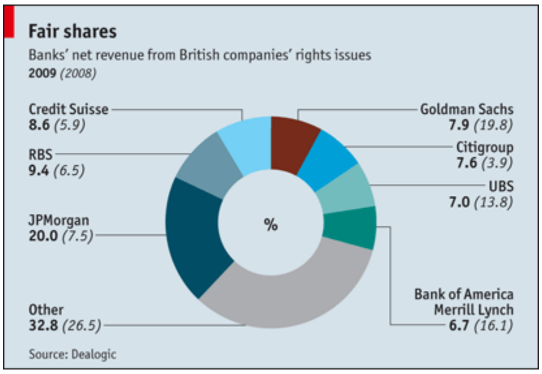
The Economist

Economics focus

Rights and wrongs

Why price competition between investment banks is so feeble

Jun 17th 2010 | from PRINT EDITION



WITH governments seeking soft targets for tax revenues and regulators looking to curb their activities, investment banks have plenty to contend with. Now they face a new battle. The Office of Fair Trading (OFT), a British competition agency, said on June 10th that it would conduct an inquiry into equity underwriting, following complaints from issuing firms.

What might the OFT be looking for? One concern is that the industry may have too few firms to ensure vigorous price competition. One bank may have so big a share of the market that it can charge high fees without worrying how its rivals will respond. But it is rare for trustbusters to find a single firm that dominates in this way with a market share below 40%. No investment bank comes close to that threshold. Rights issues by already-listed firms accounted for the bulk of equity-raising in Britain last year; the leading bank's share of revenues was 20% (see chart).

A related worry is that a small group of firms might act together to keep fees high. That could be achieved by a formal pact to fix prices (a cartel, in other words) or a tacit agreement not to compete too hard. Cartels are illegal and there is no suggestion that the OFT's inquiry is of a criminal nature. But an implicit agreement can work in the right conditions—if demand is stable from year to year and if the bulk of the market is served by four or fewer firms, each with a similar share of business. In such circumstances, firms would have few incentives to undercut their peers. If one firm cut its prices, destroying the unspoken deal to carve up the market, it would succeed only in starting a price war.

For all its excesses, however, investment banking in Britain does not have the traits of a collusive industry. The market structure is too fragmented for banks to co-ordinate their activities easily. The top four captured less than half of the revenue from rights issues last year. If concentration is judged on deals in which firms were the lead bank (or "bookrunner"), the share of the top four banks was higher, at 58%. In both cases other banks would still have enough clout to undercut any collusion by the biggest competitors. And the market share of each firm varies from year to year, a sign of healthy competition.

Industry profits are also too "lumpy" for the market to be readily carved up. In 2009 rights issues in Britain produced $1.9 billion of revenues for banks, says Dealogic, a financial-information firm. That was a bumper year: the corresponding figure for 2007 was just $84m. An unspoken agreement to keep prices high could not be stable in a business that goes from famine to feast in this way. There would always be an incentive for one or more firms to break ranks and grab at any short-term profits on offer.

Investor groups nonetheless feel that the fees charged by banks do not reflect this competitive

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structure. One complaint is that fees have got fatter in a way that is not explained by any increase in banks' risks or costs. Although there was variation, a typical fee for underwriting and distributing a rights issue when stockmarkets were more stable was 2% of the deal's value. A chunk of that, perhaps 1.25%, might go to sub-underwriters (often insurers with shares in the firm raising equity) for taking on some of the underwriting risk. In last year's jumpy markets, however, banks' fees rose to 3% or more and have been slow to fall back. Sub-underwriters moan that their share of the spoils did not rise, too. They think banks were overpaid for the risks they took. Issues were priced as much as 40% below market prices so stocks would have had to plunge before banks would be out of pocket.

The fault may lie partly with buyers. Heads of big companies have a habit of spending shareholders' money a bit too freely when they want to raise funds for an acquisition (think of the fees paid recently by Prudential, or earlier by BHP Billiton, on aborted takeovers). "Our clients want the best, not the cheapest," says a corporate adviser. That means they often pay over the odds. Like other professionals, investment bankers tend not to compete on price lest customers interpret low fees as a sign of poor quality.

Corporate chiefs may feel they have little choice but to pay what they are charged. By their nature, rights issues are rare (serial dealmakers may be better placed to win concessions on fees because they can offer repeat business). A lot rides on their success: the proceeds might be needed to avert bankruptcy or to finance a takeover. The need for discretion makes it natural for a firm to look to its corporate broker, the investment bank which (in Britain) acts as the link between the company and investors. The broker does this without charge in the hope that another day it will be paid well for other services.

A switch in time saves nine

This kind of relationship is the norm. But the OFT's trustbusters frown on markets where "switching costs" for consumers are high (retail bank accounts are a particular bugbear). They fear that firms locked in to a single supplier for a vital service could be overcharged for it—and for related services. A restaurateur may work hard to get customers in the door. But once inside, the diner who wants to buy a bottle of wine with his meal faces a monopoly supplier. Bankers retort that rivalry for corporate brokerships is intense and switching is common. "It's not like changing your checking [current] account," says a banker. "It's more like changing your clothes."

One innovation that might make the market work better is for the terms of a corporate brokership to be set out explicitly at the start. That way banks can say what they would charge for services should the need arise. As things stand, fees are almost an afterthought. Like diners at a fancy restaurant with no prices on the menu, customers may not even know what the charges are until the bill arrives. Whatever its problems, however, the market in Britain seems to work better than in America, where investment banks routinely charge a 7% fee on initial public offerings, roughly twice the European norm. That gap has never been satisfactorily explained. Once America's new regulatory set-up is established, its trustbusters may well follow the lead of their British counterparts and take their own look at investment banking.

from PRINT EDITION | Finance and Economics