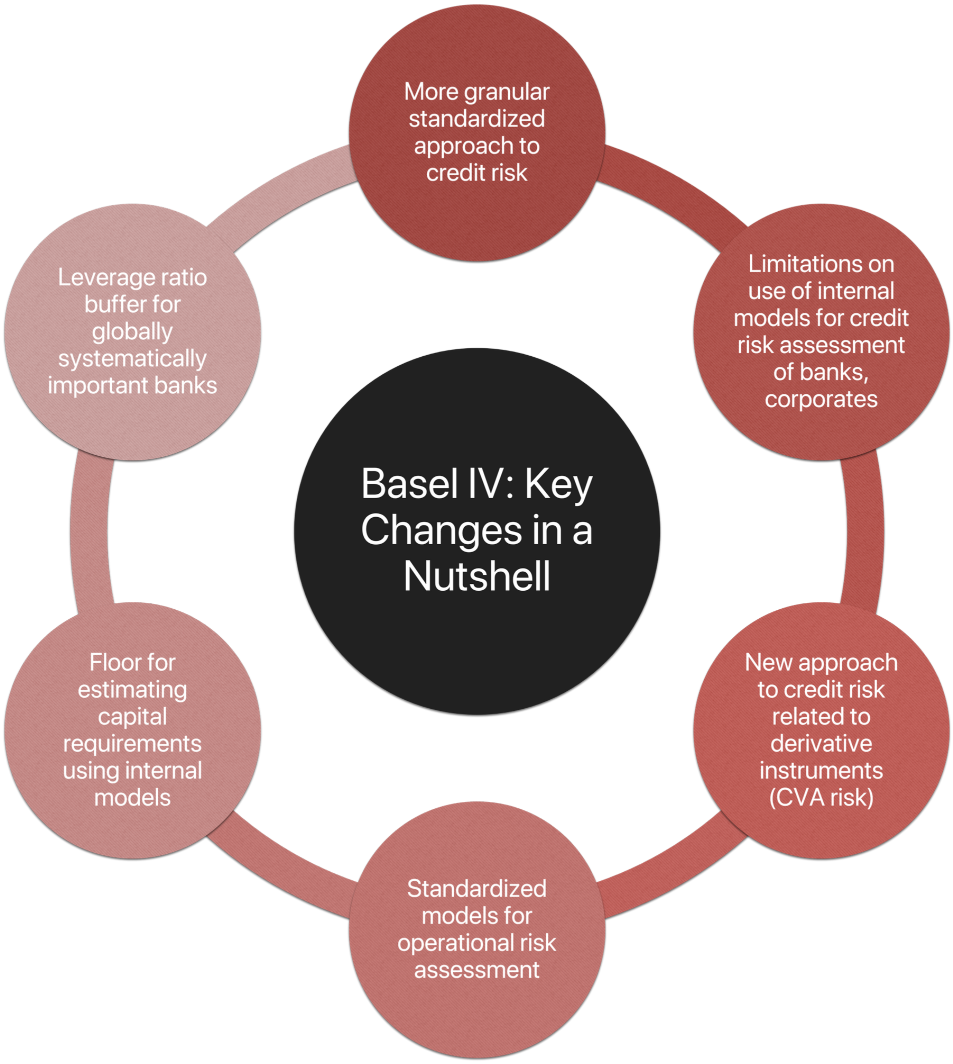
Faced with higher capital requirements, banks can choose to either increase their capital or reduce their assets – they could trim their balance sheets until their current capital levels are sufficient to meet the required thresholds. According to the CE report, if banks choose to deleverage rather than increasing their capitalization, this could reduce available credit by €2.9 trillion.

Such widespread deleveraging seems unlikely. More realistically, banks may choose to pursue a combination of raising capital and shrinking their balance sheets, leading to some reduction in lending and an increase in lending costs. Through this mechanism, the Framework may reduce economic growth.



Outlook

The EBA has recommended the full implementation of the Final Basel III Framework, with a few relatively minor modifications. In contrast, the CE report recommends a number of fairly substantial adjustments to the Framework that would reduce the increase in MRC to 6-10%, thus mitigating some of its potential economic and competitive impacts.

Europe is the first major jurisdiction to begin the process of implementing the revised Basel III requirements. Its experiences are certain to impact the debate in the US, which has not yet begun its public implementation discussions.

Intuition Know-How has a number of tutorials that are relevant to Basel III:

- Basel III – An Introduction
- Basel III – Pillar 1 & Capital Adequacy
- Basel III – Measurement Approaches
- Basel III – Liquidity & Leverage
- Basel III – Pillar 2 & ICAAP
- Basel III – Pillar 3 & Risk Reporting
- Credit Risk – Measurement & Capital Requirements
- Operational Risk – Measurement & Reporting
- Market Risk – Management