Global Capital Markets 2014

The Quest for Revenue Growth

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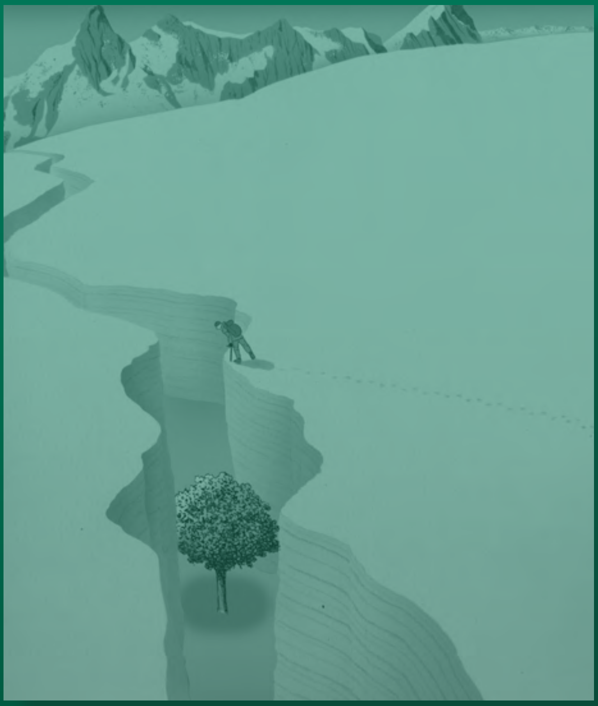

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THE QUEST FOR REVENUE GROWTH

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INTRODUCTION

THE CAPITAL MARKETS AND investment banking (CMIB) industry continues to try to navigate its way through a transformational period that requires tough strategic choices. Declining revenues, an extremely challenging regulatory climate, clients that demand higher service levels and more innovative products, a shifting workforce culture, and the need to forge meaningful business partnerships are common items on the agendas of senior management teams globally.

Although the industry-wide revenue decline in 2013 was not dramatic, at about 2 percent, the largest revenue pool—fixed income, currencies, and commodities (FICC)—suffered a steep drop of 16 percent. This decline was offset to some degree by substantial rises in equity and investment banking division (IBD) revenues. But after-tax return on equity (ROE) remains under pressure, falling slightly in 2013 to 11 percent, with further declines probable in 2014. Overall, we believe that the industry's focus on regulatory compliance and cost reduction, necessary as those activities may be, has worked somewhat against placing sufficient emphasis on improving core business capabilities and increasing revenues. As for regulation, the framework for the future has largely been set. It is the implementation of this structure that still has a long way to go—and that continues to generate uncertainty regarding both revenue models and costs.

With the outlook for revenue growth so dim, the industry winners will be those institutions that are able to increase market share. Several factors will be key to this battle. First, client centricity continues to be critical as a way to make relationships more comprehensive, more durable, and more fruitful both for the client and the bank. Second, CMIB institutions need to define what the investment banker of the future looks like—and to make sure they can attract the best and brightest. Such individuals will need a broad set of skills, an entrepreneurial and innovative spirit, and the ability to embrace a deep cultural sense of compliance and collaboration. Third, CMIB players need to investigate commercial partnerships in order to mitigate the revenue effects of retrenchment in certain regions and products.

In our 2013 report, *Survival of the Fittest,* we asked whether the CMIB industry could survive in the long term. Our answer then, as it is today, is yes, but tall challenges remain. In this, our third annual report on the global CMIB business, we take a deeper look at those challenges, particularly regarding the core dynamics—revenues, regulations, clients, people, and partnerships—that influence the six business models that we feel are most viable. Our aim is to provide food for thought for senior management teams as they refine their strategies.

OVERVIEW
KEY MARKET DEVELOPMENTS

WE see two key challenges facing CMIB players. First, revenues have now become a scarce and volatile resource, pressuring short-term ROE. Second, regulation continues to take its toll and will remain a critical element as banks address cost structures, revenue models, and strategic positioning. Both revenue and regulatory dynamics will affect what we see as the six core business models in the CMIB industry.

The Revenue Challenge

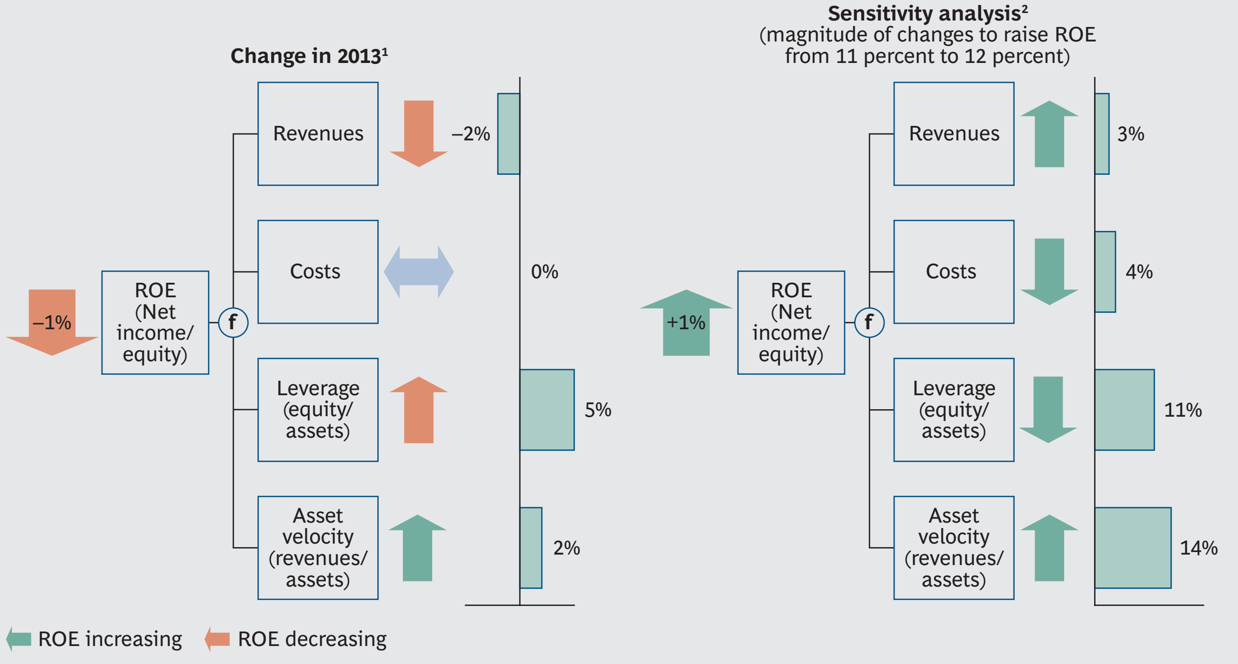
ROE in the CMIB industry fell to 11 percent in 2013, a decline of 1 percentage point from the previous year. This level, which remains at or just below the typical cost of equity (10 to 12 percent), might seem relatively stable. But given the trend toward combined reporting of corporate banking and CMIB activities, appearances can be deceptive. For example, corporate banking activities—such as project finance, trade finance, and cash management—that have traditionally had low capital requirements and low cost-to-income ratios (around 35 to 40 percent) have contributed positively to ROE, potentially hiding decreasing profitability in pure capital-markets activities. Overall, the industry ROE has not returned to its precrisis levels, and the range of ROE outcomes for individual institutions has widened.

In order to fully understand the dynamics behind ROE, it is important to examine the principal ROE drivers: revenues, costs, leverage, and asset velocity. (See Exhibit 1.)

Revenues. CMIB revenues fell by 2 percent to $227 billion in 2013, and have declined by 13 percent since 2010. Pressure on margins has remained high across all asset classes as electronification has continued to expand, a trend that shows no signs of slowing. Even as some asset classes (such as equity derivatives) and cross-asset products show strong growth, they will not be able to offset the declines in other, much larger asset classes. Risk-taking, measured by value at risk (VaR), has continued to decline—dropping about 45 percent from 2010 to 2013 for the top nine players—with ever-decreasing inventories and lower revenues from market-making activities. Funding costs have gone up, partly resulting from more equity-based (as opposed to debt-based) funding to comply with regulations that mandate higher capital availability. We forecast compound annual revenue growth of between –6 percent and 4 percent through 2015. (See Exhibit 2.)

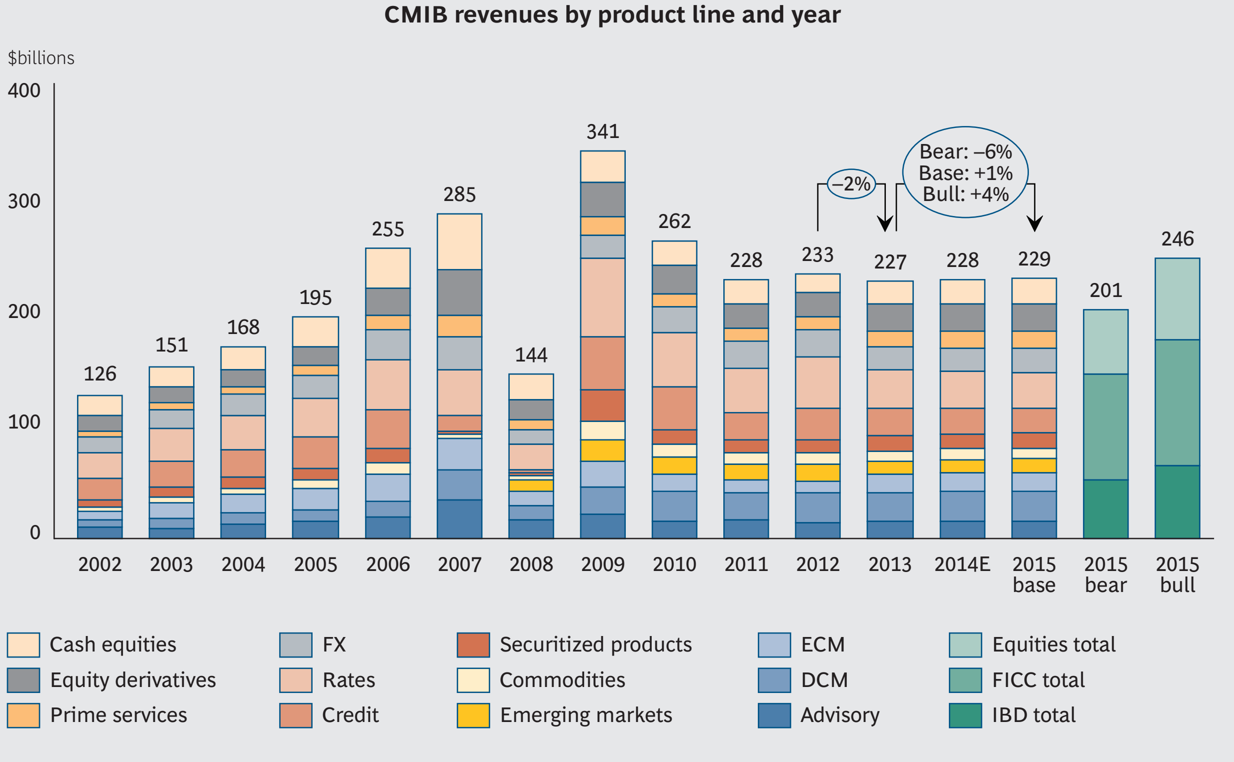
- FICC, the largest CMIB revenue pool at nearly half of the total, fell by 16 percent in 2013 to $112 billion. This represented the bulk of the 23 percent decline from its 2010 level and was driven largely by low client flows and low volatility. In the rates business, the move toward central clearing will exert further pressure on margins,

EXHIBIT 1 | ROE Depends on Multiple Drivers



Sources: Financial statements; BCG analysis.
[1]Revenues are based on a sample of 28 institutions for CMIB only; costs are based on a sample of 17; and leverage and asset velocity are based on a sample of 12.
[2]Based on a sample of 12 investment banks at reported CMIB segment; ROE is after taxes, estimated on the basis of a 30 percent tax rate. (Many combinations of changes are possible.)

EXHIBIT 2 | The Outlook for Revenue Growth Is Dim



Sources: Financial statements; BCG analysis.
Note: Based on a sample of 28 banks. The indicated growth rates are compound annual rates (where applicable).

while the anticipated rise in interest rates in certain parts of the world (notably the U.S.) could help improve client demand and increase volatility. Commodities revenues in banking will likely decline further as banks exit the space because of regulatory difficulties and as the business moves to physical players. In currencies (FX), despite the already-high level of commoditization, we expect further margin erosion (which could, however, be partly offset by volume increases stemming from global trade growth). In credit, future U.S. mortgage reform and the negative net supply from 2013, along with increasing M&A activity and investment spending, could spur growth. But downside risk remains high if credit trading increasingly takes place through indexes.

- Equity revenues offset the decline in FICC revenues to some extent, increasing by 21 percent in 2013 to $59 billion and stabilizing at their 2010 level. Growth in equity revenues in 2013 was driven largely by the 24 percent and 15 percent growth rates in cash equities and equity derivatives, respectively. However, we expect the commoditization and electronification trends in cash equities to continue in 2014, hindering further revenue growth. In equity derivatives, we expect further strength in 2014 as investors continue their quest for yield, but these potential gains will not be sufficient to offset the much larger revenue declines that are expected in FICC.

- IBD revenues rose by 11 percent in 2013 to $56 billion, reversing three straight years of declines. This growth was driven primarily by a 56 percent increase in equity capital markets (ECM) revenues, which offset a moderate decline of 2 percent in debt capital markets (DCM) revenues that resulted from depressed activity in credit markets. We foresee further modest increases in M&A revenues in 2014, which should create some second-order benefits for ECM and DCM revenues. Moreover, in anticipation of potential interest-rate increases, companies continue to issue significant volumes of debt. This trend will likely lose steam, however, and we expect a rebalancing with equity funding in the long run.

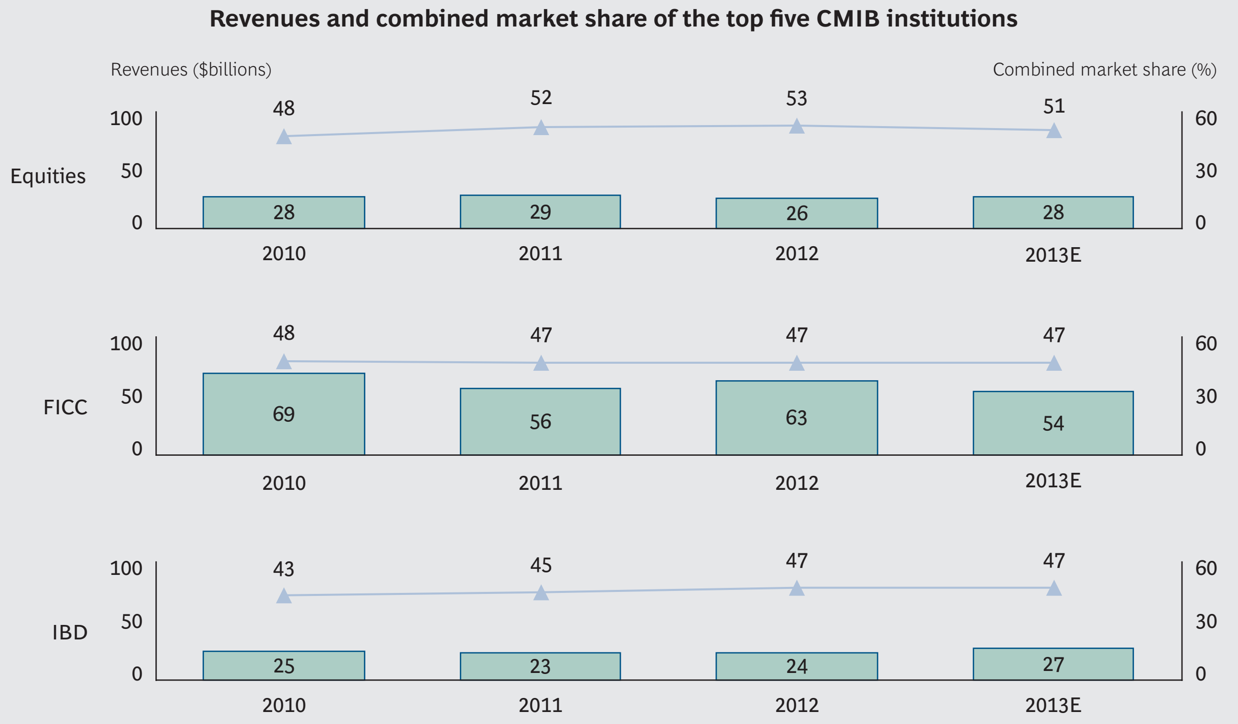
In a broader sense, we believe that the significant effort involved in meeting regulatory deadlines and reducing costs has somewhat sidetracked CMIB senior-management teams from putting sufficient focus on improving core business capabilities and driving revenue growth. Indeed, in a bearish environment with limited repricing opportunities, gaining market share is the only way forward. That said, we have not yet seen a clear trend toward consolidation, with the market share of the top five players in 2013 declining only slightly to 51 percent in equities and remaining stable at 47 percent in both FICC and IBD. (See Exhibit 3.)

> In a bearish environment, gaining market share is the only way forward.

Still, a number of Tier 1 players were able to capture a degree of market share, along with some Tier 2 and Tier 3 players that have shown remarkable resilience by refocusing on their core franchises—essentially, not trying to be everything to everyone. We expect more downsizing in the next couple of years in an industry that is still characterized by overcapacity. This trend will trigger new market-share and revenue-growth opportunities for Tier 1, Tier 2, and Tier 3 institutions alike.

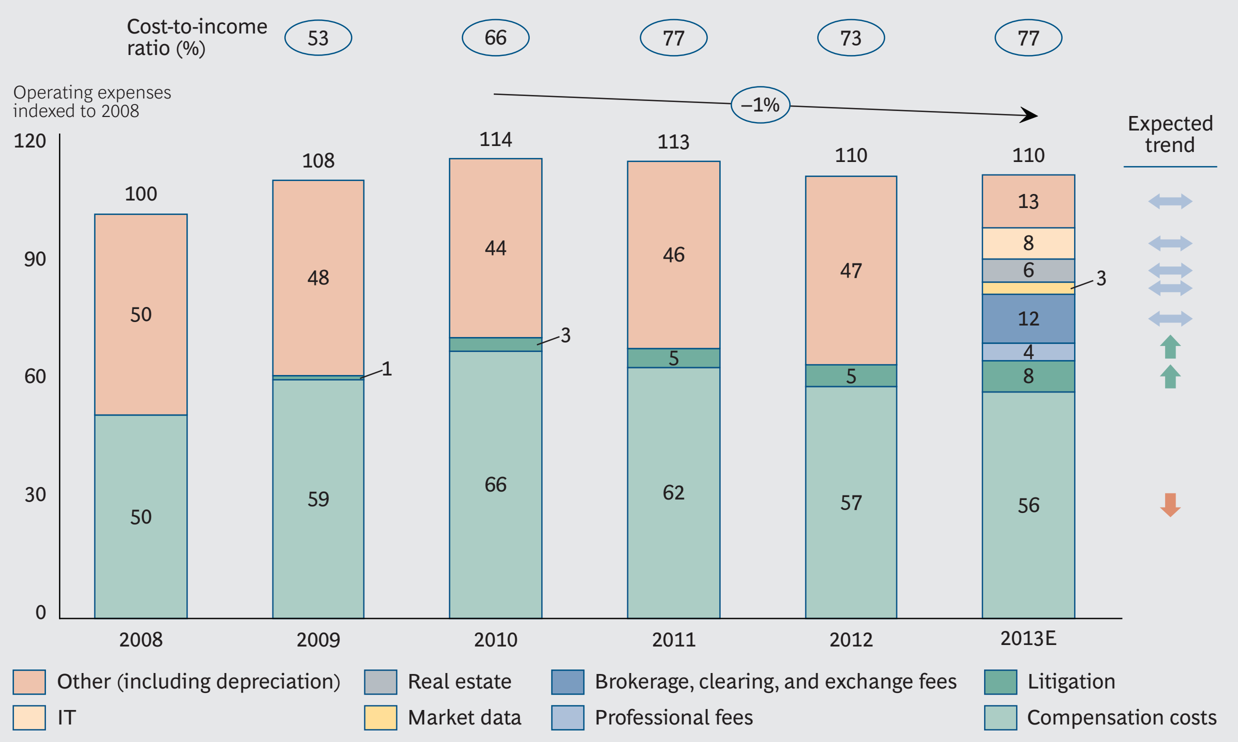
Costs. CMIB players continued to make progress on a number of cost reduction programs in 2013. (See Exhibit 4.) Compensation costs fell by 2 percent (and have declined by 15 percent since 2010), driven both by staff redundancies and by a decrease in average compensation (down 25 percent since 2010). Noncompensation costs (excluding litigation) also fell by 1 percent (but have increased by 4 percent since 2010). Total costs, however, have remained fairly flat, owing to rising litigation expenses, which increased from about 3 percent of total costs in 2010 to 8 percent in 2013.

Exhibit 3 | Market Shares Have Remained Fairly Stable



Sources: Financial statements; BCG analysis.
Note: Based on a sample of 17 banks.

Exhibit 4 | Cutting Costs Is an Ongoing Battle



Sources: Financial statements; BCG analysis.
Note: Operating expenses are based on a sample of 17 CMIB institutions. Compensation and noncompensation costs are based on a sample of 10 CMIB institutions (with noncompensation cost allocations estimated on the basis of BCG analysis). Operating expenses exclude restructuring costs.

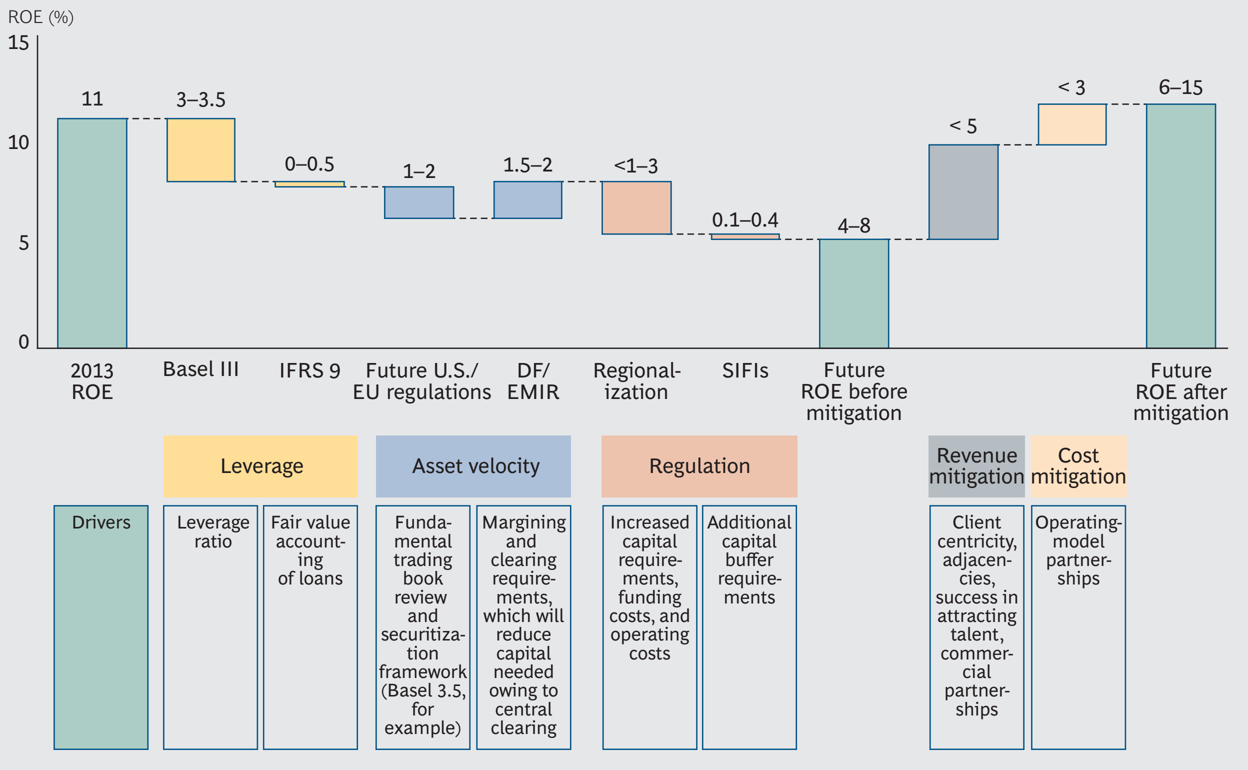
Banks have seemingly reached an impasse of sorts, with the industry's cost-to-income ratio remaining stubbornly above 70 percent—even rising from 73 percent in 2012 to 77 percent in 2013 (albeit with wide variation depending on the business model). We believe that still more can be done in areas such as simplifying organizational structures, standardizing processes, and increasing straight-through processing. As we discuss later in this report, banks need to take significant action to break up silos and explore synergies across asset classes, and also to share or outsource infrastructure. Ultimately, we do not expect costs to decrease significantly, because banks will partly reinvest any cost savings to support new revenue initiatives—such as acquiring more front-office expertise and beefing up IT capabilities. Cutting costs by 10 percent would improve ROE by approximately 3 percentage points. Such a gain, however, would not be sufficient to return the industry to a sustainable level of profitability.

Leverage. As a result of Basel III regulations, leverage ratios (measured by the ratio of equity to total exposure) have been steadily increasing, from 2.4 percent in 2010 to 2.7 percent in 2012 and 2.8 percent in 2013. Leverage is no longer a tool for boosting ROE but a risk-based constraint that banks have to comply with. We expect further increases in leverage ratios, to as high as 5 percent (with differences between the U.S. and Europe), as a result of more stringent regulation—leading to decreases in ROE of 3 to 3.5 percentage points. (See Exhibit 5.) ROE will likely take an additional hit of up to 0.5 percentage point as International Financial Reporting Standards regulations (IFRS 9) are applied to the fair value accounting of loans.

Asset Velocity. After several years of declines, asset velocity increased from 1.49 percent in 2012 to 1.53 percent in 2013, close to its 2010 level of 1.57 percent. The rise resulted from banks' efforts to offset the impact of regula-

Exhibit 5 | Regulation Will Continue to Dampen ROE

Effect of financial regulation on ROE (percentage points)



Source: BCG analysis.
Note: DF = Dodd-Frank; EMIR = European Market Infrastructure Regulation; SIFI = systematically important financial institution.

tion by taking steps such as the following: continuing to exit activities that consume a high degree of risk-weighted assets; working on their risk methodologies; improving data quality; and increasing the internalization of client order flows. Size matters here, and the largest CMIB players benefit.

Looking ahead, the impact of Basel 3.5—specifically, the fundamental trading-book review and securitization framework—will continue to put pressure on banks that may have been more aggressive with their internal risk models and accounting treatments, while regulations on margining and clearing will reduce capital requirements. Consequently, we expect asset velocity to remain relatively flat in the coming years.

Revenues will be the key lever in restoring return on equity.

We should see further downward pressure on ROE in 2014 as several regulatory initiatives that stem from a systemic trend toward the regionalization of banking come into force. Regulators on both sides of the Atlantic, as well as in Asia, broadly aim to take the following steps:

- Require foreign banks to adhere to national regulatory regimes.
- Restrict the activities of national institutions in international markets.
- Limit cross-border, intragroup lending activities.

Overall, the impact will be varied, with some U.S. banks experiencing little impact (less than 1 percentage point of ROE) and others, such as European banks with sizable business in the U.S., feeling an impact of around 3 percentage points of ROE. Some European institutions have already announced significant reductions to their U.S. balance sheets because of the so-called Tarullo rules, which require them to structure their U.S. affiliates in a way that complies with the Dodd-Frank Act. We expect more European banks to follow suit.

Finally, we believe that revenues will be the key lever in restoring ROE. Successful CMIB institutions will increase market share and raise revenues by 10 to 15 percent, lifting ROE by up to 5 percentage points to approach 15 percent. In a bearish revenue environment, others will continue to struggle to meet the cost of equity.

The Regulation Challenge

Despite ongoing updates to banking regulations, the direction of the CMIB industry's regulatory framework has largely been set. The focus has now shifted to the implementation phases that will take place over the next few years—and the new opportunities that may emerge. The next big impact will come from the accelerating push toward more exchange-traded and agency-like models.

On the one hand, cash over-the-counter (OTC) products are continuing to evolve in the direction of listed exchange models. More volumes and bigger tickets are moving through electronic channels (around 70 percent, 50 percent, and 20 percent of total volumes for FX spot, government bonds, and corporate bonds, respectively), and multidealer platforms are gaining ground in consolidating market liquidity. As a result, a number of players are reviewing the viability of single-dealer platforms in their current forms, particularly with regard to products for which banks do not need to provide extra liquidity to the market. In addition, both regulators and clients are pushing for greater transparency on the elements that make up the total "cost of trade," as well as for more fee-based models.

On the other hand, we see OTC derivatives products developing in three phases:

- *Phase 1.* Regulators have already imposed central clearing of some OTC products in the U.S. and Europe. The true costs are still emerging, because the costs of collateral and post-trade servicing are masked by quantitative-easing subsidies as well as by banks that are pricing for market share rather than for profit.

- *Phase 2.* Regulators have started to restrict trading of some OTC products to regulated, more transparent trading venues. This began at the end of 2013 with swap execution facilities (SEFs) for interest rate swaps and credit default swaps in the U.S. The next wave will encompass more products and will expand to Europe with organized trading facilities (OTFs). To date, these developments have not opened up the game, as pre-SEF interdealer brokers have maintained their market share in the SEF environment. Most of the volumes remain on a request-for-quote (RFQ) model, with a few nonbank financial institutions directly accessing liquidity on dealer-to-client (D2C) venues. In the long run, SEFs will force more transparency and accelerate electronification. As a result, they are likely to increase pressure on execution margins.

- *Phase 3.* Some OTC products, particularly the most liquid and standardized, will move toward an agency-like model. Clients will partly shift to cheaper and less-tailored listed products—the so-called futurization of the market—although a sizable market will remain in OTC products for liability-matching purposes (particularly where hedge accounting is a necessity) and to mitigate the lack of liquidity. As SEFs develop and nonstandard OTC products become standardized, the most-liquid and shortest-tenor instruments may be directed to a central limit order book (CLOB).

Although much uncertainty remains about regulatory evolution, we believe that the regulatory climate will have a medium-term impact on banks' strategic positioning along the value chain, as well as on both the CMIB revenue model and the operating model.

For both cash and derivatives products, tensions will rise around the value added by trading compared with sales, as more volumes go to electronic multilateral venues. For derivatives products in particular, clearing and collateral management have become part of the client value proposition, with a heavy emphasis on execution. While buy-side clients have already chosen their primary and secondary listed clearers to handle their OTC products, most of them have added executing brokers—on the basis of strong credit ratings and service models—that offer clearing nearly free of charge. In phases 2 and 3, we expect this trend to weaken (although not disappear) as a result of the following:

- The standardization of products

- The evolution of the competitive landscape, especially with European banks reducing their capital commitments to the U.S. (and the number of clients they can clear for), accompanied by a small number of new entrants from North America

- Emerging clarity on the true costs of clearing following full implementation of Basel III and the EU Capital Requirements Directive (CRD) IV, plus the tapering of quantitative easing

Much uncertainty remains about regulatory evolution and its impact.

The revenue model will evolve slowly for derivatives. We expect revenues from execution to decrease as more volumes are traded electronically on SEFs, and as some volumes shift to lower-margin listed products. In parallel, while clearing and collateral-management revenues account for less than 10 percent of total revenues today, they may account for a much higher percentage in the future as collateralization gradually takes hold. We also expect to see some fresh revenue opportunities with new customized listed products (such as long-dated interest-rate futures), as well as further innovation in the netting of listed versus OTC products through central counterparty clearinghouses.

Finally, the operating model will be affected. As we see more listed and cleared products—and further fragmentation of liquidity, capital, and relationships—there will be a greater need for standardized and shared platforms for pre- and post-trade messaging, regulatory reporting, reconciliation, clearing, settlement, and payments. We expect third-party vendors to aggressively try to benefit from this situation and, where relevant, to build consortia and utilities for the industry.

Impact on the Six Core Business Models

In our 2013 report, we highlighted six business models that we believe to be the most advantaged in the "new new normal" environment. While we still view these models as winning strategies, they all face challenges. Institutions embracing any of these models will need to reconfirm their value proposition and sharpen their competitive edge.

Powerhouses. These are the largest capital-markets players, with dominant share in one or more asset classes. Most of the powerhouses in today's CMIB landscape are universal banks. Yet many are not capturing all of the synergies that they have access to. As more value shifts away from execution toward clearing and collateral management, differentiation among powerhouses will stem more and more from the ability to manage synergies with adjacent businesses (such as asset servicing and payments). There are also significant balance-sheet synergies to be captured, although some will be applicable only if ring-fencing regulations do not come into full effect.

Powerhouses must continue to actively prune their long tail of unprofitable clients. They should avoid the old habit of trying to be everything to everyone, and focus instead on product areas in which they can achieve true, scale-based competitive advantage.

Haute Couture Institutions. These players focus on creating sophisticated products for entities such as hedge funds, private banks, and sovereign wealth funds. They are likely to benefit from the return of a niche need for highly structured, high-margin derivatives, where they have a clear advantage. Further, we are seeing more demand for cross-asset and liability-driven investment strategies from yield-seeking investors. For example, collateralized-loan-obligation volumes are picking up again. But these institutions will also have to live with higher capital requirements and greater volatility in client demand. And they are likely to be continuously challenged in traditional products, where they cannot compete with powerhouses on efficient clearing and collateral management.

Overall, the competitive advantage for haute couture players is shifting from sheer product innovation to end-to-end, time-to-market excellence (such as process efficiency for new-product approval, and the agility of IT platforms). Human resources excellence will be critical both for attracting first-rate talent and for embedding the appropriate culture and "spirit of the law" that should help institutions navigate in the new environment.

> Powerhouses must continue to actively prune their long tail of unprofitable clients.

Relationship Experts. These institutions, typically Tier 2 and Tier 3 players, leverage proximity and customized knowledge to build deep, long-term ties with their clients. Most relationship experts have been retrenching, yet also showing their resilience. Indeed, the CMIB business has proven to be very important to other business lines (such as corporate and private banking). Partnerships (both commercial and those involving the operating model) may prove crucial for relationship experts in order to secure client relationships that require global coverage, as well as to build a broad product offering and to gain scale and realize cost benefits.

Relationship experts continue to be challenged on client centricity, because the competition for client share is high. They will need to maintain investments in client-related IT, analytics, and big data to ensure that the service gap relative to powerhouses—all of which are Tier 1 players and have a natural advantage in this domain—does not become too large. Furthermore, it is of paramount importance that relationship experts place the bulk of their effort on those clients with which they can win significant share—particularly corporates, SMEs (small and medium-size enterprises), and small or regional financial institutions.

Advisory Specialists. These players provide premium advice to their clients' top-management teams, particularly in M&A and capital structuring. The value of advisory specialists is clearly being questioned by some of the larger CMIB clients, a development illustrated by shrinking volumes at traditional, full-service advisories. With more deals being stock transactions—and with many corporates having strong cash positions—we expect volume to shift further toward niche advisory players. Looking ahead, we expect more commoditization of M&A execution (some of it being taken over by corporates), lower value added in DCM distribution (with many issues oversubscribed by investors), and little innovation in ECM structures. To remain competitive, advisory specialists need to attract and retain a few rainmakers capable of originating large deals. They also need to nurture their global networks.

Hedge Funds. The focus of hedge funds will continue to be on generating superior alpha, particularly over long time horizons. The extent to which they will be affected by further regulation remains unclear. So far, they have been less affected than the sell side, especially by measures that address compensation and capital. However, ring-fencing in the UK, for example, would lower a hedge fund's access to leverage. Proposed European regulations would increase deal transparency, introduce capital requirements, and place limits on the types of investors that can invest in hedge funds.

Nonetheless, we expect hedge funds to remain advantaged compared with sell-side players. Furthermore, as more products become listed and cleared and as liquidity improves, hedge funds can fill some of the gaps left by sell-side entities.

Utility Providers. These players concentrate mainly on insourcing from investment banks and providing IT, operational, and (potentially) accounting solutions. Utility providers are slowly emerging not as outgrowths of consortia of banks but as neutral third-party vendors, clearinghouses, and other entities. They are still challenged by banks in their capacity to significantly reduce costs by means of labor-cost arbitrage, offshoring, improving operational excellence, and sharing change-the-bank costs. Many investment banks feel that using utility providers forces them to give away too much control and flexibility—with limited financial benefit, especially given the long-term uncertainties of such arrangements. To date, any substantial use of third-party vendors remains limited to Tier 2 and Tier 3 banks, although some Tier 1 players have engaged vendors on specific low-value-added activities.

Ultimately, the CMIB industry finds itself in a strategic deadlock of overcapacity and flat (or falling) revenues. Similar situations in other industries have sometimes been overcome through mergers, but regulation will likely prevent such a solution in CMIB. As we have discussed, successful institutions will be those that focus on revenue growth and market share. To win in these areas requires special emphasis on three domains: clients, people, and partnerships.

CLIENTS

Client centricity—as a way of deepening relationships, increasing share of wallet with current clients, and attracting new clients—remains a top priority. The overall goal is to make relationships more holistic, leveraging greater knowledge of each client's specific, evolving needs and bringing the full capabilities of the CMIB institution to bear.

Until recently, client focus was predominantly the playing field of relationship experts. However, many investment banks, including powerhouses, are increasing their investment in client-centric initiatives, reviewing their segmentation and coverage models, and continuing to reduce their long tail of unprofitable clients. We expect three key initiatives—which are still in their formative stages—to make a difference: improving client-related analytics capabilities, exploiting adjacencies, and tracking client satisfaction.

Improving Client-Related Analytics Capabilities

There is a clear opportunity for banks to gain a competitive edge by providing their front offices with client-related analytical tools and making greater use of big-data solutions. According to Expand Research, there is already a wide gap emerging in terms of recent client-related technology investments between the highest-spending investment banks ($50 million on average) and the lowest-spending ($15 million on average).

Sales Tools. Value is shifting away from simply providing broad ranges of raw data toward filtering, organizing, storing, and delivering the most important data to clients when they need it most, as in the following examples:

- Tracking real-time corporate-client cash flows (for accounts managed by the bank or by a third party) and predicting consumption of directly related products (such as FX hedge and money-market offerings)

- Tracking market sentiment through social media and other unstructured, external data sources and embedding this data into equity and credit research (provided to buy-side investors) or into an M&A-tracking tool across small, medium-size, and large companies

The salesperson is instrumental in delivering this information. Furthermore, many resources currently on offer to clients—not only capital, leverage, and liquidity but also trading, direct advisory time, access to research analysts, and pricing advantages—have become increasingly limited. More sophisticated analytics for monitoring the resources allocated to each and every client would provide the salesperson with tools and guidance to further prioritize what the bank wants to offer.

Client Profitability. A robust and real-time client profitability measure is becoming more and more important in driving client discussions and deciding the best course of action—particularly for unprofitable clients. Most banks are struggling with a number of elements: the tradeoff between simplicity and robustness of the methodology; the reliability of data; buy-in from internal stakeholders; the interpretation of outputs; and the best use of technology to automate processes. Cost allocations to clients can range from 33 percent of total costs (focusing on certain direct front-office costs) to 100 percent (forcing full indirect-cost allocation). We believe that up to two-thirds of costs (including sales, trading, research, market data, brokerage fees, IT, and operations) should be allocated to clients, along with capital and liquidity costs.

CMIB institutions need to track client satisfaction much more rigorously.

When it comes to big data, cracking the challenge in CMIB requires a strong focus on three areas: the actual data (access to data and sourcing capabilities); the data-mining technology (real-time tools to generate insights rapidly); and deep analytics (sophisticated modeling of client behavior). While such initiatives are relatively new in CMIB, investment banks may well be inspired to import knowledge from the B2C world, where a number of players have demonstrated mastery in these areas.

Exploiting Adjacencies

Most investment banks have been structured in silos for too long and separated from the rest of the wholesale-banking business. We believe that CMIB players must actively address synergies with other businesses in order to unlock new revenue opportunities and optimize operating models, cost bases, and investments. We see significant potential between CMIB and the following adjacent business areas:

- *Lending.* Banks should capture their fair share of CMIB cross-selling on the basis of their ranking as core lenders, and should reinforce the European origination-to-distribution model by leveraging credit capabilities such as structuring and distribution.
- *Transaction Banking.* Banks should track and execute cross-selling opportunities across current accounts, cash management, trade finance, FX, money markets, and interest-rate derivatives—bringing everything onto one e-portal.
- *Asset Servicing and Clearing.* Banks that have not done so already should consolidate central collateral-management capabilities, as increasing mark-to-market margin calls create a need for the effective use of collateral and enable the attachment of other products (such as those related to FX).
- *Group-Level Synergies.* CMIB divisions should reinforce cooperation with the asset-and-liability management and treasury functions in order to capture a larger proportion of the CMIB flow that these functions generate. Furthermore, group relationships should be actively managed to foster reciprocity and create further revenues for the CMIB division.
- *Wealth Management.* CMIB and wealth-management divisions should work closely together to design and distribute products such as structured offerings, primary issues, and private placements.

Tracking Client Satisfaction

CMIB institutions need to track client satisfaction much more rigorously. We believe that because investment banks have historically focused on product-oriented quality measures, no sophisticated, industry-specific client-satisfaction measure has yet been developed. Indeed, other B2B and B2C industries are more advanced in tracking client satisfaction, and have deployed an interesting set of tools over the years (such as The Boston Consulting Group's Brand Advocacy Index, which tracks performance and client satisfaction). Building on the experience of other industries (and acknowledging the uniqueness of their own), investment banks could develop CMIB-specific client-satisfaction measures by taking steps such as the following:

- Gather input from a large sample of clients and nonclients.
- Rate themselves on the basis of that input.
- Solicit precise reasons for unfavorable input and request suggestions in order to gain a deeper understanding of customer satisfaction issues that are specific to CMIB. Banks should systematically link the client satisfaction measure to initiatives aimed at improving areas such as research, pricing, latency, sales coverage, advisory services, capital commitment, reporting, and operational service quality.

IMPLEMENTING client-centric strategies will require changes in how investment banks currently operate. They will need stronger governance from the top to drive these changes—and to foster employee behavior that creates value.

PEOPLE

Ever since the 2008–2009 financial crisis, and increasingly over the past several years, investment banks have found themselves in a battle to attract talent. For one thing, innovation in the CMIB industry is likely to pick up again as the regulatory environment stabilizes and new forms of compliance solutions need to be designed. Successful innovation will require a broader set of skills in the front office in areas such as technology, data, and regulation—all concentrated in fewer employees. Moreover, there will be greater emphasis on the post-trade side of the value chain, with greater numbers of high-caliber people needed in areas such as operations, compliance, legal, and risk. In addition, rising litigation costs have highlighted the industry's need for employees who are knowledgeable about—and act in accordance with—new and evolving regulatory parameters.

There is some evidence that the turnover rate in the CMIB industry has increased among both younger cohorts and senior staff. Indeed, traditional buy-side institutions such as hedge funds and private-equity firms—as well as some newer suitors such as social-media and technology companies—are doing their best to attract the brightest minds. With a 25 percent drop in the average CMIB compensation package since 2010, the compensation gap between investment banking and other sectors has narrowed and has even become negative in the case of hedge funds and private equity firms. Social-media and technology companies are attracting Millennials by appealing to their desire for global experiences, high levels of responsibility, rapid advancement, and an attractive work-life balance. Overall, investment banks are losing the human resources battle.

Meanwhile, heavy regulation is also having a significant impact on the ability of the CMIB industry, whose compensation policies have always been a primary lure, to compete for top talent. For example, CRD IV caps the bonuses of "material risk takers"—those who earn more than €500,000 per year in total compensation or who fall within the highest-earning 0.3 percent of the bank's staff—to a 1:1 fixed-to-variable ratio that can be increased to 1:2 only with board approval. This rule is putting European banks at a disadvantage compared with their U.S. peers. Section 956 of the Dodd-Frank Act requires banks to prove only that bonuses are not excessive and do not create incentives to engage in overly risky activities.

A string of ethical scandals and public scrutiny of bonuses have led banks to focus on revising compensation packages for their senior bankers, introducing scorecards linked to compensation and designing their learning and development curriculum around compliance topics. We believe that such efforts have come in part at the expense of putting sufficient resources into developing the careers of the vast majority of banks' employee bases.

What is the best way forward? CMIB institutions must identify what the investment banker of the future looks like and take steps to attract this type of individual. The next-generation investment banker needs to possess a broader set of skills, have an entrepreneurial and innovative spirit, and embrace a strong cultural sense of compliance, collaboration, and client service. Investment banks also need to overcome their reputation as places that do not rank high on "best places to work" lists. Only one investment bank has ranked in the top 100 best companies to work for in the U.S. in recent years. Nor do CMIB institutions rank high among the top 50 LinkedIn inDemand employers, currently dominated by technology companies. Investment banks will therefore need to radically change their value propositions in order to appeal to this new generation of employees. They must also find ways to develop the raw talent that they acquire.

To deliver this change, strong governance and long-term commitment from the top will be required. We see two areas of immediate focus.

First, work on people development:

- Ensure that basic people-management disciplines are carried out. These include soft metrics (such as pulse-check-based overall satisfaction) as well as harder metrics (quality-of-performance reviews conducted at regular intervals).

- Create personalized learning and development plans that offer training across silos and divisions and also provide necessary compliance content.

- Recognize that many high-performing individuals (such as traders) may not necessarily be effective people managers, and that forcing them into such roles can be detrimental both to the individuals themselves and to their subordinates.

- Address next-generation concerns such as better approaches to work-life balance (perhaps through part-time or flexible working policies), greater mobility, and opportunities for social initiatives (such as social-impact leaves of absence).

Second, work on strategic workforce planning:

- Evaluate alternative channels for recruiting Millennials.

- Build a more rigorous approach to managing career paths (including full transparency on titles and promotions).

- Reinforce active performance management and outplacement (aside from cost-cutting programs).

PARTNERSHIPS

HISTORICALLY, INVESTMENT BANKS HAVE seldom managed to forge fruitful partnerships, whether in shared operating models (sharing infrastructure and costs by setting up utilities to be used by a consortium of banks) or in commercial partnerships. Most partnership discussions hit a snag over issues such as governance, legacy systems and processes, accountability, and even a reluctance to make overtures.

Nonetheless, we believe that a combination of factors has increased the pressure on investment banks to reconsider partnerships, with goals such as mitigating the effects of retrenchment in certain regions and products, reducing fixed costs, tackling overcapacity, and—with many products becoming commoditized—adapting to the shift of revenue sources in the value chain.

Operating-Model Partnerships

The areas in which CMIB players can collaborate will continue to expand. Such areas cover a broader scope of pre- and post-trade value-chain activities and a wider range of products (as more OTC offerings are being cleared and listed). Each bank's size and specific value proposition will dictate its approach to upgrading operating models.

Tier 1 Institutions. We expect powerhouses to continue focusing on achieving scale in-house and on potentially being insourcers. However, they can benefit from looking beyond siloed asset-class optimization and breaking down their indirect cost bases into four layers:

- The first layer (estimated at 20 percent of total indirect costs) consists of costs (such as front-office IT and pricing-engine costs) that are specific to each CMIB asset class because they are a key component of the client value proposition and therefore of the bank's competitive edge.

- The second layer (20 percent) consists of costs that can be shared across certain CMIB asset classes. These costs (such as costs related to electronic platforms, collateral management, pricing algorithms, and trade management) are driven by cross-asset commonalities but whose close links to the CMIB segment are necessary given specific customer needs.

- The third layer (25 percent) consists of costs (such as those related to static market and customer data, payment systems, and treasury functions) that can be shared beyond the CMIB division with the bank's other divisions. Such costs have overlaps in client bases and processes.

- The fourth layer (35 percent) consists of costs (such as costs related to confirmations and reconciliations, IT infrastructure, and know-your-customer processes) that can be outsourced to third-party vendors or shared through industry partnerships. Such activities lend themselves to scale benefits and are not competitive differentiators. Sharing or outsourcing these costs could involve existing utilities or outsourcers or even new providers (such as e-retailers for cloud data warehousing).

For Tier 1 institutions, breaking down costs in this fashion should be aligned with a better balancing of operating-model investments: front-office versus (neglected) back-office, IT versus (neglected) operations, short-term versus (neglected) long-term, and single-asset-class versus (neglected) cross-asset-class investments. The goal should be as much about designing the operating model as about executing it. Relatively few Tier 1 institutions have a commendable track record in large, cross-divisional, transformational programs. Strong governance and the attention of top management will be required for successful execution.

Tier 2 and Tier 3 Institutions. Utility providers are slowly emerging from the ranks of third-party vendors and business process outsourcers, as well as from exchanges, custodians, derivatives-clearing organizations (DCOs), and central securities depositories (CSDs). Only a few partnerships are up and running, but there are plenty of ongoing discussions led by a few vendors fighting to build scale. Early CMIB adopters will bear high execution risk, but they will have more opportunity to shape the solutions that vendors are in the process of designing with regard to IT capabilities, data integration, protocols, and processes.

We see three very different types of utility providers emerging. First are those with niche offerings in specific functional areas such as regulatory reporting, aspects of collateral processing, know-your-customer measures, and legal-entity-identifier (LEI) management. Second are those with offerings in the complete CMIB processing value chain. Third are those with broader offerings that incorporate any other business-line adjacencies for which the concept of a utility makes financial sense. Banks will have a strategic choice to make here.

A number of key operational considerations must also be carefully assessed by CMIB institutions when evaluating potential partnerships. These include the scope of products involved (such as structured OTC products); the scope of activities beyond pure operations (such as pretrade IT, risk, and finance); the type of IT solutions (among the handful that seem to have leading positions); the complexity of connectivity to downstream systems (such as general ledger and pretrade IT); and potential interdependencies among other parts of the bank (such as the asset and liability management function).

We expect commercial partnerships to emerge as a tactical option.

For Tier 2 and Tier 3 banks, partnerships could promise cost savings of up to 40 percent of IT and operations costs (or about 10 to 15 percent of total costs)—although the costs of transition and, more important, interfaces with other bank processes tend to be underestimated. This level of savings would help some Tier 2 and Tier 3 banks improve their cost positions, but it might not always be enough to turn around unprofitable asset classes.

Commercial Partnerships

We expect commercial partnerships to emerge as a tactical option. On the one hand, Tier 1 institutions such as powerhouses and advisory specialists will attempt to capture new volume and position themselves ahead of new competitors' exits. On the other hand, Tier 2 and Tier 3 institutions pursuing haute couture and relationship expert models will attempt to secure their client bases by continuing to provide an appropriate spectrum of products and coverage.

Two types of partnerships are likely to gain momentum: regional partnerships and product partnerships.

- *Regional Partnerships.* These will involve partnering with an institution that has a complementary local or regional footprint in order to offer clients access to local products—or "bringing one country or region to another bank's clients." Because these partnerships are likely to be forged exclusively among Tier 2 and Tier 3 players, there are clear first-mover advantages. Key considerations include the partner's local franchise strength, appetite for new counterparty risk, and clarity of the value proposition for clients.

- *Product Partnerships.* These will involve partnering with another bank or an independent boutique that has a complementary product offering. Typical examples include seeking access to cutting-edge FX single-dealer platforms, electronic execution in cash equities, primary dealership for government bonds in nondomestic markets, M&A capabilities, and a partner's retail- and private-banking network. Key considerations include the partner's strategic fit (especially the degree of overlap in target client bases so as to avoid competitive risk), the impact on brand, the ability to enable business reciprocity, the nature of the operating model, and the model's capacity to reduce indirect costs.

Ultimately, in both operating-model and commercial partnerships, banks are typically looking for greater agility (rather than direct ownership of all elements of the processing model) and variable cost structures that flex down as well as up.

With the perspective of the five years since the financial crisis first began to subside, a key question presents itself: To what extent has the CMIB industry truly recovered?

As we said in last year's report, each institution must choose its own path on the basis of its legacy, its particular strengths and weaknesses, and its aspirations. Within each choice of business model, there are tall challenges—but also great opportunities for the most adept players. There *will* be winners and losers.

In our view, although banks clearly need to pursue additional cost reduction and manage the implementation of the regulatory agenda, it is time to put revenue growth at the top of the priority list. Achieving meaningful revenue growth will require increasing market share by improving client centricity, building stronger client-related analytics, tapping opportunities from adjacent businesses, attracting and retaining the right kind of human resources, and forging relevant commercial partnerships.

At this juncture, those institutions that make the right choices in critical areas can achieve ROEs of up to 15 percent between now and 2020, while others will struggle to cover their cost of equity—even in good years.

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NOTE TO THE READER

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