New but not yet normal: Corporate and investment banking in transition

In this article—adapted from our June 2010 white paper, "The future of corporate and investment banking"—we offer our view of how the next few years in wholesale banking may unfold.

Markus Böhme, Sandra Boss, Stephanie Gross, and Daniel Klier

The conflagration that started three years ago seems at least temporarily to have subsided, with the recent economic resurgence driven, in part, by solid fundamental demand in a number of areas. Companies have pressing needs for refinancing, and some investors have rediscovered their appetite for risk.

As a result, most trading and capital markets businesses have been running at or above pre-crisis levels. These results might suggest that with only a few exceptions, corporate and investment banking are back to business as usual. We argue, however, that the new environment is far from normal. Banks have benefited from a confluence of benign conditions—especially unprecedented fiscal stimulus and liberal monetary policy. Meanwhile, profound regulatory change is approaching.[1] Add in the looming possibility of sovereign defaults, and the world looks far from normal.

As government market support is withdrawn, banks' deleveraging will pick up speed, hurting revenue growth. Combine that with regulatory change, and we can expect returns from corporate and investment banking (CIB) activities to compress dramatically if banks simply resume business as usual. The top 100 banks' return on capital would fall to something like 10 percent to 12 percent in 2012.[2] This is a far cry from the approximately 20 percent they enjoyed before

[1] For more on regulatory change, see "Basel III: What the draft proposals might mean for European banking," available at mckinsey.com.

[2] This and other data in this article are drawn from a revised, expanded version of analysis originally presented in "Corporate and investment banking 2011: The path back to profitability," *McKinsey on Corporate & Investment Banking*, Number 8, June 2009, pp. 3–17.

the crisis. Even the global investment banks could see returns fall to 14 percent to 15 percent in 2012—half of their peak returns in 2007, which exceeded 30 percent (before write-downs).

Management and shareholders are unlikely to accept such a fundamental reduction in return potential from a business that already suffers from highly volatile earnings. Banks can make three immediate and practical moves to begin to restore profits: increase operational efficiency, change compensation practices, and maintain appropriate risk-based pricing. These have the potential to restore about 3 percentage points to their returns, pushing return on capital employed (ROCE) up to 13 percent to 15 percent.

Perhaps more important, fundamental structural change is on the anvil. The business models that flourished over the past two decades will likely have to adapt, and some will give way to new ones. In many ways, the next decade will more likely resemble the 1970s than the 1990s, with the biggest leaps in innovation shifting from product development to go-to-market approaches and distribution models.

The coming challenge

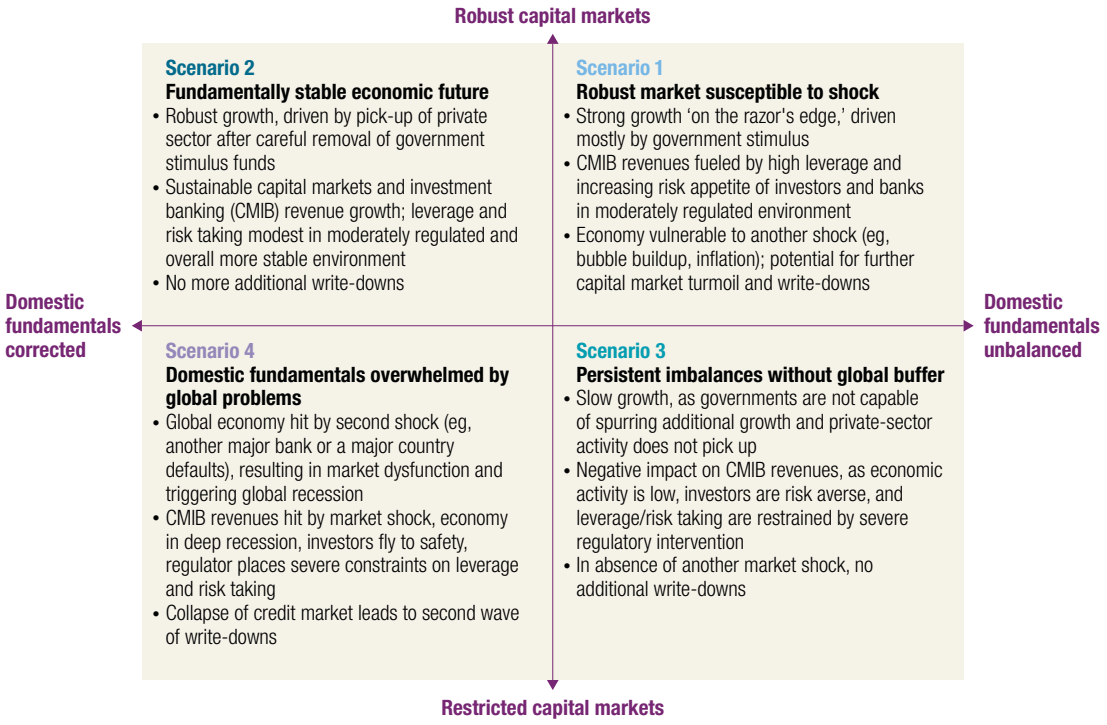
Structural changes to revenues and returns on capital will be most pronounced in capital markets and investment banking (CMIB).[3] For now, the picture for these businesses appears solid. We estimate that CMIB revenues in 2009

[3] We define CMIB revenues as those derived from secondary trading and sales with institutional, corporate, and retail intermediaries, hence excluding retail network margins but including proprietary trading and on-balance-sheet principal investments, as well as revenues from M&A, equity, debt underwriting, and other similar businesses. We define corporate banking revenues as those derived from specialized finance (such as leveraged or project finance), "plain vanilla" lending (before risk costs), and transaction banking (for example, cash and trade and securities services).

Exhibit 1

Four potential scenarios

Fundamentals and regulations determine possible futures for the global economy and capital markets.

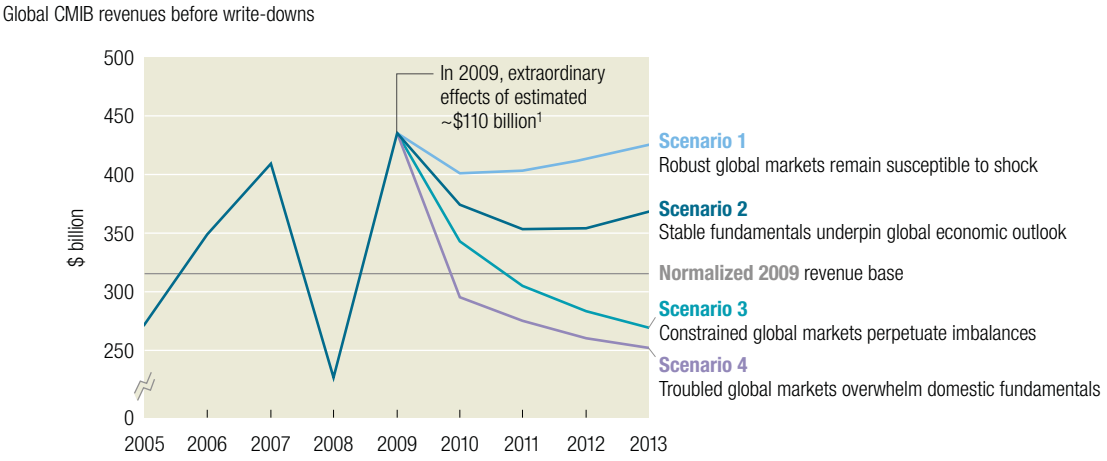


Source: McKinsey Global Institute

Exhibit 2

Revenues in four scenarios

Estimates of potential in the capital markets and investment banking (CMIB) industry strongly depend on which scenario materializes.



[1] Revenues in 2009 in equities and fixed income, commodities, and currencies (FICC) were boosted by effects that will not continually recur and that we estimate at $110 billion.

Source: McKinsey Global Capital Markets Survey; McKinsey Global Banking Profit Pools; McKinsey Global Institute; annual reports

substantially exceeded the high-water mark of about $400 billion posted in 2007. (For more on how banks created value in the run-up to the crisis, see the box on p. 5.)

Regrettably, many of the drivers of the resurgence are waning, leading us to conclude that 2009-level revenues may not be achieved again anytime soon. Just how strong will the future be? Thinking in scenarios that incorporate the major dimensions of uncertainty is a powerful tool in such situations.[4] Our scenarios build on the current set of economic scenarios from the McKinsey Global Institute (MGI), adapting them to the CMIB context.[5] The key variables are whether economic fundamentals will correct or remain unbalanced and whether new regulation proves severe enough to diminish risk appetite (Exhibit 1).

Depending on how these two key uncertainties play out, the size of the industry revenue opportunity will be substantially different (Exhibit 2). Even more interesting, the spread in performance across business models could decrease substantially (Exhibit 3).

Can banks do any more than just stare at the chessboard of scenarios and react rapidly to market conditions? To prepare for a radically different future, banks must consider the new industry dynamics and make their choices on six different fronts.

Market risk: Fight or flight

Both regulators and investors want to see banks manage their risks better. While the final shape of regulation remains uncertain, most agree that it will include higher capital requirements, especially in capital markets businesses, as well as some form of cap on leverage. Given all this, how much market risk should a bank take?

We expect to see a divergence in banks' stances on market risk driven by banks' overall strategy, balance-sheet structure, capital structure,

[4] For more on scenario planning, see "The uses and abuses of scenario planning," by Charles Roxburgh, available at mckinseyquarterly.com.

[5] For more on MGI's most recent scenarios, see "Economic conditions snapshot, April 2010: McKinsey Global Survey results," at mckinseyquarterly.com.

Pre-crisis business models and what created value

We analyzed the 2007 revenues and activities of the 100 largest CIB institutions before the crisis and identified six integrated business models. (Of these institutions, 88 are still independent; the rest have merged or disappeared.)

1. Global universal banks, such as Citigroup and JP Morgan Chase, have CIB divisions that cover the entire world and have significant franchises in most CIB activities (as a complement to massive retail banking franchises).

2. Global investment banks, such as Morgan Stanley and Goldman Sachs, have strong franchises in every investment banking business, but no (or extremely limited) corporate or retail banking and largely wholesale funding.

3. "Global challengers," such as BNP Paribas, are globally competitive in a focused set of CIB products, while offering a more complete range of products and services in their home geographies.

4. A group we call "regional champions" includes players like Santander, which leads in regional markets such as Spain and Latin America but is not global in its ambit.

5. Local corporate and investment banks, such as Intesa Sanpaolo and DZ Bank, provide a full range of CIB products and services in their home markets, typically with an emphasis on corporate banking.

6. Corporate banks, such as US Bancorp and some *Landesbanken*, concentrate on traditional corporate banking services such as cash management, trade finance, lending, and some structured finance.

By 2007, the top 100 also included some specialists that were either advisory boutiques, such as Lazard Frères and Rothschild, or securities servicers, such as State Street and BNY Mellon.

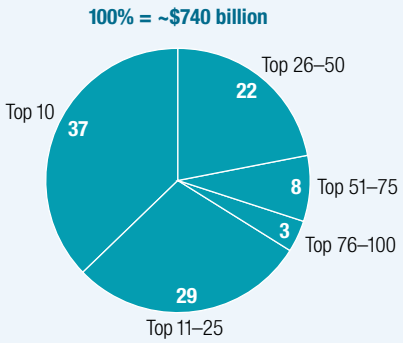
The exhibit shows the concentration of revenues, as well as the wide range in return profiles—while size and business model explain a lot of the performance profile, it is clear that quality of execution ultimately trumped everything else.

Exhibit

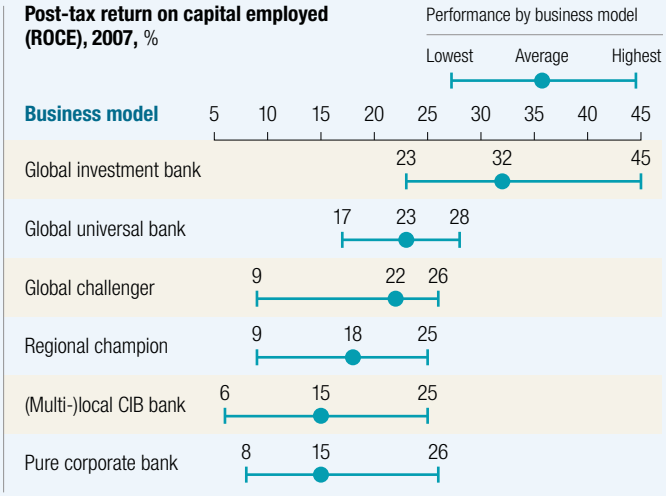
Distribution of revenues and returns

The biggest banks took a disproportionate share of revenues. But size alone did not determine success; execution mattered too.

Revenues for top 100 global corporate and investment banking (CIB) institutions, 2007, %



Post-tax return on capital employed (ROCE), 2007, %



Source: McKinsey Global Banking Profit Pools; McKinsey Global Capital Market Survey; annual reports; McKinsey analysis

and risk appetite. In the regulated banking system, much market risk will be concentrated among those few institutions whose extraordinary talent, risk culture, and systems allow them to make profits despite the higher cost of holding risk-weighted assets. Other banks will focus on making markets in more liquid risks, and some might go further and focus on limited flow aggregation and bundling or providing market access to, for example, central counterparties.

Ultimately, we expect that much of the most assertive risk taking will shift out of regulated institutions and into the so-called shadow banking system (Exhibit 4)—nonbank institutions such as sovereign wealth funds, private equity firms, hedge funds, and other financial firms that are just taking shape.

Talent and innovation: Finding new formulas

How much should banks pay for talent? While the industry is starting to adjust its pay schemes, we believe even more fundamental change is pending. The shift in risk taking spurred by the crisis will be an important driver over time. As risk shifts out of many banking businesses, especially in more conservative institutions, so, too, will the imperative to pay top dollar.

The defining characteristic of this shift will be the distinction between true "alpha" producers, for whom tremendous compensation levels may still be warranted, and the much more numerous "beta" producers (employees whose value creation has more to do with the bank's franchise than with exceptional talent), for whom compensation levels will be lower. And to the extent that risk-based innovation and structured risk taking will be concentrated in a few banks and firms in the shadow banking system, so, too, will compensation. Firms that reduce or even retrench their risk taking will come to see many of their people as engineers rather than rock stars and structure their compensation accordingly.

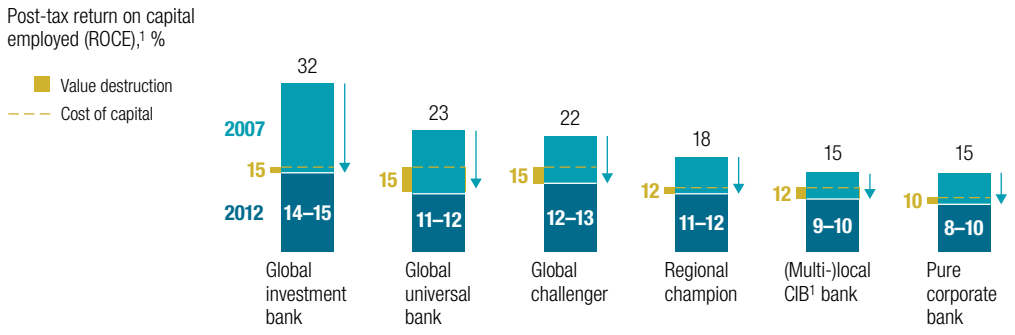
The pursuit of scale economies

Are there further scale economies to be captured? The crisis has ratcheted up the pressure to build scale in commoditized activities. Pushing

Exhibit 3

The coming challenge

Standing still is not an option. Economics will come under pressure, and each category will face challenges.



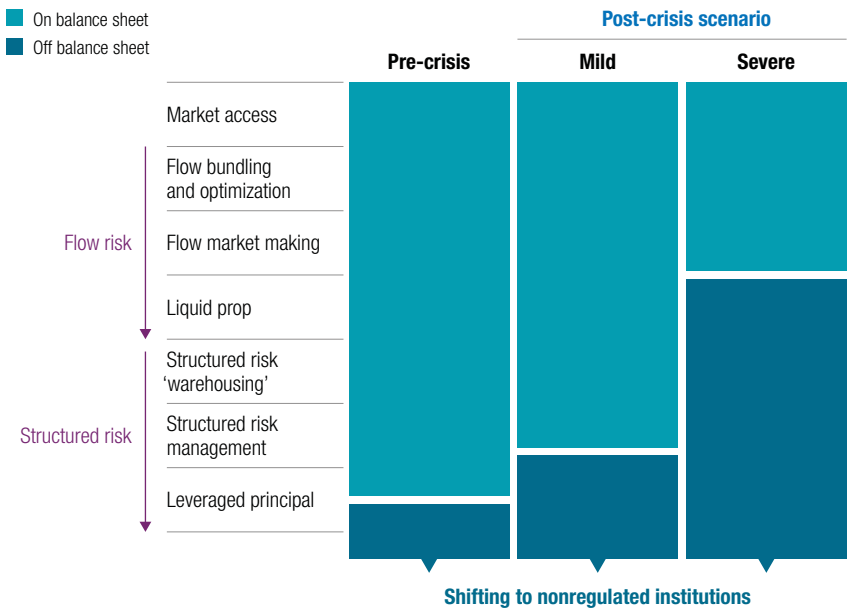
[1]Estimates of ROCE before any mitigating actions banks might take.
[2]Corporate and investment banking.

Source: McKinsey Global Banking Profit Pools; McKinsey Global Capital Market Survey; annual reports; McKinsey analysis

Exhibit 4

Shifts in risk taking

Even if the mild scenario unfolds, much risk, and the revenues associated with it, will leave banks' books.



more volume through high-fixed-cost platforms is one way to sustain and expand profitability and returns on capital given the headwinds that discourage risk taking.

In flow trading products like cash equities, foreign exchange, and rates, it is typical for leaders to incur only 20 percent to 30 percent of the post-trade cost per trade of a typical "midscale" provider. And that gap continues to widen. Several big banks are showing the way by embarking on major transformation programs to redefine operational efficiency. Further efficiencies can be extracted from reengineering core processes by applying the principles of lean manufacturing; offshoring work to low-cost locations, including even some mission-critical work; managing noncompensation expenses; extending the reach of automation; and doing even more with shared services. Banks that take on the full range of this work typically see reductions in cost per trade of 25 percent to 35 percent within two years.

The race for scale is taking some new forms. Leaders are beginning to explore the revenue synergies made possible by "cross-pollinating" among businesses such as global cash management, trade finance, foreign exchange, rates trading, and cash equities. Looking forward, the consequences for those banks that aim for scale and come up short may be severe—especially if their investments are substantial. Institutions that fall behind and cannot insource flows and transactions from others will eventually have to cede the ground to the leaders and outsource market-making or risk-taking and processing activities to other banks. Some smaller banks today have given up on manufacturing products in foreign exchange and equity derivatives and now sell private-label products manufactured

by larger banks, with their industry-low cost structures. Over the next few years, we expect to witness more innovation, for example, in operations utilities and other cost-sharing measures.

Balance sheets: A new strategic weapon

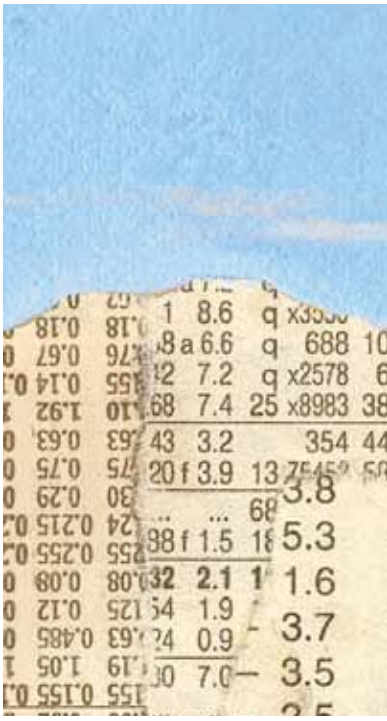
Although it is too early to tell how new regulation will unfold and how investor behavior will change, it is clear that banks should flex their balance sheets in very different ways.

Banks that choose risk over scale will need to significantly shrink their balance sheets and reduce their reliance on wholesale funding. As a corollary, they will also need to build their deposit bases. Banks with world-class product capabilities, strong client franchises, and robust retail deposit bases should be able to rapidly win share in balance-sheet-intensive activities such as prime brokerage or repos. While many aspire to this, only a few have the ability to monetize their advantage; JP Morgan Chase is the leading example. Others, such as local and regional corporate banks, with primarily credit risk on their books, can maintain or even expand their balance sheets without making regulators and investors uncomfortable.

Local franchises matter

Before the crisis, many markets were flooded with capital from global banks, global challengers, and even national banks from adjacent markets. Now, however, we find evidence of "reverse globalization" everywhere. Many globetrotting banks are pulling back. Some have done so by choice; several French banks, for example, have cut back their US presence. Others have been required to reduce their footprint in order to qualify for state aid; RBS, for instance, sold its Asian banking activities and has become much less active in lending in continental Europe.

Two groups of banks will compete for the newly available local business. First, some of the strongest global universals and regional champions, such as Santander and Deutsche Bank, are keen to strengthen their multi-local positioning. JP Morgan Chase's new global corporate bank is a recent example. The second and larger group includes local (or multi-local) banks, many of which will be able to regain their "natural" market share as traditional relationship-based lenders. If these banks can maintain discipline, relationship lending



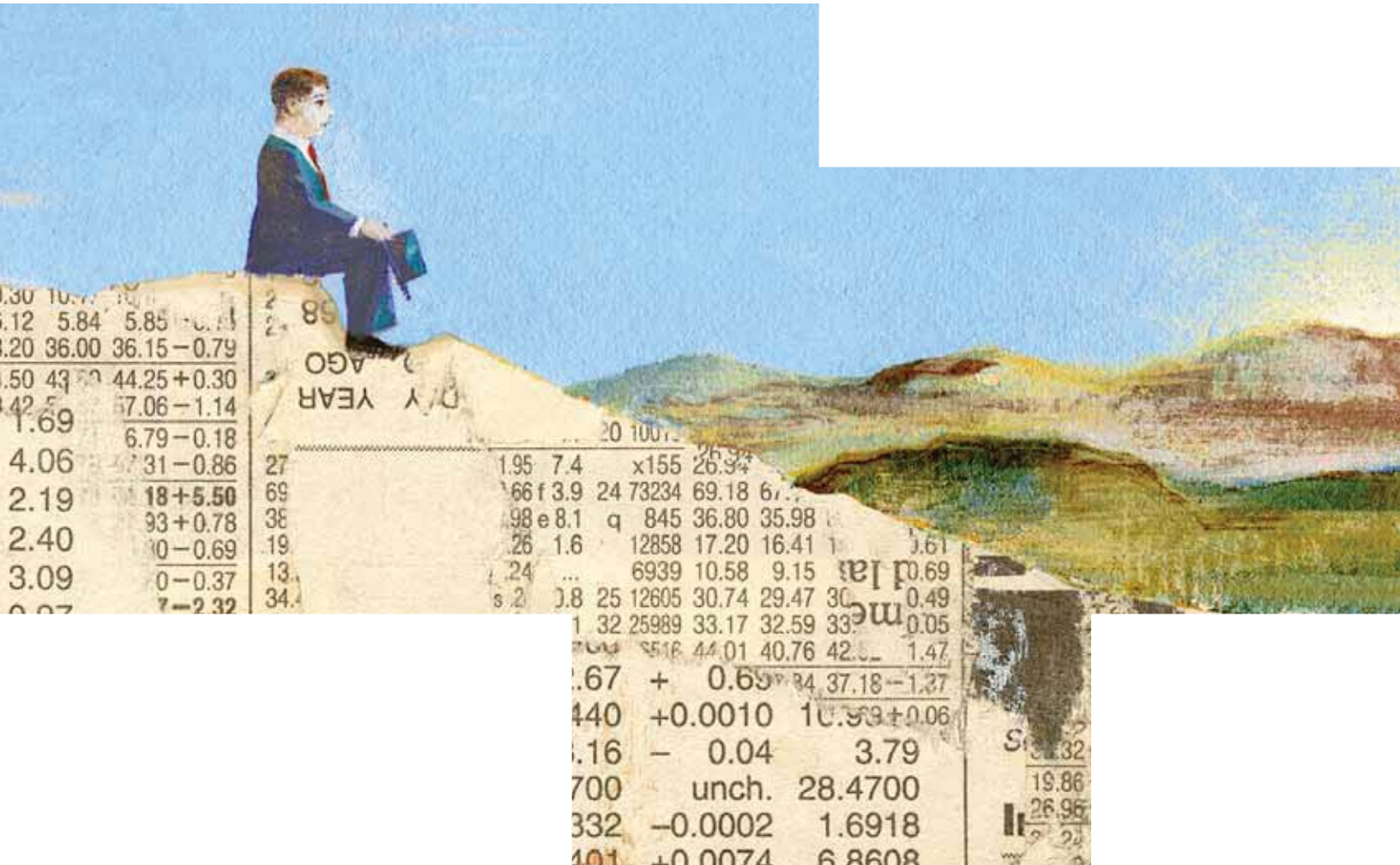
will enjoy a renaissance. While more often than not top global banks will continue to prevail in M&A and will coordinate the books for landmark IPOs, local players with strong product skills will now be able to fight their way into senior roles and become joint bookrunners.

Institutional relationships: Up in the air

The crisis has begun a broad-based reshuffling of institutional relationships. Sell-side distribution models have already become quite varied, ranging from the product-centric and opportunistic to true partnerships between bank and client. We believe this differentiation could go further.

While much depends on how regulation unfolds, the bright line that used to divide asset management from capital markets will blur. Some hedge funds, such as Millennium Global Investments, have already become leading market makers in high-frequency and low-latency trading. Others are increasingly focused on providing structured risk-management solutions to other institutional investors. This group includes not only hedge funds but also some long-only firms.

A few firms are going further and may soon become a new breed of risk-taking intermediaries (as opposed to today's risk-neutral interdealer



brokers). They are strengthening their expertise in risk-enabled and structured solutions, such as taking on and actively managing dividend risk or structuring exotic risk products like tailored dispersion swaps. As such, they are also beginning to compete with traditional banks for the biggest institutional clients.

As market participants make choices related to the six dimensions above, their current business models will begin to morph. The theme of this change is already becoming clear. Many of these trends favor greater specialization of one kind or another and work against the integrated offerings of the past decade. Accordingly, new specialist models will emerge and proliferate.

Business models for the future: Hedgehogs and foxes

"The fox knows many little things. The hedgehog knows one big thing."
— Isaiah Berlin

In investment banking, the hedgehogs are those that have traditionally known one of two big things: infrastructural scale (as in securities services) and talent (in advisory boutiques). We expect these firms to continue to prosper. Beyond that, we expect a new model to emerge and further blur the frontiers between the buy side and the sell side. The bigger, more versatile foxes—the generalists—will have to adapt.

Specialist models

1. Infrastructure specialists. New regulation (for example, central clearing of over-the-counter derivatives) will likely result in infrastructure-driven businesses claiming a bigger share of industry revenues. The biggest securities specialists will likely extend their scale-based dominance to new businesses (as seen in State Street's and BNY Mellon's expansions into prime brokerage and electronic trading).

2. Advisory specialists. Boutique advisers (for example, Evercore and Moelis) will play an increasingly important role. Fairly or not, some corporate executives and their boards will hold big banks accountable for the excesses and conflicts of interest that contributed to the recent crisis. In that light, the objectivity of independent advisers is more valuable than ever. Success for these advisers will come from building and leveraging a global network of talent and finding suitable balance-sheet partners to compete with larger institutions.

3. Advanced risk enablers. One important new model to watch is one we call the "advanced risk enabler," which will thrive on a diet of innovation and risk taking in liquid markets. Institutions employing this model have their roots on the buy side but are adapting to the new regulatory and technological environment to wrest control of some businesses from the traditional sell-side stronghold. Some first found sustainable sources of alpha in liquid markets through a combination of superior algorithms, improvements in low-latency trading, and dynamic hedging. They are now beginning to offer a viable alternative to the classic, integrated broker-dealer. Their ability to offer fast trading to other buy-side participants will only increase as the universe of standardized, central-counterparty-cleared derivatives expands.

4. Alpha generators. On the less liquid side of the market, there is room for another new model,

We expect a new model to emerge and further blur the frontiers between the buy side and the sell side. The generalists will have to adapt.

the "alpha generator." This model can take many forms, including nonbank proprietary investors and managers that invest side-by-side with third parties or new-style long-only asset managers such as Assenagon. These institutions will be research-centric—taking long-term, fundamental views on a select number of opportunities, which they may access through securities markets or even private equity–like acquisitions of whole operating companies. These institutions may use a different funding model comprising "patient" equity from sophisticated investors along with a reasonable amount of longer-term debt.

Integrated models

1. The new investment bank (target of $20 billion in revenues and more than 20 percent post-tax ROCE) is a descendant of the pre-2008 investment bank, but with different capabilities and aspirations. The new investment bank will serve a select client franchise and provide it with high-touch, risk-enabled solutions and advisory services, leveraging superior talent. Clients of the new investment banks will reward their services with high margins and value the independence of these products from lending. In their steady state, we expect these banks to have substantially smaller balance sheets than today, focused more on market risk than those of their universal cousins. Firms like BTG Pactual and Greenwich Capital are early examples of these, with others in the making.

2. The flow-driven universal bank (target of $25 billion in revenues and 20 percent post-tax ROCE) will be enormous. Much has been said about this model in recent months. The CMIB revenues of these banks would be similar to those of the new investment banks but would be generated in different ways, with a more client- and flow-heavy mix. Transaction services at these banks will also be at scale and generate more than $5 billion in net revenues.

   We expect at most ten institutions to successfully transition to this model. As a group, they could capture up to 35 percent of the CIB revenue pool shared among today's top 100 players. Globalization will be one dimension these players will need to master as they compete with one another for geographic dominance. A well-crafted "co-opetition" strategy, including alliances and perhaps targeted acquisitions, will be critical.

3. The franchise bank (target of $15 billion in revenues and 15 percent post-tax ROCE) is named for the broad and deep corporate franchise it has in its home markets. Its product offering is likely to be balanced across transaction services, lending, and investment banking, with near-critical mass in capital markets (usually about $5 billion in revenues in major markets). Its drivers of value will be serving the needs of its franchise and leveraging its lending power and status as "house bank" to gain a strong share of wallet on value-added

Exhibit 5

Restoring order

In coming years, greater scale and more efficient operations and capital use will lead the industry to greater profitability.

Post-tax return on capital employed (ROCE) of top 100 corporate and investment banking (CIB) institutions,[1] %

[1] Excluding specialists.

Source: McKinsey Global Banking Profit Pools; McKinsey Global Capital Markets Survey

products. The key challenge for a franchise bank will be achieving moderate scale—a franchise bank needs a large home market, or a distinct multilocal strategy, in territories such as emerging Asia, Central and Eastern Europe, or Latin America. We expect 12 to 15 institutions to successfully deploy this model; among them will probably be quite a few institutions that are not yet household names. As a group, they might capture up to a third of the CIB revenue pool enjoyed by today's top 100 players.

4. The new corporate bank (target can vary but is typically much greater than $10 billion, with much smaller market business and 10 percent post-tax ROCE) shares with the franchise bank deep local roots and the lending balance sheet it commits to its customers. However, it can operate at a much smaller minimum size and thus compete in smaller home markets. It will be client-focused, with lending, structured finance, transaction banking, and capital markets product "factories" geared toward local franchises. It will be able to operate with limited technology investments and a talent formula that makes its economics work. It will mostly refrain from market risk and complex services, such as sophisticated corporate finance solutions.

Becoming a successful new corporate bank requires some tough choices. Banks will need to review their product portfolios and possibly exit some products—for example, complex capital markets and investment banking solutions. In some cases, such as foreign exchange and retail derivatives, white labeling offers a viable alternative to exiting products completely. While in the aggregate, new corporate banks will cede market share to their larger, scale-driven competitors, individual banks can take advantage of the opportunities provided by the industry's consolidation and expand their position. We expect half of tomorrow's

CIB top 100 to compete with this model; as a group, they should capture at least 20 percent of the revenue pool.

Before the crisis, business models were plentiful. In the future, most of these will present the banks that used them with tough strategic choices when selecting and transitioning to the new business models outlined.[6] Quite often, the desired position will require major trade-offs and changes along one or several of the six transformative trends outlined. But the transition to the new world and its new business models has already begun—12 of the top 100 in 2007 have disappeared as independent players. A "barbelling" of the industry into fewer but bigger flow-driven universals and franchise players on one end and a number of specialists and lean corporate banks on the other will create scale and efficiency.

The migration of market risks into bigger books and in many cases out of bank balance sheets altogether, along with much-needed upgrades on counterparty and collateral management, will reduce capital consumption. After a successful transition to the new models, the industry should be able to regain healthy economics and enjoy an after-tax return of 15 percent to 18 percent on its capital employed (Exhibit 5).

• • •

Although the industry's transition will take several years, the time is ripe for institutions to move. In many of the new models, there are fewer places available than there are hopefuls. Even banks that are in the lead need to act quickly and decisively to monetize these advantages. To claim a spot at the table, banks need to develop a clear aspiration, matching their strengths and culture to the available opportunities. With the right aspiration in place, banks can design a broad transformation program to successfully manage the change in all critical dimensions—product, client, operations, and organization.

[6] For more detail on the transformative trends and the business models that CIB institutions may deploy in coming years, see our white paper, "The future of corporate and investment banking," June 2010.

The authors would like to thank their colleagues Christian Dörr, Matthieu Lemerle, and Frank Wachtler for their outstanding contributions to this article and the research underlying it.

Markus Böhme (Markus_Boehme@McKinsey.com) and **Stephanie Gross** (Stephanie_Gross@McKinsey.com) are principals in McKinsey's Munich office. **Sandra Boss** (Sandra_Boss@McKinsey.com) is a director in the London office. **Daniel Klier** (Daniel_Klier@McKinsey.com) is a consultant in the Berlin office.

McKinsey on Corporate & Investment Banking is written by experts and practitioners in McKinsey & Company's Global Corporate and Investment Banking practice.

To send comments or request copies, e-mail us: McKinsey_on_CIB@McKinsey.com.

Editor: Mark Staples
Global CIB Practice Manager: Anne Steels
Art Direction and Design: Cary Shoda
Editorial Production: Elizabeth Brown, Heather Byer, Nadia Davis, Torea Frey, Sue Rini, John C. Sanchez, Venetia Simcock

Illustrations by Gérard DuBois

McKinsey & Company
Industry Publications
Editor-in-Chief: Saul Rosenberg
Managing Editor: Lucia Rahilly