No more easy money
Chris Hughes

Late on Monday October 13, canary Wharf played host to one of the most unusual parties London's financial district has ever witnessed.

There was no champagne. The UK's financial sector had been humiliated that same morning, as the government committed itself to a £37bn ($58bn, €45bn) part-nationalisation of several leading banks, and the mood was subdued. The entertainment consisted of a Japanese drum dance designed to ward off evil spirits.

The location was 25 Bank Street, the former European headquarters of Lehman Brothers, the failed US investment bank. Nomura, the Japanese bank, had just signed a deal to buy the bulk of Lehman's operations in the region out of administration.

It was an event that would have been unimaginable even three months earlier. The shiny new office building had been the staging post for the 158-year-old Wall Street bank as it pursued ambitions to branch eastwards and become a global player. Now it was home to an eastern financial institution keen to move westwards as it pursued the same ambition.

"It's over," Christian Meissner, Lehman's former head of Europe, had told staff when the bank collapsed a few weeks earlier. Now Mr Meissner was breaking open sake barrels with Yugo Ishida, Nomura International's president and chief executive.

The ascendancy of eastern finance, the end of self-regulation and, above all, a lack of fizz: it is hard to imagine a moment that better captures the transformation under way in the City of London. After decades of almost unbroken expansion, in which it was given the benefit of the doubt by government and regulators, Europe's premier financial centre is now retrenching.

A City in disarray has far-reaching consequences for the companies that rely on it to raise capital, as well as for investment institutions that trade billions of dollars through London's financial district on behalf of savers and pensioners. "The City is going through a hangover after a tremendous party," says a top banker at one of the Square Mile's leading investment banks.

The immediate impact of the credit crisis on the City can be measured in job losses. From a peak of 353,000 last year, London's financial district will see employment fall to around 291,000 during 2009, according to the Centre for Economics and Business Research.

At the sharp end of this decline are the businesses that represent the core of the City - the investment banks, stockbrokers and advisory boutiques that act as intermediaries between companies seeking to raise capital and investors looking to invest.

But aside from this obvious contraction, the City has also started to see some structural changes. It is not just the substitution of a globally ambitious Japanese bank for Lehman in Canary Wharf. The two investment banks that led in the so-called "middle market" are being consigned to history.

Dresdner Kleinwort, the latest incarnation of the venerable Kleinwort merchant bank whose roots go back to the 18th century, is being shrunk following the acquisition of its parent by Germany's Commerzbank. The new owner has said it is not keeping the Dresdner Kleinwort name - although the brand could yet be sold.

ABN Amro, Kleinwort's closest mid-market rival, is also facing aggressive shrinkage under Royal Bank of Scotland, which bought it last year. RBS had intended to use ABN as the foundation for a push into investment banking. That strategy is now being reversed in the wake of its government-sponsored recapitalisation.

On a narrow view, the credit crisis could be seen as accelerating a trend already under way the decline of the investment banking middle-market -while taking only selective casualties at the extremes of the marketplace.

But the changes so far are early evidence of some fundamental forces that will reshape London's financial district over the coming decade: the shift in the balance of financial power from west to east, the decline in the appetite for risk-taking and the need for what were previously thought of as large players to become even bigger.

"If you look back at what has happened to the City from the late 1960s onwards, you see change that was pretty radical and evolutionary. And I expect it will go on changing in relatively surprising ways," says John Nelson, a veteran of Kleinwort Benson, Lazard and Credit Suisse, and now a non-executive of JPMorgan Cazenove.

The challenge is, in essence, simple. If the City is about making money out of money, in future it will require more to make less at the end of the day.

Regulators are insisting that banks become less risky, holding bigger capital cushions for even relatively low-risk activities. Meanwhile, banks are under pressure to strengthen back-office operations and invest in staff whose job is to keep an eye on the "front office" staff and the risks they are running.

The greater caution of regulators is shared by the wider investment community. Perceiving higher risk, investors are demanding higher returns, and this is raising the cost of capital for financial institutions.

The result? Activities that flourished in a world awash with easy money have become much less profitable, or even unviable. This new dynamic amounts to a massive increase in the cost of doing business for the City. It will favour larger institutions and become a force driving consolidation even between institutions that are already thought of as large.

"The middle ground is getting squeezed. You will have to be of a size that you can absorb what amounts to an indirect tax of increased regulation and compliance. That is inevitable. You've got to be bigger today than in the past," says Alan Yarrow, chairman of the London Investment Banking Association and vice-chairman of Dresdner Kleinwort.

Philip Augar, the former broker and author of The Death of Gentlemanly Capitalism, the seminal work on the decline of British merchant banking, says only the largest financial institutions can now be thought of as genuinely big. "Scale is being redefined.

Now a scale player means Citi, Bank of America, JPMorgan Chase," he says.

But some observers believe this new world also favours the very smallest players in the City - the boutique firms that sell pure advice and whose raw material is human capital rather than financial capital. Having always eschewed lending and underwriting, they are largely unaffected by the revolution elsewhere.

"The market will favour the scale battalions, but the position of boutiques as independent advisers will be strengthened by concentration among the scale players. The City will be a fertile ground for people with a reputation for a high degree of independence and integrity," says Roger Carr, chairman of Centrica, the UK energy group, and Cadbury Schweppes, the confectioner.

This raises a question as to who will occupy the ground vacated by the likes of Dresdner Kleinwort and ABN, providing advice to medium-sized companies, making markets in their shares and providing associated investment research. They have proved to be both too big to be niche players and too small to enjoy economies of scale.

It is a tough segment of the industry, but some believe it could be a target for non-banking institutions, possibly including the large audit and consulting firms. "Hedge funds and private equity could become the new independent investment banks. One of the biggest relationship bankers of the last 15 years has been John Studzinski. And he now works for Blackstone as an M&A adviser," says Mr Augar.

Either way, the City of the future looks less diverse. That will have an impact on its customers, which broadly fall into two categories - investment clients that trade in securities such as bonds and shares, and corporate clients that use the City to raise capital and for advice in pursuing deals.

The trading desks of investment banks will return to the job of matching buyers with sellers.

This may sound like going back to business as usual. But the reality is that, over the past decade, investment banks became increasingly willing to act as a direct counterparty to their clients' trades, confident that they could find a third-party buyer to take on the position afterwards.

Banks will now charge more for it. Legal & General, the UK insurer, is among the biggest users of the City. Its investment management business has £300bn under management on behalf of retail and institutional clients, and its life and pensions business also manages billions in assets and liabilities.

"We were enjoying doing £250m trades at mid [price]. Today, you can't get these things done. The cost of capital will be higher and the amount of capital put up to support trading will be lower. If you want to buy bond A and sell bond B, or trade shares, it will cost more," says Tim Breedon, chief executive.

This increased cost of trading is a direct cost for pension funds, and it is likely to make investment managers think twice before making changes to client portfolios. But this may not be a bad thing if it means they also think more carefully about their long-term investment strategies.

There are also consequences for corporate clients. The City of the past decade was one where it seemed that no deal was beyond financing in myriad ways. Investment banks were quick to commit their resources to underwriting even the largest fundraisings. In future, corporations will have fewer, albeit larger, underwriting institutions to choose from when raising capital.

Mr Carr says the changes should not be overplayed, reflecting on the favourable support he sees for the large rights issue recently launched by Centrica. "What is interesting is that in all the turbulence, the fundamentals [of the process] still hold good... [Before the crisis] there would have been multiple routes for obtaining finance. Now the routes may have reduced. But the fundamental process is intact."

Fonte: Financial Times, London, November 11 2008, Primeiro Caderno, p. 7.