White Paper

Responding to the New Reality in Banking

Blurring Borders: Is the Value Migration Toward Alternative Asset Managers a Threat or Opportunity for Ecosystem Players?

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Table of Contents

Table of Contents

It has been a turbulent year for the financial system, punctuated by high profile collapses and takeovers in the United States and Europe. We have witnessed continued volatility, underpinned by untamed inflation and continuous increases in interest rates from central banks, which have not yet stabilized. This uncertainty is further compounded by continued geopolitical instability.

For banks, the impact of the current climate has varied widely, depending on their individual business models. For most lending/deposit houses, net interest margins have grown significantly following years of zero or near-zero interest rates. The higher-interest-rate environment, supported by a favorable spread for banks between deposit and loan rates, is clearly leading to healthier overall profitability.

On the other side of the spectrum, banks that are more reliant on advisory fees are facing sluggish top-line growth. This dynamic, however, is more conjunctural than structural, reflective of the macroeconomic cycle and current weak appetite for corporate M&A—an appetite that will strengthen again as the market continues to shift.

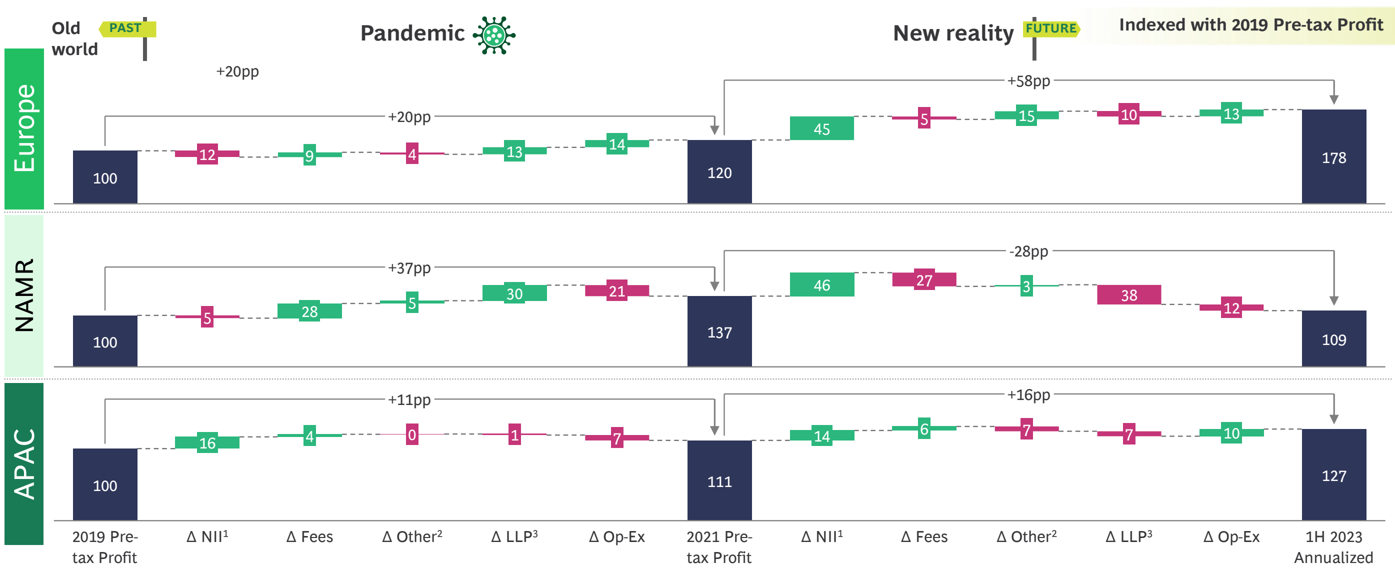
Given a variety of factors, including climate transition and the accompanying high costs of net-zero initiatives, we are likely to see sustained inflationary pressures and persistently higher rates. Such an evolution would have a structural impact on the shapes of banks' P&Ls, with a higher proportion of income stemming from net interest income (NII)–assuming that banks maintain their increased spreads.

The current trends are not uniform, however, and regional differences are apparent. These must be considered in trying to obtain a truly global perspective.

Regional Differences Are Striking

We see clear regional differences in the impact of current volatility (See Exhibit 1). For example, recent earnings for financial institutions globally—including results for the first two quarters of 2023—indicate strong tailwinds for banks in Europe, driven largely by healthy increases in NII.

Exhibit 1. The drivers of profitability, notably net interest income, have largely reversed course



1. Net interest income 2. Other income 3. Loan loss provisions
Source: BCG expertise and analysis. Minor differences in aggregated numbers owing to rounding off.

By contrast, large North American banks, especially those with business models geared toward advisory and capital markets, were hurt by a decline in fee income in Q1, although this trend rebounded in Q2. Increases in loan loss provisions (LLPs), largely linked to higher rates, have also hurt their profitability. Thinking more broadly, since LLPs are more of a conjunctural effect and can be perceived as a forward-looking measure of overall economic health, we expect these provisions to ease up in the event of a "soft landing" in the US economy. Nonetheless, while fee income and LLPs may positively contribute to profitability in H2, there are headwinds facing NII. Net interest margins remain under pressure as North American banks compete for deposits to shore up their balance sheets in light of the recent bank failures.

Meanwhile, in Asia-Pacific, a healthy combination of stable NII and lower operating expenses has led to an overall increase in banks' profitability—despite lower average gains on interest income than those at European and North American institutions. Expenses appear to be contained for the time being, with worries over high inflation potentially driving cost spikes as yet unfounded.

Nonetheless, it is expected that the cost dimension will indeed hurt future profitability, particularly in the near-term, as discussed in the previous edition of our New Reality in Banking series, "Containing Costs Amid High Inflation."

It is also worth noting that the response of nonbank players to the new reality is critical—especially given varying business models, the flexibility of industry roles, and the blurring of traditional borders that once separated different types of players. In formulating a strategy, it's key to consider the effects of actions taken by a wide array of ecosystem players, including asset managers.

The New Reality and the Investment Universe

In the new reality, the world faces investment needs that appear unprecedented since the end of World War II. First, global priorities such as those linked to climate change, sustainability, and infrastructure are leading to significant financing requirements. A report coauthored by BCG and the Global Financial Markets Association (GFMA)–titled "Climate Finance Markets and the Real Economy"–estimated that between \$3 trillion and \$5 trillion will be needed each year, on average, in order to achieve net-zero carbon emissions by 2050. On top of that, adapting the world to higher temperatures and more-severe climate events will mandate considerable investment.

Banks will be key contributors, but alternative financing solutions will also be required. This is especially true for time-consuming, complex projects with specific characteristics—such as long-term R&D, long capital cycles, and uncertain technological solutions—that traditional players would struggle to finance on their own. In addition, as global geopolitics evolve, industrial footprints and supply chains will need to adapt, including by "reshoring" industries. Global technology transformation, an ongoing dynamic that shows no signs of abating, will also require massive resources.

In parallel, one element of the banking landscape that remains unchanged in the new reality is the ever-tightening regulatory climate for banks and insurers. Depending partly on their geography, these players are facing higher capital and liquidity requirements. Amid global macroeconomic uncertainty and the recent bank collapses, this is a trend that will only continue, limiting and sometimes excluding banks from certain transactions—as we have witnessed this year in LBO financing and high-yield credit. Another key example is a significant part of climate-transition finance requiring a new form of financing.

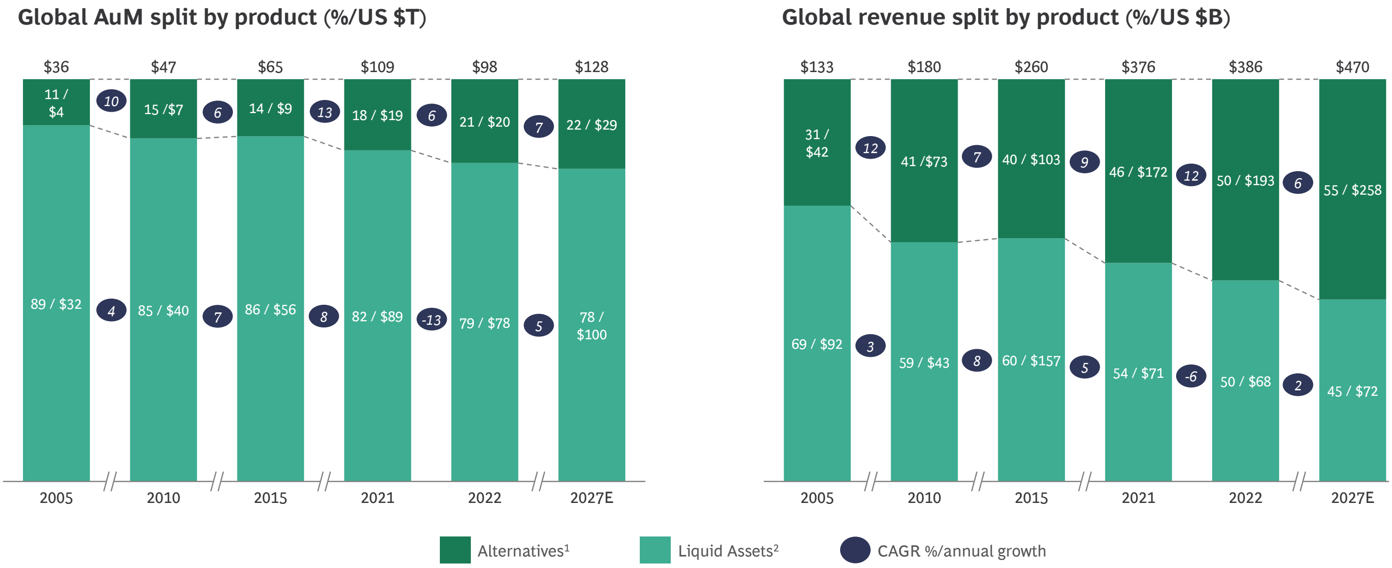
Alternative asset managers are looking for diversification and scale. Many alternative asset managers, including those on the larger end of the scale, have historically been anchored by private equity. Over the past ten years, however, they have diversified into broader alternative approaches that include venture, debt, infrastructure, and real estate, which have different risk/return characteristics and economic cycles. In doing so, they have reflected the recent behavior of asset owners, insurers, pension funds, sovereign wealth funds, and family offices, which have invested massively in alternative strategies—trading off (expected) better returns for lower. Liquidity Private debt, in particular, continues to grow rapidly, complementing or even disintermediating the traditional domain of banks.

General partners are temporarily struggling to raise capital. In the new reality, higher interest rates have led to widespread revaluation of bond portfolios and a reallocation of assets. At the same time, macroeconomic worries have hit valuations of portfolio companies. The overall result has been a particularly challenging fund-raising playing field in 2023. The landscape has been heavily tilted toward large multi-asset-class managers who have gained significant share.

Value Migration Will Continue

For roughly 20 years, we have been witnessing the gradual rise of alternative asset management. Globally, alternatives now represent roughly $20 trillion in assets under management (AuM), or about 21% of total AuM. At BCG, we are convinced that the momentum driving alternatives will continue, with AuM in alternative asset classes (including private equity, private debt, real estate, and infrastructure) expected to grow at a compound annual growth rate (CAGR) of 7% between 2022 and 2027, compared with a projected CAGR of around 5% for AuM in traditional asset classes. (See Exhibit 2). BCG's Global Asset Management Reports for both 2022 and 2023 provide a deep dive on the industry.

Exhibit 2. Alternative asset classes are outgrowing traditional asset classes



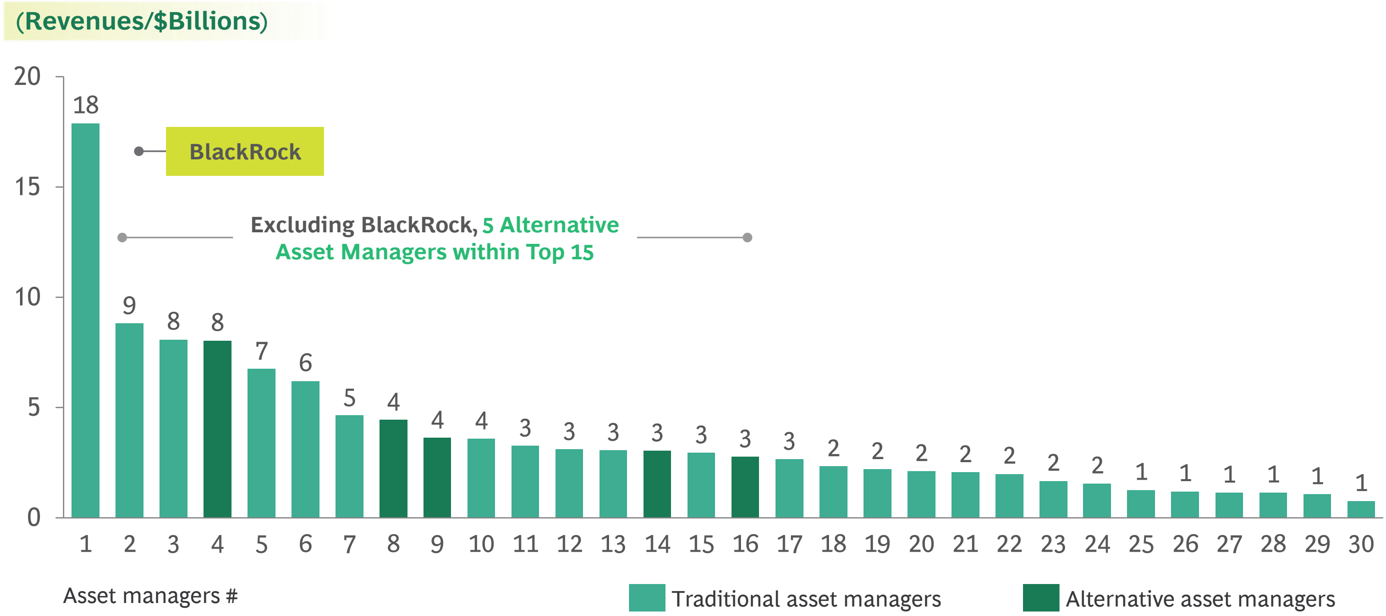
1. Includes hedge funds, private equity, real estate, infrastructure, commodities, private debt, and liquid alternative mutual funds (such as absolute return, long and short, market-neutral, and trading-oriented); private equity and hedge fund revenues do not include performance fees; 2. Includes equity specialties (global and emerging market active equity, developed market small and mid-cap, and themes) and fixed-income specialties (emerging markets, high-yield, flexible, inflation-linked); target-date, target maturity, liability-driven, OCIO, multi-asset balanced and multi-asset allocation; actively managed developed market large-cap equity, developed market government and corporate debt, money market, and structured products

Note: Bar chart values may not add up to 100% or to the specified sum because of rounding; LDI = liability-driven investment

Sources: BCG Global Asset Management Market Sizing 2023; BCG Global Asset Management Benchmarking 2023; ISS Market Intelligence Simfund; P&I; ICI; Preqin; HFR; INREV; BCG analysis

Yet even more important than AuM, alternative asset managers are now capturing half of the asset management revenue pool, up from 41% in 2010. This means that a meaningful share of industry value has migrated to alternative players—a migration that is poised to continue. Indeed, we are witnessing a new breed of global leaders in the asset management industry. In 2022, five alternative asset managers were among the top 20 in revenue terms, gaining a collective $22 billion. (See Exhibit 3).

Exhibit 3. In 2022, five of the top 20 asset managers in revenue terms specialized in alternative investments



Source: BCG analysis and public company reports.

This evolution could accelerate even further. Although alternative strategies have long offered superior alpha over the cycle (at a cost of low liquidity), they have not been widely accessible to private investors, only to those in ultra-high-net worth segments. Even for the wealthy, alternatives have typically held a relatively small percentage of asset allocations.

In light of current fund-raising needs, alternative asset managers are now clearly in the market for individual, private investors. Their barriers of entry may be higher, but solutions are being deployed through feeder funds, digital platforms, and other means. Forward-thinking GPs seeking this "retailization" of alternatives are actively building capabilities to address the opportunities.

Action Steps for Banks and Asset Managers

The new reality requires clear priority setting for all types of financial players. In our view, the below imperatives are most relevant for banks and asset managers of varying stripes.

Banks' wealth management units and private banks need to double down on alternative strategies.
For banks, offering alternative strategies—first to their wealthiest clients and progressively to clients with lower levels of AuM, potentially down to affluent segments—should be seen as an imperative. Most private banks already offer alternatives to some extent, but this level can be elevated.

Since alternatives still represent a relatively nascent opportunity, banks should ask themselves a number of questions, such as:

- Which GP(s) will help us provide the best solutions for our clients?
- Which fee structure is optimal? (Compared to mutual funds, there is less of an industry standard).
- Which target client segment should have top priority?
- How will we manage regulatory compliance and misselling risk?
- What is the most efficient operating model?

As for corporate and investment banks (CIBs), some value has migrated from them toward alternative asset managers' private credit units. Yet the size and business models of some alternative players make them attractive clients and partners, for multiple reasons.

For example, so-called "financial sponsors" require the full suite of investment banking products, from advisory to capital markets and debt. Asset managers can be the buyer of assets originated by banks, making room for a rotation of the banks' balance sheet and enhancing revenues. While "originate-to-distribute" approaches have become the norm, we believe most players are far from pushing it to the full potential. To do so, CIBs could establish partnerships with asset owners, work on operating models and incentives, and adapt their priorities to match investors' expectations.

Last but not least, banks have capabilities that can be extremely relevant for alternative asset managers, such as in origination, credit-risk assessment, and regulatory compliance. We see more and more partnerships being developed, and still more to come.

Traditional asset managers need to reinforce alternative strategies. Although most large asset managers offer a full suite of strategies, alternatives tend to occupy a relatively low proportion of the mix. This raises key questions that players need to address, such as:

- Which alternative strategies—both across private-equity asset classes (VC, growth, small, medium and large cap)—as well as across infrastructure, debt, real estate, and the like, bring the highest potential for our particular firm and capabilities?
- Should we expand on alternative strategies via organic expansion or through M&A?
- How can we most effectively manage very different talent pools and create the right kind of incentives within our asset management institution?

Alternative asset managers need to drive high growth and address new challenges. While alternative asset managers benefit from riding a recent wave of 9% growth per annum, a set of imperatives remains that must be acted upon if players hope to unlock their full market potential. These include:

- Accelerate growth and diversify risk, which includes expanding into a wider range of alternative asset classes.
- Diversify third-party funding sources, including those stemming from individual clients.
- Diligently manage costs, including those related to compliance and risk functions. Tightening regulations will bring additional costs of complexity as players grow.
- Explore consolidation plays, acknowledging they are difficult to execute well in a business driven by strong individual talents.

Ultimately, the new reality will have many different meanings for various types of financial institutions. But one thing is certain: grasping the ongoing evolution of the financial landscape is a timely opportunity to create competitive advantage.

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