WHITE PAPER

Investment Banking & Global Markets Update

2023 unveiled: Cost excellence rises to strategic prominence

March 2024
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Investment Banking & Markets Update

Overall Market Summary

General market performance in 2023 was characterized by:

Regulatory divergence – For the first time, US regulatory proposals relating to Basel now appear more punitive than in Europe. This development, coupled with the loosening of capital distributions requirements in Europe, may provide a platform for some valuation convergence between the two geographies.

Macroeconomics – Higher, but more stable, rates have pushed bank net interest income (NII) to record highs. This development has made it more difficult to justify some IB&M businesses as funding costs increase and other areas of the banking group start to look more attractive.

Uncertainty – Volatility spurred by continued geopolitical issues have prompted businesses to make certain cost adjustments and arrangements that may eventually turn into something more permanent. The market uncertainty has led to overall reduced dealmaking activity but some consolidation on varying scales.

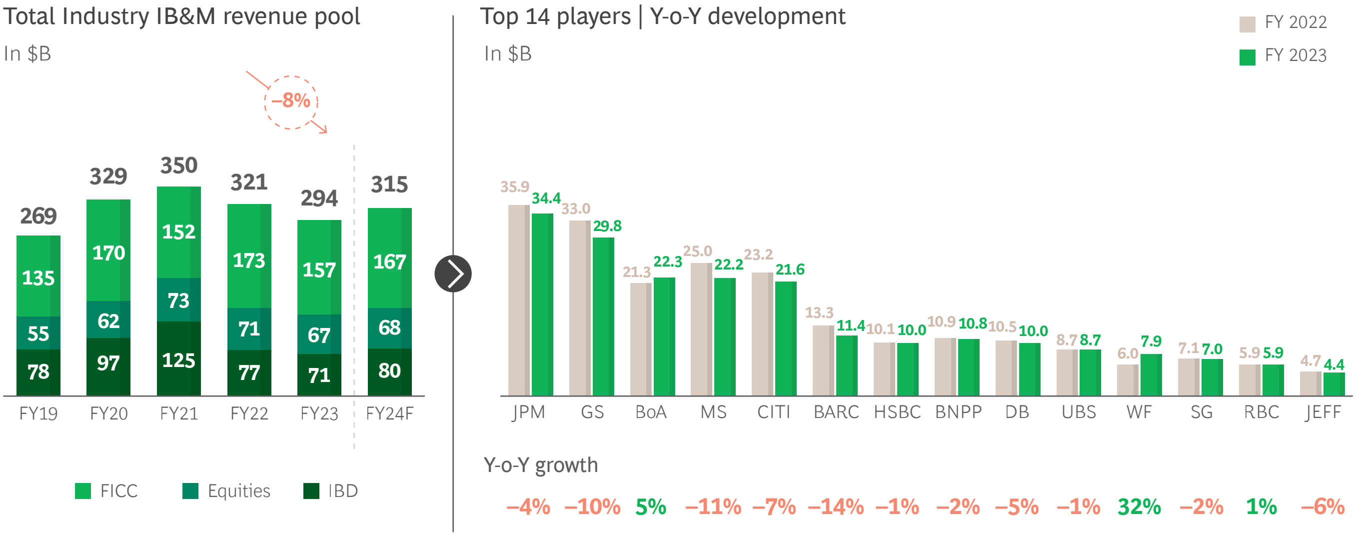
Cost excellence – Amid contracting revenue pools across O&A, FICC and Equities, executive priorities have moved towards cost management and productivity.

Continuing shareholder scrutiny – Shareholders of groups focusing heavily on Investment banking and markets divisions (IB&M) continue to demand higher returns on tangible equity (RoTE) than they do for more balanced players that trade at similar price-to-book ratios (P/Bs), perhaps due to the perceived volatility of the business. In the new net interest margin (NIM) environment, other divisions tend to outperform IB&M in terms of RoTE.

In 2023, the Top 100 Investment Banking and Markets revenue pool contracted by 8% YoY. Origination & Advisory pools contracted by 9% YoY. The equities and FICC revenue pools reduced by 6% and 9% YoY respectively.

Exhibit 1 - Overall Market

IB & Markets revenue pool has contracted 8% YoY



Sources: Company financial statements, Expand, BCG analysis.

Origination & Advisory

In 2023, the origination and advisory pool contracted by 9% YoY, marking the second consecutive year of declining deal activity. The overall slowdown resulted from several factors, such as persistent macro-economic uncertainty surrounding inflation and interest rates, fears of a global recession and heightened geopolitical tensions. These factors triggered some reconfiguring of investor and issuer expectations on pricing, valuation and yields, which in turn had an impact on primary capital markets issuance activity and buyer-seller expectations in **M&A dealmaking**.

Corporate priorities shifted away from executing large capital expenditure plans toward maintaining core profitability. Financial sponsors focused on reviewing portfolios and risk/return profiles, leading to postponed leveraged buyout (LBO) exits and/or new LBOs with higher equity stakes upfront but lower leverage.

Secular trends, such as the **rise of private credit markets** in recent years and the increasing popularity of direct listings, represent emerging competitive threats that may affect traditional investment banking revenue pools. Direct lending has repercussions for traditional syndicated leveraged loan and high yield bond issuance, as it constitutes around 13% of these markets. Direct listings have an impact on equity capital market (ECM) issuance. Private equity fundraising has accounted for a growing percentage of total equity fundraising (public ECM and private equity raising), going up from 30% in 2013 to approximately 60%.[1]

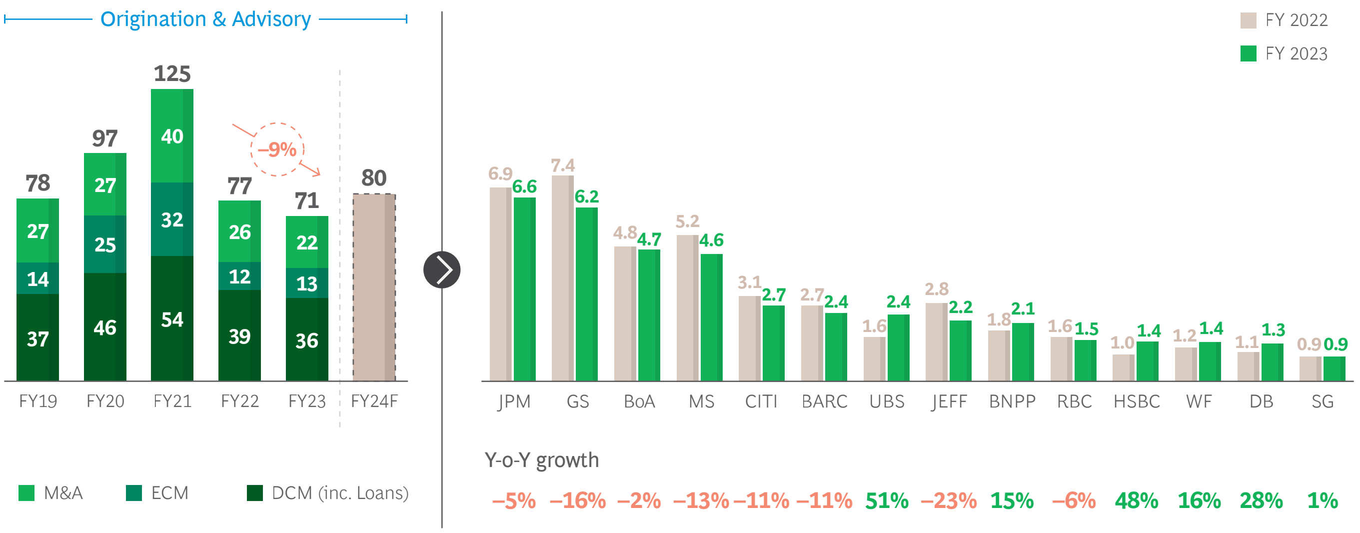
The mergers and acquisitions **(M&A)** revenue pool contracted by 16% YoY. The trend can be attributed to the delayed impact of aggressive rate hikes on M&A volumes. That is to say, capital markets access tightened in 2022, and then M&A volumes declined in 2023. The challenging M&A deal environment in 2023 led to a shift toward smaller, less complex deals. This bolstered the revenues and market shares of boutique advisory firms due to their mid-market capabilities, in contrast to traditional full-suite banks more weighted toward large-cap, cross-border complex deals. As financial conditions have now eased in 2023, ushering a return to more normal capital markets issuance, there is scope for greater optimism regarding M&A activity in 2024.

Exhibit 2 - Origination & Advisory

Origination & Advisory revenue pool has contracted 9% YoY

Total Industry revenue pool
In $B

Top 14 players | Y-o-Y development
In $B



Sources: Company financial statements, Expand, BCG analysis.

1. Prequin and Refinitiv deals data.

The **ECM** revenue pool increased by 8% YoY. Most ECM issuance in 2023 can be ascribed to convertible bond and follow-on issuance, with activity mainly emanating from cash-rich corporates capable of raising capital in any market environment. Issuers sought creative ways to minimize interest expense and maintain flexibility in their capital structure. In the second half of the year, the IPO market reopened, prompting a convergence of pricing and equity valuation expectations between corporate boards and end investors. Low volatility across major equity indices also generated the necessary conditions for increased IPO activity as issuance windows widened.

The debt capital market **(DCM)** revenue pool (including loans) decreased by 9% YoY. The overall decline was mostly caused by high-yield debt when leverage loan markets tightened significantly. Investment grade activity was largely resilient due to a rise in maturing debt in 2023, as the bulk of debt issuance activity has been spurred by the refinancing of maturing debt. Fixed-income instruments have become more popular among investors in 2023 due to increased yields, with some credits offering returns akin to the S&P 500 due to current interest rate levels.

Equities

Equities revenue pools were down around 6% YoY due to lower volatility, leading to a normalization in derivatives revenues, as well as to significantly lower cash volumes with banks reporting weaker client flows. However, a stronger second half of the year, in which trading volumes increased significantly, offset some of the prior weaker performance. Revenues also remained resilient in the futures market, while the financing segment of the prime market (supported by a macroeconomic environment involving high rates and inflation) maintained its robust showing.

Prime balances continued to grow, albeit at a slower rate as balances for the top three players neared USD 1 trillion.[2] Securities lending posted the highest revenues since 2008, boosted by activity in US specials (hard-to-borrow securities). However, despite increases in US securities lending, EMEA revenues were still constrained.

Within the prime market, delta one trading had a slow start to the year but improved in the fourth quarter. However, synthetics trading was robust throughout the year.

Exhibit 3 - Equities

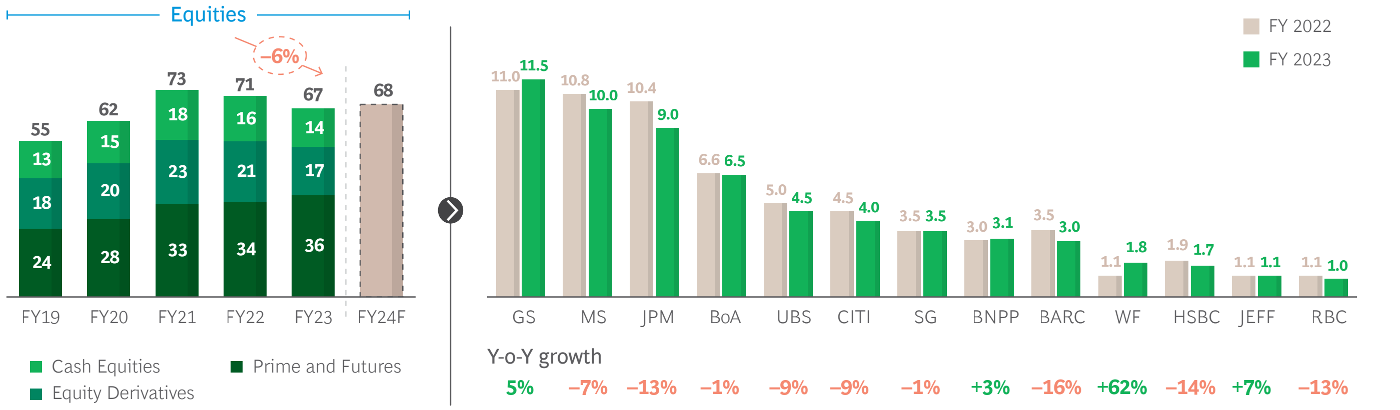
Equities revenue pool has contracted 6% YoY

Total Industry revenue pool

In $B

Top 13 players | Y-o-Y development

In $B



Sources: Company financial statements, Expand, BCG analysis.

2. S&P.

Fixed Income, Currencies & Commodities (FICC)

FICC revenue pools fell by around 9% driven due to a normalization in emerging market (EM) macro rates, foreign exchange (FX) and commodities after an exceptionally volatile 2022. G10 rates performed well on the back of volatility and changing inflation expectations. Issuance of United States Treasury (UST) securities was around 35% higher than in 2022, while trading volumes also rose by approximately 10%.[3]

Both structured and flow credit performed well. Despite the higher-rate environment, both issuances and trading volumes[4] improved in terms of investment-grade credit as stability grew and spreads tightened. Spreads were tighter on bonds issued by financial institutions versus corporate bonds. Distressed markets also enjoyed a strong end to the year.

FX revenues from corporate clients grew, while institutional activity remained suppressed.[5] FX swap and forward markets benefited from some normalization after the structural challenges of 2022. Swiss Franc and Asian currencies outperformed peers.

Commodities normalized in comparison with 2022, but remained at robust levels. Securitized products had a stronger year because of both agency and non-agency residential mortgage-backed security (RMBS) prices rallying as investors chased yields. This performance benefited US banks which have stronger franchises and scale. Despite limited issuance, trading volumes somewhat recovered from a poorly performing year in 2022.

Exhibit 4 - FICC

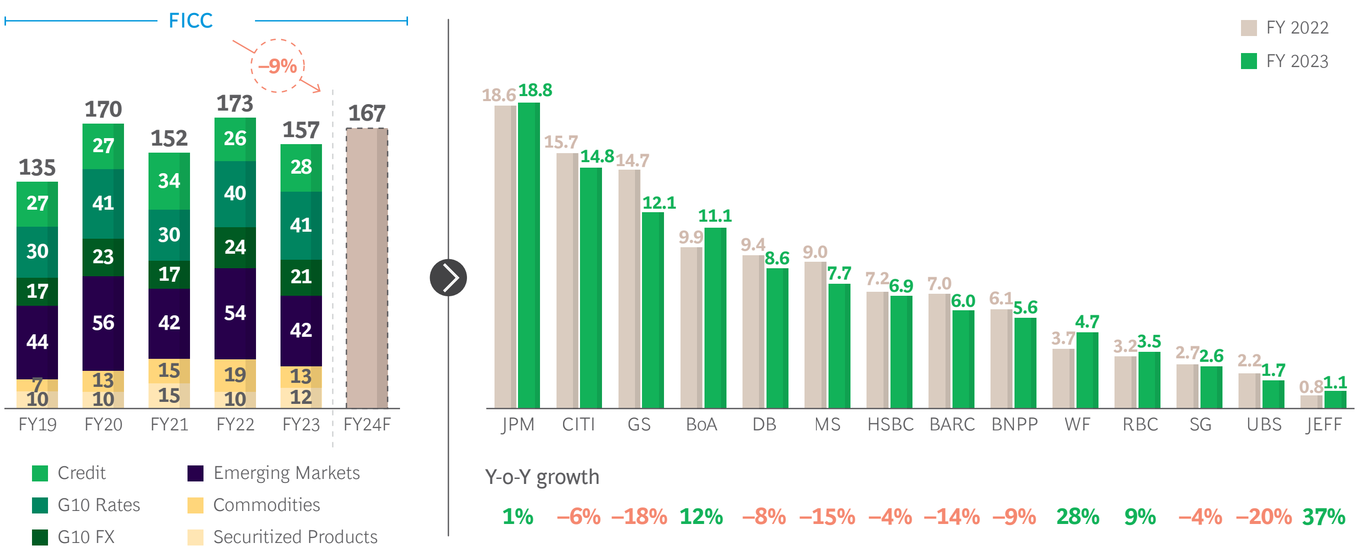
FICC revenue pool has declined 9% YoY

Total Industry revenue pool

In $B

Top 14 players | Y-o-Y development

In $B



Sources: Company financial statements, Expand, BCG analysis.

3. SIFMA.
4. SIFMA.
5. Expand FX Volumes Survey.

M&A activity is poised for growth in 2024

Banks can adopt a new M&A posture

The year 2023 delivered the lowest completed global M&A volumes in a decade. The market consensus among corporate leaders, however, is that the turbulence of the last two years is largely behind us. Leading indicators - such as decreased volatility in financial markets, stabilizing interest rates, converging expectations between buyers and sellers, lower valuations, high cash reserves among large corporates and high dry powder levels among financial sponsors – all point to an expected rebound in dealmaking in 2024. Please refer to **BCG's 2023 M&A report** for more information.

As CEO confidence builds, dealmaking pipelines should strengthen and pent-up demand should boost activity. Strategic corporate deals are expected to lead the rebound, with sponsor deals to follow. However, any optimism ought to be guarded given the risks associated with escalating geopolitical tensions, the potential for a hard landing if inflation remains sticky, and tight financial conditions that could continue for longer than anticipated.

The year 2024 will be pivotal for investment banking divisions within global financial institutions, as they conduct strategy reviews to establish where best to place organic growth bets to capture fee wallet shares based on sector, region, product, client segment, average deal size and Managing Director productivity analyses. Executives should also explore inorganic opportunities, potentially expanding into adjacent businesses to capitalize on secular shifts in the banking industry, such as the rise of private markets, increasing capital requirements, advancements in AI technology and machine learning.

As demonstrated in **Exhibit 5** below, BCG categorizes investment banking players into four archetypes. Looking at fee trends from 2018 to 2023, the market has shifted away from Tier II banks and toward independent IB firms and smaller boutique advisory-only firms. The expected M&A rebound in 2024 may precipitate a mixture of defensive and offensive plays among CIB executives who wish to maintain and grow world-leading IB franchises. Boutique bank consolidation and partnerships may materialize as healthy investment banks position themselves for growth when activity eventually rebounds. Banks in a less healthy state may consider divestitures, enabling capital-intensive assets to be offloaded to strengthen the core CIB division.

Exhibit 5 - Tier II banks are struggling to maintain share in IB activity

	Boutique Advisory only	Independent Investment Banking Firms	Tier II Universal Banks	Global Bulge Bracket
Market archetypes	Boutiques with asset-light model via focus on advisory business; often differentiated in niche expertise	Firms with M&A and ECM focus; opportunistic expansion into DCM & LevFin given limited B/S capacity	Universal banks with broad IB and CM franchises and either focusing on home-country or specific industries	Top-5 US banks with full suite of IB & CM products and true specialists, that are fully global and the biggest brands
Sample Size	19 Banks	51 Banks	24 Banks	5 Banks
Key takeaways	• Leverage niche expertise and ability to attract top talent to compete and gain M&A share • Cyclical product revenues, high comp ratios	• Benefit from weakness in Tier II model to pick-up M&A and ECM share • Challenged by lack of balance sheet access, high comp ratios	• Scale challenges and high capital reqs. impair ability to earn cost of capital • further challenged with significant loss of advisory revenue	• Struggle with current combined business model to generate higher ROTE; • Continue to reduce capital intensive activities

Mkt. share (% fee pool)	Boutique 2018	Boutique 2023	Boutique Trend	Independent 2018	Independent 2023	Independent Trend	Tier II 2018	Tier II 2023	Tier II Trend	Global 2018	Global 2023	Global Trend
				Gained share across categories			Lost share (except DCM)					
M&A	11%	14%	↑	21%	22%	↑	28%	23%	↓	40%	41%	↑
ECM		n/a		15%	16%	↑	38%	35%	↓	47%	49%	↑
DCM		n/a		1%	1%	→	64%	68%	↑	35%	31%	↓
LevFin		n/a		6%	7%	↑	57%	54%	↓	38%	39%	→

Sources: Refinitiv, BCG analysis.

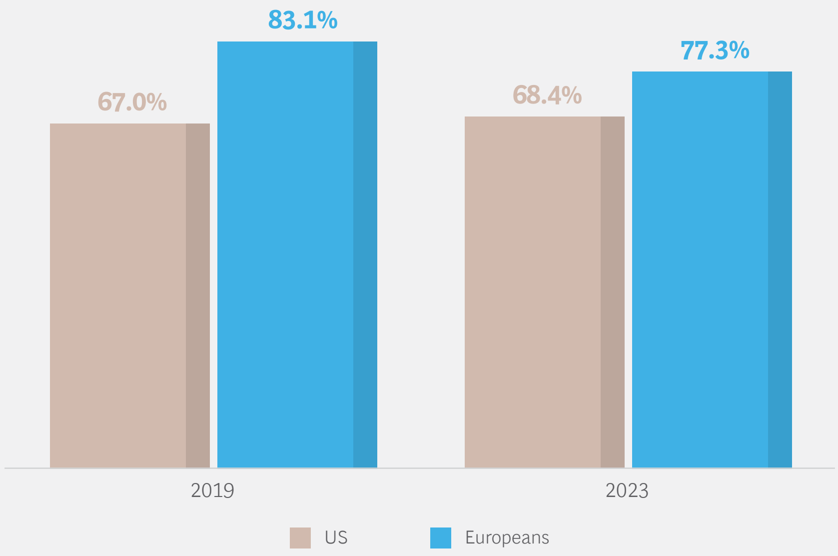
[1] Market share & total fee pool based on league tables (fees) of top 100 players; excludes players that do not fit into archetypes (e.g., national banks, PE funds, Big 4 advisory); Global view, excludes China, Japan, Supranational and unknown sector/region allocations.

Balancing acts: Adaptive thinking for cost inflation

Given the continued twin pressures of increasing regulation and inflation, the industry has been focusing on cost. Many publicly announced cost reduction programs are underway, targeting efficiencies worth more than USD ~20bn. However, let us first examine the recent evolution of the cost base and cost-income ratio (CIR) for IB&M.

Exhibit 6 - CIR Evolution - US vs EU

IB&M CIR for US and European Investment banks

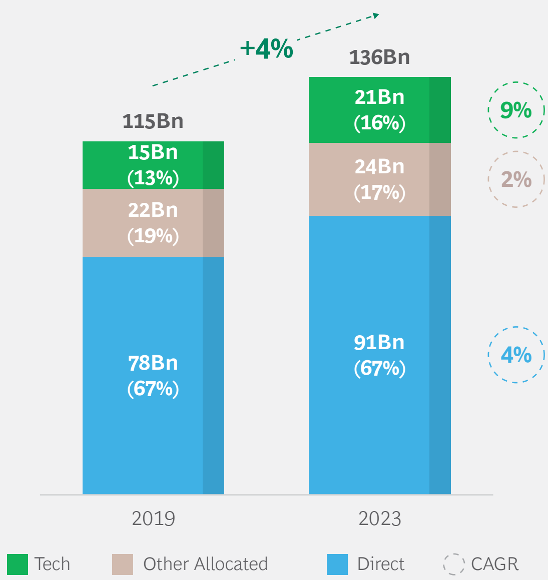


Source: Expand Research.

Note: Includes BofA, CITI, GS, JPM, MS, WF, BARC, BNP, DB, SG, HSBC, UBS.

Exhibit 7 - Total cost split by type

Total cost breakdown for IB&M franchises ($)



Source: Expand Research.

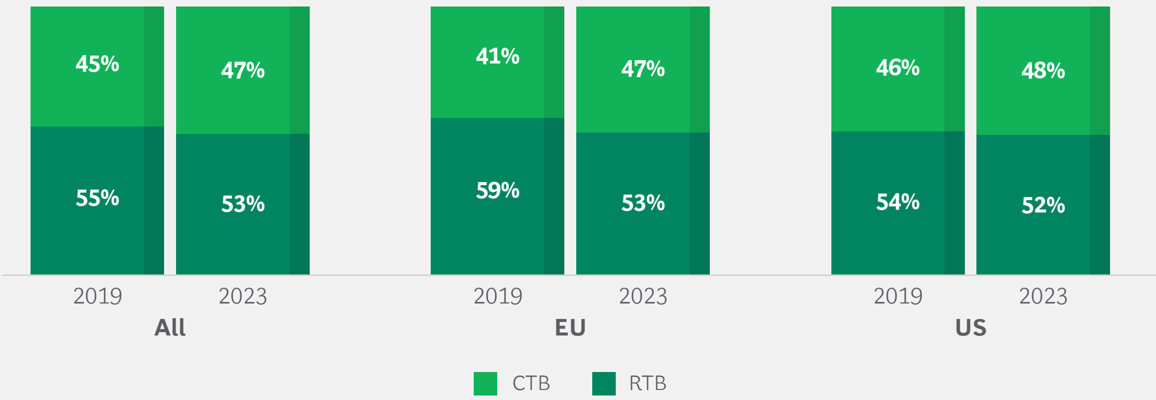
Note: Includes BofA, CITI, GS, JPM, MS, WF, BARC, BNP, DB, SG, HSBC, UBS.

Since 2019, the top twelve banks in IB&M alone have had to contend with cost inflation of more than USD 20 billion. Out of this 18% increase in the cost base, 5% (just less than one third) ensued from technology cost inflation. CIRs have remained broadly flat for US banks, but there have been slight improvements for European banks, many of which struggled in 2019. Although the gap has narrowed, it is nevertheless still there. Given the RoTE differential between the US and European banks (as covered in our **paper** for the first half of 2023), this cost disparity is unsurprising. However, the most significant contributor to allocated cost inflation has been technology, and this therefore merits further investigation.

Despite European and US banks registering similar ratios of RTB (run-the-bank) and CTB (change-the-bank) expenditure, it is clear that spending remains higher for US banks in absolute terms. Increased spending to meet constantly changing regulatory requirements has been a major contributor to inflation in technology expenditure, although without the accompanying productivity gains

Exhibit 8 - Tech RTB & CTB

RTB/CTB % breakdown for US and European Investment banks

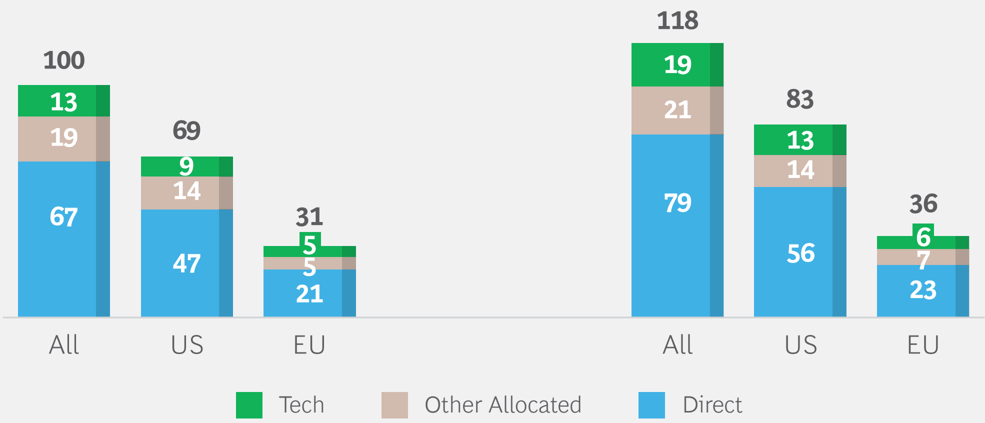


Source: Expand Research.

Note: Includes BofA, CITI, GS, JPM, MS, WF, BARC, BNP, DB, SG, HSBC, UBS.

Exhibit 9 - Total cost split by type (Indexed)

Total cost breakdown for IB&M franchises (Indexed to 2019 All)



Source: Expand Research.

Note: Includes BofA, CITI, GS, JPM, MS, WF, BARC, BNP, DB, SG, HSBC, UBS.

When examining technology cost inflation both now and in the future, we must now consider how much of it can be addressed. We can offer some suggestions in approaching this task:

- Identify opportunities to impact cost and productivity through assessing the delivery model by asset class across the whole value chain

- Accelerate the transition to product/platform-based delivery models through:

— Step-change investments in engineering excellence

— Transition to cloud-like capabilities

— Progressive refactoring of legacy estates (this also serves as a foundation to facilitate the scaling of Generative AI (GenAI) capabilities)

AI & GenAI – Scaling of data-driven optimizations of the delivery model should be considered, such as utilizing initial GenAI use cases to optimize middle-office and back-office processes that require the management of unstructured and complex data – for example, client onboarding and recertification, risk processing, reconciliation management, and step changes in collateral management.

Front-to-back (F2B) cost programs – Many executives are exploring end-to-end cost optimization programs, making use of artificial intelligence to enhance efficiency in middle and back offices, particularly in areas such as onboarding, credit applications or trade order, execution and post-trade processes.

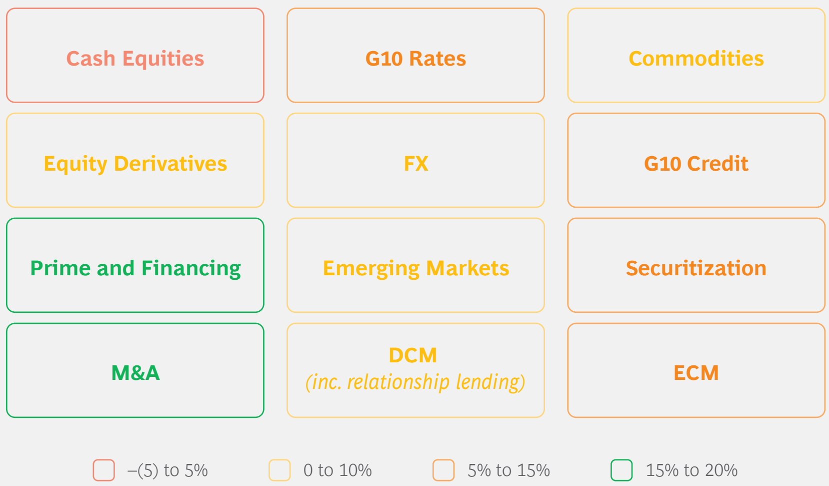
Although opportunities do exist for optimization, the combination of inflationary pressures and the volume of addressable spending suggest **that cost initiatives are necessary but nevertheless unlikely, in isolation, to solve the challenges of improving IB&M returns** and justifying their scale within the banking group.

Exhibit 10 looks at how business lines have performed on average in the past. This simple summary can serve as a basic starting point when assessing capital and/or cost optimization processes. As an example, joint ventures in cash equities with non-bank market makers could improve the RoTE of cash equities in banks.

To generate strong product level returns, executives must continue to take more bold decisions when it comes to scarce capital allocations.

Exhibit 10 - RoTE Heatmap

Avg. product RoTE (2016–2023)



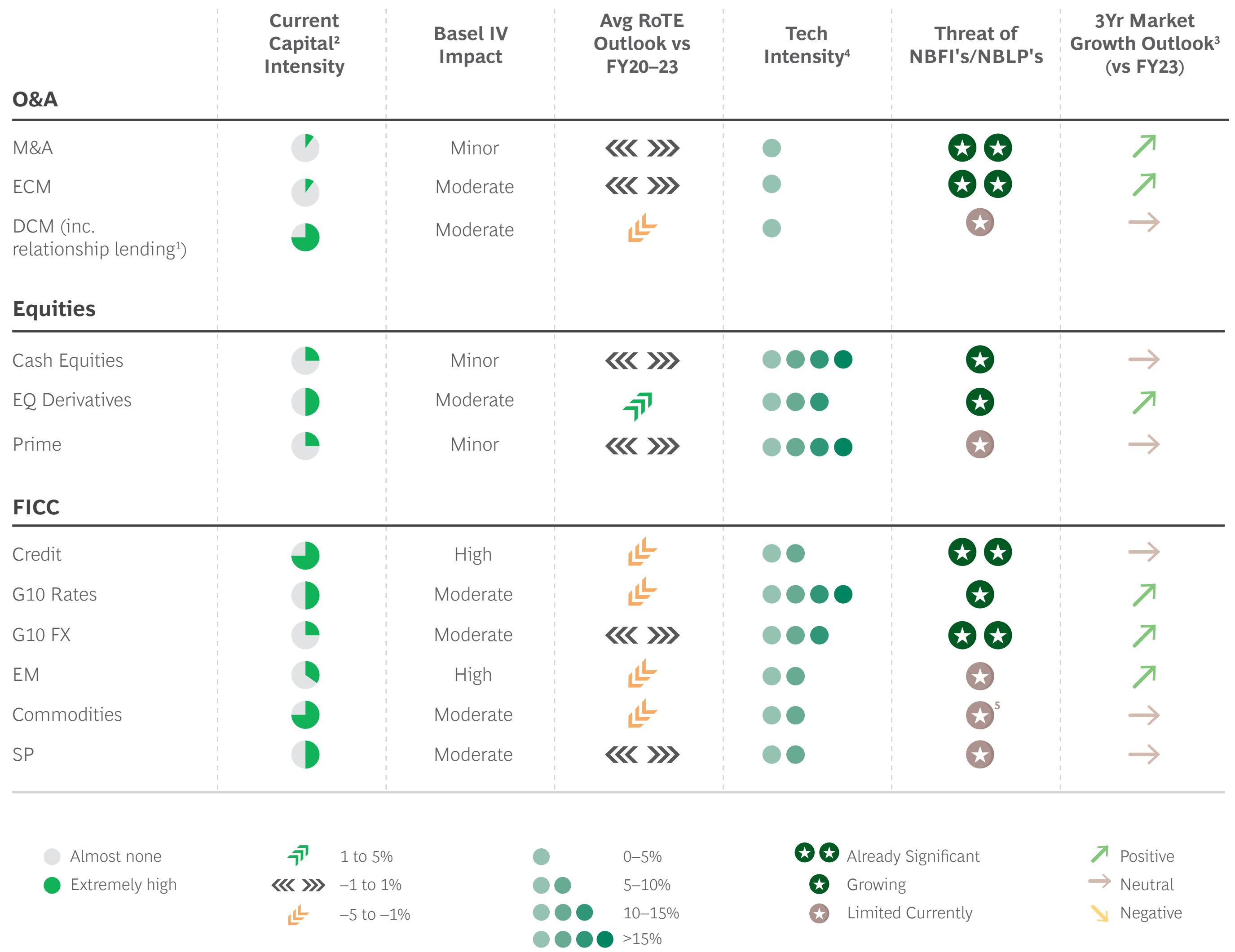
Sources: Expand Research, Company Filings, Industry interviews.

Outlook and Strategic Implications for CIBs

In Exhibit 11 below, we take a simplified view of several business lines and have incorporated technology considerations and non-bank threats to our original analysis from the first half of the year. The framework is a useful first step in thinking about capital allocation as well as business decisions which, as noted above, are especially pertinent. For the most part, the current reality involves further constraints on capital and resources for IB&M businesses that will inevitably reduce the scope of activities in which they can meaningfully operate.

Exhibit 10 can also provide a basic starting point when considering which business lines to commit to and which to scale back. The business lines with the lowest RoTE may be highlighted in any IB&M portfolio review, using a focus on costs and capital reallocations as the main ways to raise performance.

Exhibit 11 - Product Outlook



Sources: Expand, BCG analysis.

[1] Relationship lending typically consisting of corporate revolver facilities granted to clients.

[2] Capital intensity is based on % of RWA only (i.e. LBS not factored in) and is considered as capital required relative to revenue generated.

[3] Outlook based on sentiment from Industry interviews/discussion.

[4] Tech Intensity is defined as % of IB&M tech spend allocated to each product line.

[5] Commodities currently limited to specialist players (e.g. large producers with trading houses, however they are well positioned).

In reality, second-order effects as well as inter-business linkages and dependencies must be considered when putting together the future portfolio of IB&M products. We note below some of the strategic considerations for decision makers:

Franchise strength and capability – Banks must consider their client franchise strengths and bolster their commitment to those franchises where they have a leading position, sufficient scale, or a unique proposition that allows them to grow faster than competitors and benchmark averages. It is in these areas that banks can generate disproportionate, less volatile RoTE in relation to the market average. The strength of capabilities (such as technological) vis-à-vis other market participants may also play a role in shaping the business.

Cost Management – A combination of tactical cost cutting and sustainable F2B cost programs is necessary to remain competitive and deliver returns. Cost pressures are likely to continue to intensify. It is therefore crucial to identify the right actions to take, such as capitalizing on technology to enhance efficiency and selecting the most appropriate cost function to target (for example, onboarding, or middle-office and back-office processes).

Regulation and competition – Regulatory considerations continue to play a part in decision making. Proposals in the US for the Basel 3 Endgame are particularly stringent, while even the Europeans are facing risk-weighted asset (RWA) inflation. These developments have also put banks at a competitive disadvantage against non-banking financial institutions or non-bank liquidity providers (NBFIs/NBLPs), which do not have to satisfy the same regulatory requirements.

Joint ventures/partnerships – There may be opportunities for partnerships on products (such as research), balance sheet topics (such as DCM and lending), cash equity partnerships with non-bank market makers, or partnerships in adjacent areas that have attracted recent attention (such as private credit, capital arbitrage and technology arbitrage).

Capital-light innovation – Thinking beyond traditional capital-light businesses (such as M&A) can lead to winning strategies. Banks should bring capital-light thinking to the traditional business model, for example. expanding the scope of the originate-to-distribute (OTD) model considering recent growth in synthetic risk securitisations, significant risk transfer activity and the rise of private debt funds

Execution – The most significant risk and failure point for many banks remain an inability to execute a well-designed strategy. As a result, shareholder reactions to announcements have become increasingly muted until tangible progress is made.

Concluding Remarks:

Investment Banking and Markets divisions will, of course, remain important and invaluable components of banking groups. However, their size, focus and profitability all need to measure up to increased shareholder scrutiny. Competition should also be taken into consideration which is not only likely to continue to intensify, but also to expand into other products (especially if there is an appetite from some of these rival entities for greater capital commitment).

For most banks, it means ending up looking very different from their predecessors, who benefited from freely available resources, less regulation, lower funding costs and lighter competition from NBFIs.

Excellence in execution will be a crucial factor in separating the leading banks of the future from those left behind. Executives should be bold, decisive and purposeful in exploring organic and inorganic ways to transform their operating models through joint ventures, partnerships and/or exits and divestitures.

Winners in the new environment will be cost-focused, capital-efficient, nimble organizations with a smaller number of strong specialist areas. Many will operate in distinct business lines, products, client types or geographies. Few may be able to maintain robust offerings across all products, but Investment Banking and Markets performance will still be judged by shareholders and regulators within the context of the divisional contribution to overall banking group enterprise value.

Overall, large IB&M franchises should only maintain scale or expand their presence if all business lines meet or exceed RoTE hurdles. If this cannot be achieved, a critical and decisive review should be conducted across individual business lines from a forward looking RoTE perspective.

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