Katarína Oravíková Podoliaková

GLOBAL TRENDS AND CHALLENGES IN INVESTMENT BANKING[1]

***Abstract**: Investment banking is one of the most dynamic sectors of global finance. Activities of investment banks impact the global economy and are very important to the smooth functioning of capital markets. Thus it is no surprise that the business of investment banking has been subject to a great deal of government regulation around the world. Especially nowadays, investment banks are operating in a rapidly changing and highly regulated environment. Their focus on strategic and operational priorities provides the key to high performance. This paper discusses the major trends and challenges in investment banking industry that we identified in the background of the ongoing macroeconomic developments. We found three areas: responding to regulation, emphasis on the client needs and establishing a new balance, which currently represent the major challenges for globally operated investment banks.*

***Keywords**: investment banking, bank, trends and challenges*

JEL: G 21, G 24

1 Introduction

Investment banking is a very competitive and dynamic business. It is a complicated industry of traders, analysts, brokers, managers, hedgers, retirement planners, and even bankers. As Fleuriet, M. said: "This business is as creative as it is mechanical, as qualitative as it is quantitative; its clients range from middle-American mom-and-pops to international billionaires, from newly created firms to multinational giants. Investment banks also work for governments" ([3], pp. 11). Thus successful bankers constantly anticipate market trends and opportunities, and then align resources to ensure that they serve those opportunities in the best way possible.

Investment bankers perform ongoing analysis of each client to provide smart solutions so that they achieve superior performance. Several important trends have emerged within the investment banking industry. For new opportunities emerging countries now provide a faster growth and thus attract the investment banks attention.

[1] This contribution is the result of the project VEGA (1/0329/11) "Capital market and its role in supporting the real economy of eurozone".

Second, many banks pursue a strategy of diversification and effectiveness of revenues to maintain sustained earnings growth. Furthermore, regulatory compliance and high standards of governance have become an integral part of the business.

In this paper, we try to explore each of most important investment banking trends and challenges in detail. For each one, we describe the background and context, as well as providing specific examples of the challenges faced by many investment banks today and the reasons why these will be front-of-mind issues for the next years.

2 Investment Banking Trends and Challenges

Investment banks are still scrambling to adjust to the realities of this business. In a straightened operating environment, where the only certainty is increased regulation, pre-crisis returns on equity (RoE) of 20 percent on average look extremely optimistic. Furthermore, they are trying to re-build reputation dented by the financial crisis and a series of high profile scandals.

In the recent years some of the trends and challenges in this industry have proved to be crucial. However, as they face up to the challenges that lie ahead, investment banks need to keep the following six macro trends front of mind. Each of them will play a crucial role in shaping the future operating environment:

a. *Demographic challenges* – widely reported, most developed economies are struggling to come to terms with seismic demographic challenges. To varying degrees, these are set to transform the way people live and work. Life cycle savings and ageing populations point to the need to save in developed economies, making asset management an increasingly vital source of revenue growth for investment banks.
b. *Emerging markets growth* – economies experiencing rapid growth, combined with little well-established competition, offer exciting opportunities for investment banks. But the risks, and operational challenges, of expansion into these new geographies are still being potentially underestimated.
c. *Technology commoditisation* – technology has repeatedly demonstrated its ability to commoditise banking offerings – particularly in non-relationship based, low value added areas. With commoditisation increasingly dominating ‘flow’ businesses, clear-sighted strategic decision-making is vital. Banks must either make the substantial investments in straight-through processing capabilities needed to achieve economies of scale, or concentrate on areas such as advisory, that cannot be commoditised.
d. *Ultimate value to investors* – investment banks have to concentrate on services and offerings where they deliver value to their clients, not just margins to themselves. This makes it essential for banks to develop deep, real-time insights into the risk/reward balance of their products and services.
e. *Re-evaluation of capital* – savings deposits may be the most desired form of capital, undemanding and sticky, but those attributes also make it rare and likely to become rarer. Investors have many more choices on where to place their capital

and the amount placed in savings has been one of the slowest growing of all areas for over a decade. With this in mind, investment banks need to re-evaluate capital's importance in any service of product and charge accordingly.

f. *Resource constraints* – mounting resource constraints point to gradually rising input costs becoming a universal backdrop to all business and banking activity. With oil approaching peak output, and basic commodity costs responding to wide demands of emerging markets, a reordering of economic priorities looks to be the likely result. Sustainability is now on the agenda (as a serious business issue) across all business sectors and investment banks must overcome their institutional cynicism and follow suit (as well as capitalise on the opportunities presented).

With these macro trends in mind, investment banking challenges could be divided into three broad themes:

Responding to regulation

Of course, banks must still take risks to achieve their targeted RoE, but they must now do so through a complex (and still evolving) regulatory framework. Beyond question, responding to the post-crisis regulation presents a major compliance challenge for all investment banks. From now on, robust risk management will be a crucial demonstration of intent to regulators, as well as allowing banks to shape regulation and protect shareholder value. If one lesson can be taken away from the crisis, it must be that previous risk governance models were largely inadequate to shield investment banks from the onslaught of systemic turmoil. Going forward, therefore, banks must commit themselves to adopting and embedding a culture of managing risk throughout the organisation, particularly in the front office.

Emphasis given to client needs

With proprietary trading operations being limited by regulators and questioned by shareholders, the importance of building and maintaining a successful client performance is now critical to the bottom line. So, there is the need to drive greater efficiencies from existing revenues. Banks must focus on providing integrated client services to attract and retain client business, as well as developing the deep analytical insight needed to monitor and maximise client returns, and undertaking realistic assessments of the costs and benefits of the services that they provide. Now more than ever, investment banks have an opportunity to regain trust amongst their clients as well as throughout wider society, while delivering returns to their core business through responsible business practices.

Establishing a new balance

Further more, banks must remain resolutely focused on the many challenges of today, they also need to keep an eye on tomorrow. That way, they are positioned to take advantage of the next wave of growth, instead of having to react to it. The

banks that successfully capitalise on future strategic opportunities will possess acute strategic insight, be early adopters of emerging technologies and, critically, be able to make measured assessments of tomorrow's key battlegrounds, and their chances of success in each of them.

However, one basic fact remains. There are still really only three ways to make money in investment banking: take risks, grow revenues and control costs.

2.1 Responding to Regulation

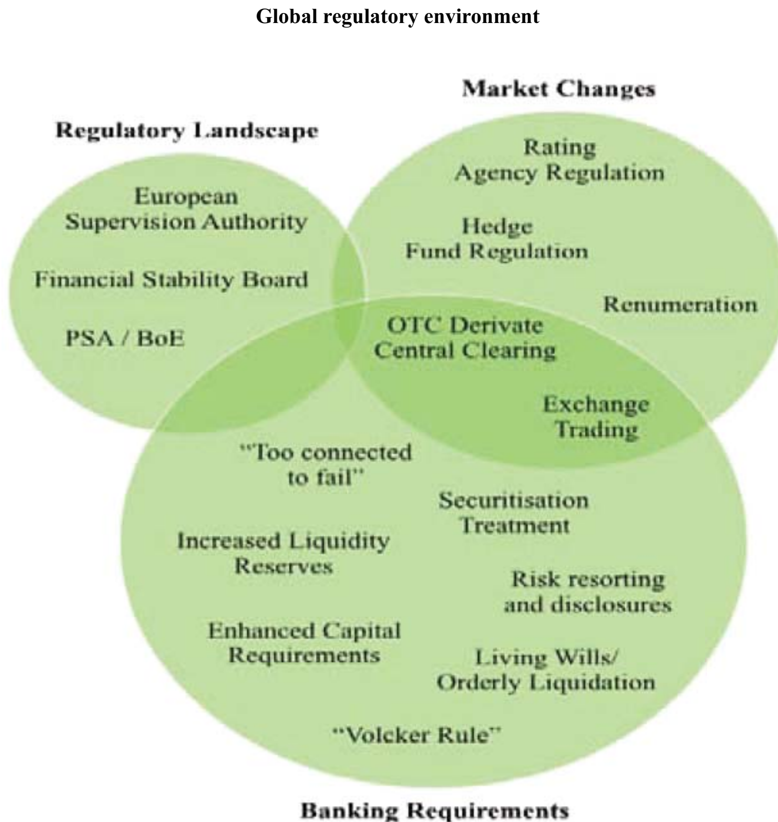
Fears in the financial services sector of a drastic increase in regulation, at a national and supra-national levels, have been realised at investment banking industry. It is increasingly difficult for investment banks to ensure complete compliance while continuing to make money in an uncertain market. In the hope of avoiding future crisis, politicians and regulators in the UK, Europe and the US have all been introducing significant changes to their regulations. Unfortunately, national governments are likely to continue to plough their own furrows as they strive to garner political support through new regulatory initiatives, instead of focusing on a more systemic approach.

The purpose of regulations is now very clear and with a number of regulatory deadlines looming, and a number of prominent deadlines having slipped in 2012 (e.g. Dodd-Frank Swap Dealer Registration), the order book for 2013 is looking very ambitious. Banks are currently facing the challenge of responding to multiple regulations that are either work in progress (e.g. Volcker), span multiple years (e.g. Basel III, G-SIFIs, ICB), or driven by local regulators (e.g. LIBOR and Rogue Trading), or indeed a combination of these factors. The sector's focus has progressed from interpreting and understanding the business impacts of new regulations to implementing change programmes, which as a minimum achieve compliance. However, these regulations mostly drive and compliment the business strategy of the investment banks.

Beyond question, fears in the financial services sector of a drastic increase in regulation have been realised. The non-exhaustive list in Figure 1 gives an indication of the range of regulations currently being implemented around the investment banking industry.

Figure 1

Global regulatory environment



Source: created by author

From these regulations, the Dodd-Frank Act is set to have a major impact on the business operations and behaviour of investment banks. According to a survey made by Accenture, 49 percent of executives indicated their profits would decline as a result of the Dodd-Frank Act. Furthermore, the survey pointed, that the investment banking industry was likely to spend from 3 billion UDS to 5 billion USD over the next three years to implement provisions of the Dodd-Frank Act [4].

In Europe such a statutory initiative is Basel III proposal. In practice, it has established a new core Tier 1 ratio of 4.5 percent plus a new capital conservation buffer of a further 2.5 percent. This provides an effective minimum at 7 percent, more than tripling the current 2 percent. However, there is likely to be local variation as national regulators determine countercyclical capital requirements and higher standards for systematically important institutions. All these measures will force banks to shrink their balance sheet and possibly may lead to increased levels of retained earnings or capital raising to ensure sufficient capital buffers.

Professor of Finance at St. John's University, K. Thomas Liaw said: "With those high-profile regulatory changes, there will be winners and losers. The winners will

likely be those who have been able to view changes in a strategic way, by divesting or closing businesses or through regulatory arbitrage across nations" ([2], p. 363).

2.2 Emphasis on Client Needs

In the years before the financial crisis 2007 − 2009, many investment banks concentrated their attention on developing complex products and taking on risk through proprietary trading. In the post crisis period, they shift the emphasis from product innovation towards client services. The focus is to better align offer of bank's services with needs of their clients. Thus, servicing clients is no longer just about sales. As stated in the Annual Report of Goldman Sachs: "Our first priority is and always has been to serve our clients` interests. " [13] These words are true today more than ever.

While banks will continue to use leverage, the higher cost of debt means that leverage rates will inevitably fall. This will make it harder for them to maintain their historic return on assets. A reduction in leverage from 95 percent of capital to 66 percent, for example, could reduce average return on equity (ROE) from approximately 15 percent to 10 percent. The leverage at investment banks approached historical highs during 2007. During 2008 and 2009, they all significantly reduced their leverage following substantial losses and the imposition of regulatory requirements that restricted leverage. This trend can also be observed on the data provided in the Table 1 and following Figure 2.

Table 1

Leverage at investment banks (%)

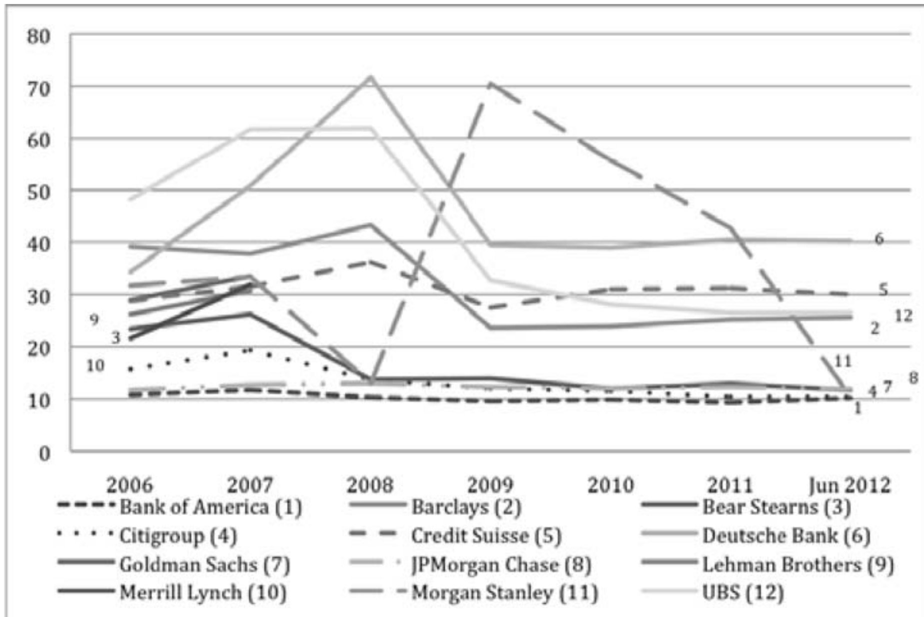
Banks	Leverage (Assets/Equity)						
	2006	2007	2008	2009	2010	2011	Mid 2012
Bank of America	10.8	11.7	10.3	9.6	9.9	9.3	10.2
Barclays[1]	39.2	37.8	43.3	23.6	23.9	25.2	25.6
Bear Stearns[2]	28.9	33.5	-	-	-	-	-
Citigroup	15.7	19.3	13.7	12.0	11.5	10.4	10.4
Credit Suisse	28.8	31.5	36.2	27.5	31.0	31.2	30.0
Deutsche Bank[1]	34.3	50.8	71.7	39.5	39.0	40.5	40.2
Goldman Sachs	23.4	26.2	13.7	13.9	12.0	12.9	11.7
JPMorgan Chase	11.7	12.7	13.0	12.3	12.0	12.3	11.9
Lehman Brothers[2]	26.2	30.7	-	-	-	-	-
Merrill Lynch[2]	21.6	31.9	-	-	-	-	-
Morgan Stanley	31.7	33.4	13.0	70.5	55.7	42.7	10.4
UBS[1]	48.2	61.7	61.9	32.7	28.1	26.5	26.5

Note 1: Barclays, Deutsche Bank, and UBS financials are presented under IFRS standards. All other banks are presented according to U.S.GAAP.
Note 2: Bear Stearns and Merrill Lynch were acquired by J. P. Morgan Chase and Bank of America, respectively, in 2008. Lehman Brothers went bankrupt in 2008 and subsequently sold its U.S. investment banking operations to Barclays.
Source: 10-K filings and annual reports concerned

Going forward, there will be reduced appetite for risk and leverage in the investment banking industry. This may lead to lower returns on equity, unless firms can make technological progress in driving costs down, and create new sources of revenue from products and services that have yet to be developed. Thus facing reduced leverage and with declining proprietary trading revenues, the banks have to focus on increased client profitability to achieve higher levels of investment banking profitability. Historically, the industry has been remarkably resourceful in reinventing itself and driving earnings through new products and services. Moreover, an improved client profitability will be crucial to replacing those revenues previously derived from high leverage ratios and lucrative proprietary trading desks. Clearly therefore, a key challenge facing investment banks is that of how to increase client revenues whilst reducing client cost-to-serve. The challenge is considerable. So as we could see, whole industry is tending to focus on client's need.

Figure 2

Development of leverage at investment banks



Source: created by author based on data from Table 1.

Only an ambitious client strategy that covers the bank's regions, client segments and product areas can deliver on the crucial objectives of integrated and consistent service delivery, deeper client insights and improved client penetration. Any drive towards this goal must start at the top with committed senior-level engagement. At large banking groups, consideration should be given to whether or not to extend the investment bank client strategy to group level. But any decision to do so must not be taken lightly. Thus flexibility is a key to do so.

However, the most important asset at any investment bank is its people. The success of business is dependent upon the team's ability to provide the most innovative and creative solutions to clients' needs. To maintain the competitive edge and meet expectations of clients, investment banks must attract, retain, and motivate their employees. Compensation based on performance that rewards results is fundamental to operations of the banks. Thus, employee‘s compensation and benefits are the largest items in expenses. Furthermore, most companies also stress an integrity, social responsibility, diversity, community service, team work, and entrepreneurial spirit.

2.3 Establishing a New Balance

One of these trends could be named revenue diversification. Investment banks used to provide their clients with huge range of services such as money lending, retail and institutional fund management, structured finance, and securities services.

Nowadays majority of their revenues are not derived from traditional investment banking activities. For example, the business mix of net revenues for Goldman Sachs in 2011 was 15 percent from investment banking, 60 percent from institutional client services (equities 29 %, fixed income 31 %), 17 percent from asset management, and 7 percent from investing and lending.

In the recent years, investment banks have been expanding also geographically to become financial supermarkets of the world. With rapid advances in information technology and greater cooperation among financial regulators, the international capital markets are now more closely linked. Larger sums of money are moving across national borders, and more countries, institutions and also individuals have access to international finance. Although, globalization is not purely a new trend, in finance environment it is still one of the important challenges.

Big banks, such as Bank of America, J. P. Morgan, Citigroup, Credit Suisse, UBS, Deutsche Bank, Barclays, Goldman Sachs, and Morgan Stanley all have a strong global position and leadership in core products. The annual reports of these banks have clearly stated that they earn a significant portion of their net revenues from international operations. For example, net revenues at Goldman Sachs from the Americas decreased from 70 percent in 2008 to 62 percent in 2011. During the same periods, net revenues from Asia increased from 4 percent to 13 percent.

By contrast, financial institutions established out of the United States such as Deutsche Bank and UBS are expanding their investment banking activities in the United States through acquisitions.

Investment banks rely on advanced technologies to enable high-speed, high-frequency trading, as well as fast and accurate analytics for client services. The ultimate goal of banks is to do more and do everything more profitably, which can be achieved using the latest technology. Many firms are using the Internet for extended trading in markets around the world. Clients now have online access to research, data, and valuation models 24 hours a day. The online auction approach brought out many IPOs for small businesses. For example, Google IPO was completed via this type of auction process. It was the largest Internet IPO raising 1.9 billion USD. This auction system has been built and operated by Morgan Stanley.

In addition, information technology has been a significant factor in improving the overall efficiency of investment banks. Their management has updated information in real time on the firm's operations worldwide. Not only globalization has been possible, but also better decision-making process and improvement in the banks competition to gain clients.

The last but not least important trend in investment banking industry is concentration on emerging markets where the middle classes are increasing their incomes rapidly. Thus, those consumers will drive higher demand for financial services. These are in contrast to developed markets, with economic uncertainty and intense competition. Many investment banks have identified emerging markets as a key part of their strategy to grow revenues. Many of them have already established operations in emerging markets. This is evidenced by the increase of net revenues

from emerging markets for successful banks, when we search within the annual reports of these banks.

3 Conclusion

The market for investment banking operations evolves over time. Investment banks are facing increasing competition for clients as well as talents. To compete for clients, investment banks need to offer integrated solutions so that the clients can achieve superior results. To compete for talents, investment banks focus on the compensation system and corporate culture. To maintain stability of earnings, investment banks diversify revenue streams and manage risks. But as we have seen in response to the crisis 2008−2009, the regulatory and supervisory authorities could change everything, mostly what and how investment banks do business.

History has shown us that implementing a single regulatory change, such as MiFID and Basel II, has caused major problems for implementation, with many banks still struggling to integrate the changes into their existing systems. Successful responses to these regulations were those that tackled the challenges through a strategic and co-ordinated response that embedded the changes within business and operating models, rather than implementing short-term tactical solutions to the regulations.

The problem is that the current wave of regulation is bringing several regulatory programmes of this scale together at the same time. More than ever, banks need to ensure that they fully understand the new regulations and the effect on their business. The objective is not just to make the required changes on time and within budget, but also to do so strategically. Thus it will be easier to manage further regulatory change as part of a continuous cycle of risk and control enhancement. Only the future will show how the investment banks will cope with the global trends and challenges.

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