



## Winning in Flow: Scale Is Everything

**Adam Bremner**

**Jared Moon**

**Tunde  
Olanrewaju**

**Peter Schloten**

**Paul Willmott**

**D**uring the boom years in capital markets, the attractiveness of the industry and the supernormal returns being generated created a rush to build out capital markets businesses. This rapidly created a fragmented industry landscape—with a small number of large players and a long tail of smaller participants. This was true both for structured products (including leveraged finance, asset finance and real estate finance) and for flow products, where smaller participants leveraged existing banking relationships.

With flow products contributing a growing share of overall revenue pools (84 percent in 2010 versus 81 percent in 2009), many smaller players began building out and investing in their flow product capabilities and platforms. More than half of the revenue pool in flow was captured by small players in 2010.

Given the market dynamics in flow products (e.g., the shift to electronic trading, regulation to increase transparency and fair pricing, and margin compression), as well as the results of the McKinsey Capital Markets Trade Processing Benchmarking Survey where the scale effects in flow products were clearly evident, this appeared to be a short-lived phenomenon (Exhibit 1).

Based on industries with similar dynamics (e.g., in the airline industry, the market share of the top three players increased from 40 percent to 70 percent from 1995 to 2010), market consolidation and the exit of smaller players seemed likely to occur. But even during the depths of the crisis, this did not happen.

### Why capital markets were different

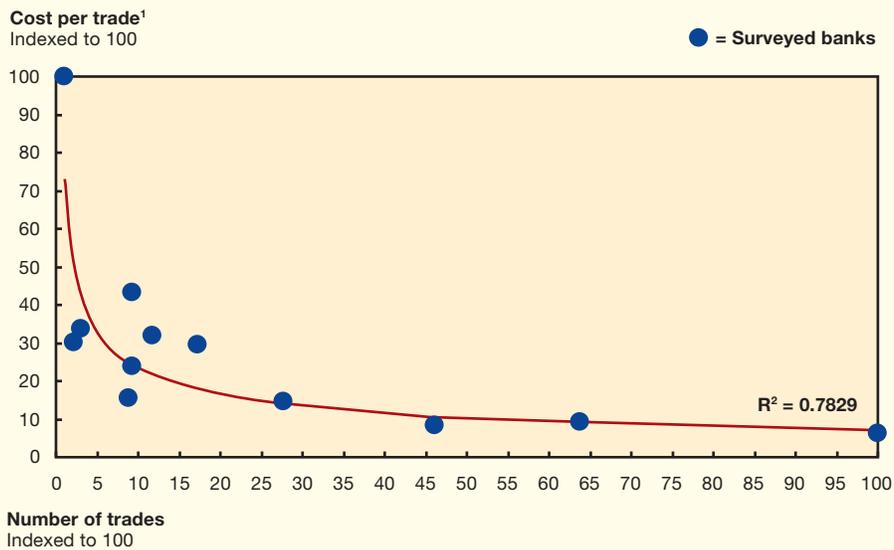
During the financial crisis and subsequent rebound, the expected consolidation in flow did not materialize for two principal reasons:

- The first was the presence of local market inefficiencies and the relationships that smaller firms have with their corporate banking franchise. This allowed smaller players to maintain a profitable niche with relatively high margins despite being sub-scale.

Exhibit 1

### Scale has a significant impact on back-office operations unit cost per trade

Cost per trade industry curve for FX (cash)



<sup>1</sup> Costs include middle office, back office, information technology and third-party costs.

Source: McKinsey Capital Markets Trade Processing Benchmarking Survey 2010

- The second was the artificially high front-office margins and business volumes during the immediate post-crisis rebound in 2009, which allowed even sub-scale players to cover significant inefficiencies due to scale differences.

The key question facing the industry in 2010 and 2011 was whether these factors would endure over the medium to long term and allow smaller players to successfully stay in the flow business.

### **The new normal**

New evidence suggests that this is not the case—creating a “new normal” for capital markets. In the current environment, market liquidity and industry revenue pools continue to be depressed; capital and funding requirements (primarily Basel III) are putting enormous pressure on returns in many structured products; and margins in flow products continue to be under pressure (Exhibit 2, page 86).

The pressure on flow products is particularly acute where over-capacity, electronic and standardization of products are making life difficult front-to-back. For example in 2010:

- FX volumes grew by 58 percent, but revenues fell by 9 percent.
- OTC equity (flow) volumes grew by 41 percent, but revenues fell by 12 percent.

In addition, the long anticipated market consolidation appears to be gaining momentum. There have been multiple instances in recent months where large players are examining their business portfolios and operating model for any sub-scale businesses. Some large players are dramatically reducing their investment banking franchises and exiting entire businesses (e.g., Credit Suisse in fixed-income, UBS across the investment bank). Small players are tightening their business focus and exiting non-core units (e.g., UniCredit and LBG announcing the exit of their equity businesses).

Given the current market outlook in general and for flow products specifically, this trend is likely to continue.

### **Why scale matters**

This is not to say that a profitable future in flow is not possible, but scale matters.

While the impact of scale (trade volumes) on efficiency (employee productivity) in back-office processing has been widely known, a deep dive into front-to-back efficiency data yields two crucial insights.

The first is that scale (measured either in revenues or trade volume) is highly correlated to front-office productivity (revenue per producer) across all asset classes and most strongly in flow (Exhibit 3, page 87). The relationship is strongest in global FX

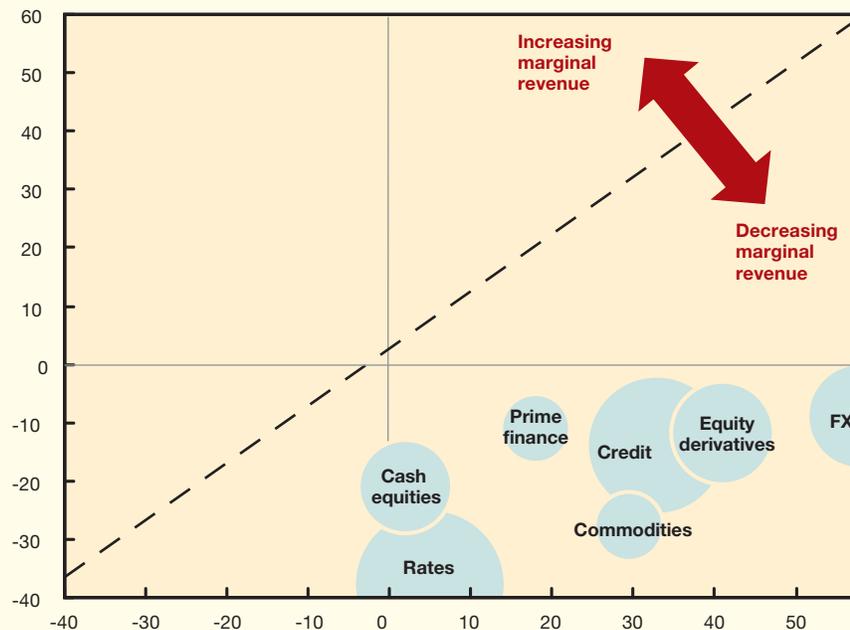
Exhibit 2

### Margin compression appears to be a reality in flow products

#### Change in revenue

Change relative to 2009, percent

● = Size of circle indicates size of cost base for each asset class



#### Change in volume

Change relative to 2009, percent

#### Summary observations

- Across all flow products, volumes grow much faster than revenues.
- Variance appears to be largest in FX and equity derivatives.
- Huge drop in rates and commodities revenues despite strong volume increase.

Source: McKinsey Capital Markets Trade Processing Benchmarking Survey 2010

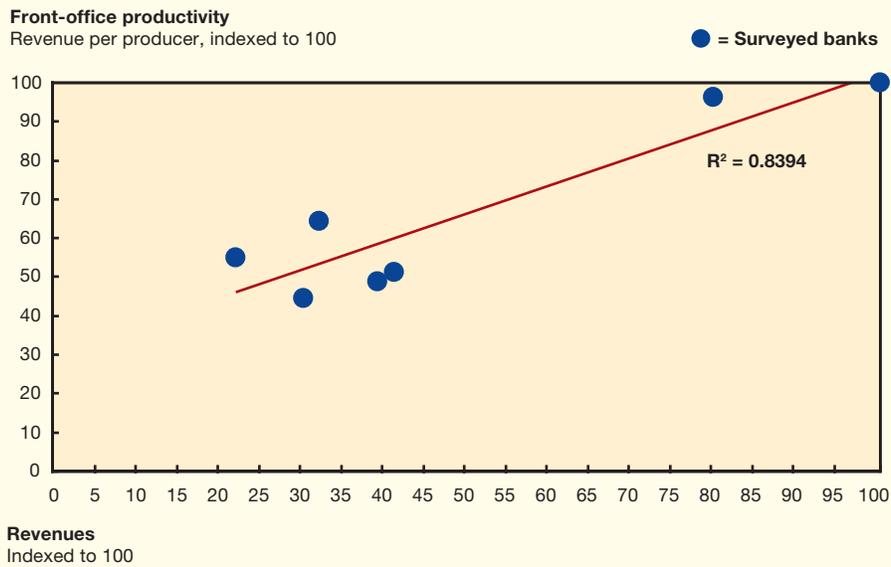
and U.S. cash, two of the most liquid flow asset classes. Differences in productivity across global investment banks are as large as four-fold:

- *Cash equities EMEA*: The productivity of the most efficient player is four times that of the player with the lowest productivity.
- *Cash equities Americas and FX (cash)*: The productivity of the most efficient player is 2.5 times that of the player with the lowest productivity.

Exhibit 3

**Scale is highly correlated to front-office productivity, particularly for flow**

Correlation between front-office productivity and scale for FX cash



Source: McKinsey Capital Markets Trade Processing Benchmarking Survey 2010; McKinsey analysis

The second insight is that there is a strong correlation between front-office productivity and back-office productivity in flow asset classes. Put another way: firms tend to have either high productivity front-to-back or low productivity front-to-back (Exhibit 4, page 88).

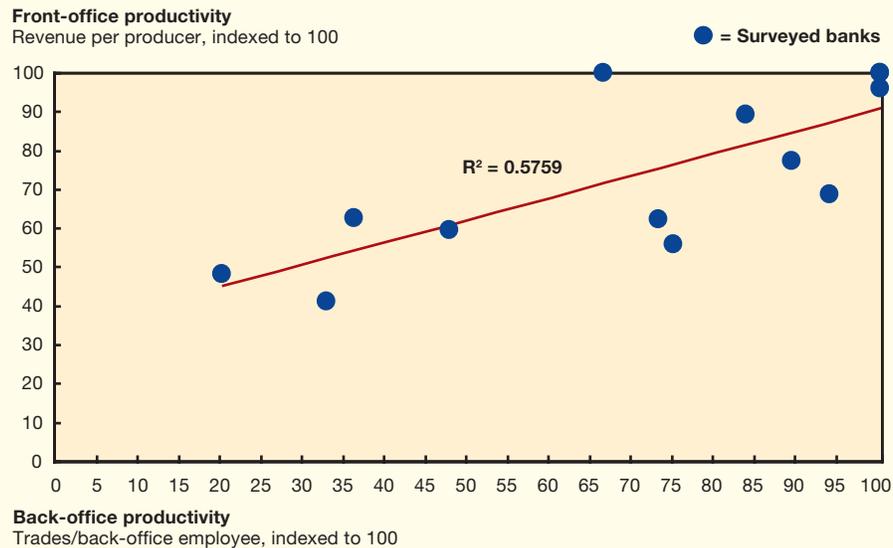
That being said, no firm was found to be highly productive in all asset classes (Exhibit 5, page 89), e.g., one firm has the highest productivity in EMEA cash equities, but is among the lowest in FX. The relationship between front-office productivity and back-office productivity holds in flow, but not in structured products where there appears to be little correlation.

Going forward, players will need to build scale in flow, partner to create virtual scale or exit the business.

**Implications**

The implications of this new normal and the need for scale are going to be felt by both large and small players, albeit in a different manner.

Exhibit 4

**Front-office productivity translates into back-office productivity**Correlation between front-office productivity and back-office productivity for flow products<sup>1</sup><sup>1</sup> Flow products include FX cash, cash equities (EMEA) and cash equities (Americas)

Source: McKinsey Capital Markets Trade Processing Benchmarking Survey 2010; McKinsey analysis

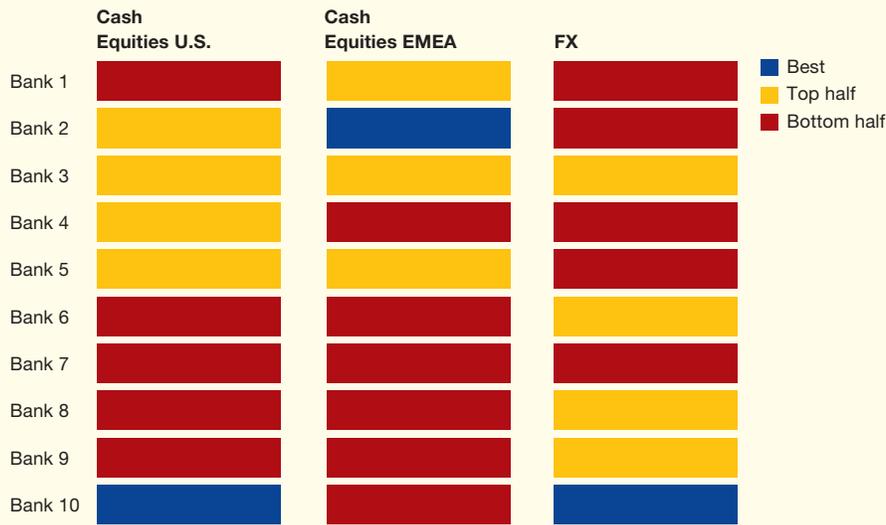
Small players will need to change their approach in three key areas. First, they need to create virtual scale—either by partnering with a third party or by creating utilities to leverage a wealth management and/or corporate banking platform. This requires highly flexible operations and technology to be able to “plug and play” with other parties or across the bank. Secondly, they need to re-evaluate the relevance of the flow business to their overall strategy by reviewing current business economics, and exit areas that will not be profitable in the long term. Thirdly, small players need to change the bank’s investment portfolios to align with this strategic agenda.

For large players, a three-pronged agenda is also critical, but a different set of actions is required. First, they need to industrialize their infrastructure, i.e., streamline front-to-back governance and processes, ensure they have a scalable straight-through processing (STP) platform with the right functionality and capabilities, and design to profit each activity conducted front-to-back. Secondly, they need to continue to invest in electronic capabilities in the front office to drive the front end of STP, but more importantly to capture liquidity and scale in flow products. Thirdly, they need to adjust compensation structures to ensure that staff are being compensated for the value being delivered incremental to the “seat value” of the franchise.

Exhibit 5

**Position of surveyed banks in flow asset classes**

League table for front-office productivity



Source: McKinsey Corporate & Investment Banking Practice

Early movers are already reaping the rewards of such actions. J.P. Morgan’s Strategic Re-engineering Program—a project that has been underway since 2009 and aims to spend \$500 million on consolidating the bank’s disparate trading systems—will eventually save \$300 million a year. Technology has allowed Goldman Sachs to reduce equities headcount by more than 50 percent from peak levels of nearly 5,000, while in FX, technological investments have contributed to margins, which have increased more than 150 percent since 2005.

Going forward, both small and large players need to establish an operating platform and capabilities to build scale in flow.

**Adam Bremner** is a director in the New York office. **Daniele Chiarella** is a director in the Frankfurt office. **Jared Moon** and **Tunde Olanrewaju** are principals, **Peter Schloten** is an engagement manager, and **Paul Willmott** is a director, all in the London office.

## About McKinsey & Company

McKinsey & Company is a management consulting firm that helps many of the world's leading corporations and organizations address their strategic challenges, from reorganizing for long-term growth to improving business performance and maximizing profitability. For more than 80 years, the firm's primary objective has been to serve as an organization's most trusted external advisor on critical issues facing senior management. With consultants in more than 40 countries around the globe, McKinsey advises clients on strategic, operational, organizational and technological issues.

McKinsey's Corporate & Investment Banking Practice serves leading global banks on issues of strategy and growth, operations and technology, marketing and sales, organizational effectiveness, risk management and corporate finance. Our partners and consultants provide expert perspectives on a range of topics including corporate strategy, business model redesign, product and market strategy, distribution and channel management, the impact of financial services regulation and performance improvement.

The following McKinsey consultants and experts contributed to this compendium:

Atul Bansal	Daniel Klier	Sasi Sunkara
Ankit Gupta	Christoph Kohlbach	Patrick Trutwein
Stefan Hansen	Andreas Kremer	Mark Williams
Holger Harreis	Akash Lal	Anna Yip
Saswati Hazarika	Davide Monguzzi	Johanna Zoelch
Nitin Jain	Raffaella Ritter	
Francois Jurd de Girancourt	Joydeep Sengupta	
	Sungmahn Seo	

## Contact

For more information, please contact:

### **Nathalie Hirsch**

Practice Coordinator  
nathalie\_hirsch@McKinsey.com  
+49 (69) 7162-5309

### **Joy Long**

Practice Manager  
joy\_long@McKinsey.com  
+1 (212) 446-8151

### **Mark Williams**

Senior Expert  
mark\_williams@McKinsey.com  
+44 (20) 7961 7249

