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Tackling the performance challenge in regional capital markets businesses

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The capital markets arms of regional and national banks are often seen as smaller versions of the capital markets businesses of the top 10 global firms. However, they are actually quite different. Regional businesses have evolved along their own paths, with distinct client franchises, operating models, and sources of profitability. As a result, they require a strategic agenda that is tailored to their specific needs.

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Until recently, the capital markets businesses of regional banks have been insulated against many of the troubles affecting larger global banks, and in some cases have performed better than them. Regional capital markets businesses' returns on equity (ROE) held up better than those of their larger counterparts and regionals maintained their market share.

Now, however, there are signs that life is getting tougher. Structural shifts such as increasing electronification and falling revenues, and questions about the sustainability and "fit" with their parent organizations, are leading to increased scrutiny of these businesses. This has been especially pronounced in Europe. Temporary revenue upticks from market volatility linked to COVID-19 are seen as providing only temporary relief.

Even seemingly more robust franchises are being forced to answer difficult questions. They have found that after stripping out the impact from internal flows and adjacent client bases, the businesses that remain are often far less profitable. They have also found it challenging to unlock the next phase of growth.

In response, regional players across geographies are focusing on improving productivity end to end. A subset of firms is also trying to identify three to five pockets of opportunity for capturing revenue.

Regional banks require a customized playbook to move forward on this agenda, focused on optimizing the front-office footprint, simplifying support functions and making them more efficient, and making a few targeted technology bets. To spur growth, banks should disproportionately allocate talent and balance sheet to their most valuable products and client segments, while paring back in other areas. The prize for those that succeed is significant. According to McKinsey analysis, for a representative $2-billion-revenue franchise, even a tactical set of levers focused on efficiency can lead to $150 million to $250 million of bottom-line impact over a two-year period and create capacity for more ambitious initiatives centered on technology and growth.

Regional capital markets businesses face a performance challenge

Regional capital markets businesses are too often analyzed alongside those of the top 10 global banks. However, this approach ignores differences that are critical to the way in which they manage their businesses and optimize their competitive positions.

Regionals are different on many counts, including revenues, clients, and key sources of profitability. They typically generate revenues in the range of $1 billion to $5 billion, while large players operate in the over $10 billion area. More of their business comes from corporate clients (in excess of 50 percent in many cases) versus the largely institutionally focused franchises of global players. The product mix is simpler, focused on a combination of debt capital markets, FX, rates, and sometimes equities, compared to the more expansive capital markets offerings maintained by larger players, and therefore easier to staff and support. Profitability for regionals relies materially on other areas of the bank (e.g., processing all the bank's FX trades, cross-selling swaps on the back of corporate loans made by the corporate bank). Finally, the regional coverage model relies more heavily on corporate bank relationship manager-led interactions and is more tightly integrated with the treasury function.

Until recently, these differences were the basis for stronger performance. Regionals routinely generated ROEs of 10 percent or more, higher than that of many of the global players. They boasted more stable client franchises, were less exposed to market volatility, attracted higher margin flows, and incurred lower relative costs. As a result, they maintained market share between 2015 and 2019 (Exhibit 1, next page).

However, over the past few years, the relatively stronger position these banks enjoyed has started to deteriorate. While there is a very wide range of performance in the regional capital markets space, with wide variation in ROEs and cost-income ratios across banks, many firms have seen ROEs consistently slip below 5 percent and cost-income ratios climb north of 80 percent. This decline in performance has been particularly pronounced at a number of European firms. Recent, temporary upticks from COVID-19-related volatility are not seen as sustainable or likely to fundamentally change the longer-term challenge facing regionals.

Even firms that appear to be far more financially strong are often not so. The profitability of treasury activities and internal retail and wealth flows can mask core sales and trading activities that are far less profitable (Exhibit 2, next page).

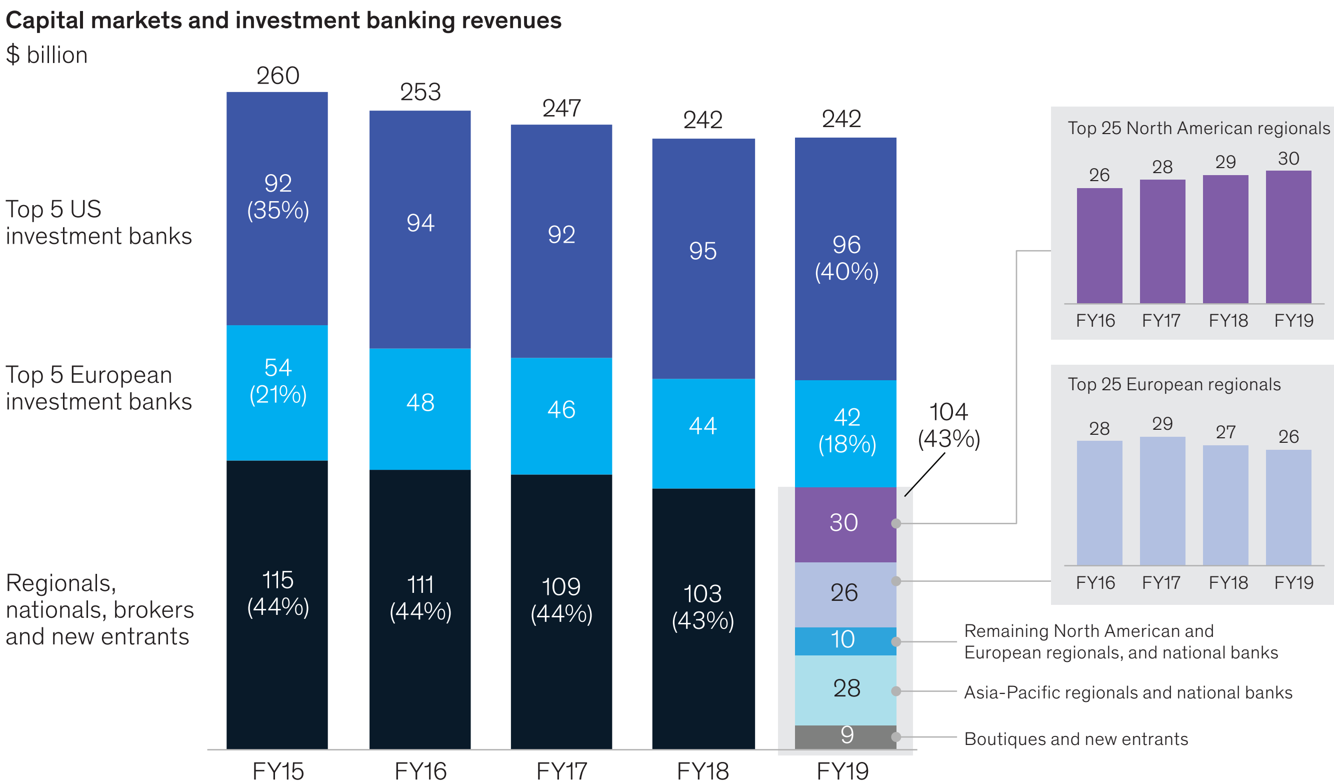
As a result, many regional capital markets businesses are facing fundamental questions about the scale and sustainability of the franchise, its contribution to the wider bank, and its risk profile. They also need to find an answer to the increasingly vexing question of where to find future growth.

We see eight key reasons why the strategic picture has become more challenging for regional capital markets businesses:

1. Regional firms play at a fundamentally less productive place on the productivity frontier
When it comes to front-office productivity, the data suggests that scale matters greatly. Regional and national capital markets businesses are inherently less efficient than larger players tend to be on a revenue-per-FTE basis (Exhibit 3, page 5). Many of their core clients have smaller wallets but still require substantial coverage and execution resources.

Exhibit 1

Regional capital markets businesses maintained share from 2015 to 2019.



Source: McKinsey CIB Insights

Exhibit 2

Even apparently robust regional capital markets franchises have weaker "true economics" when internal subsidies are stripped out.

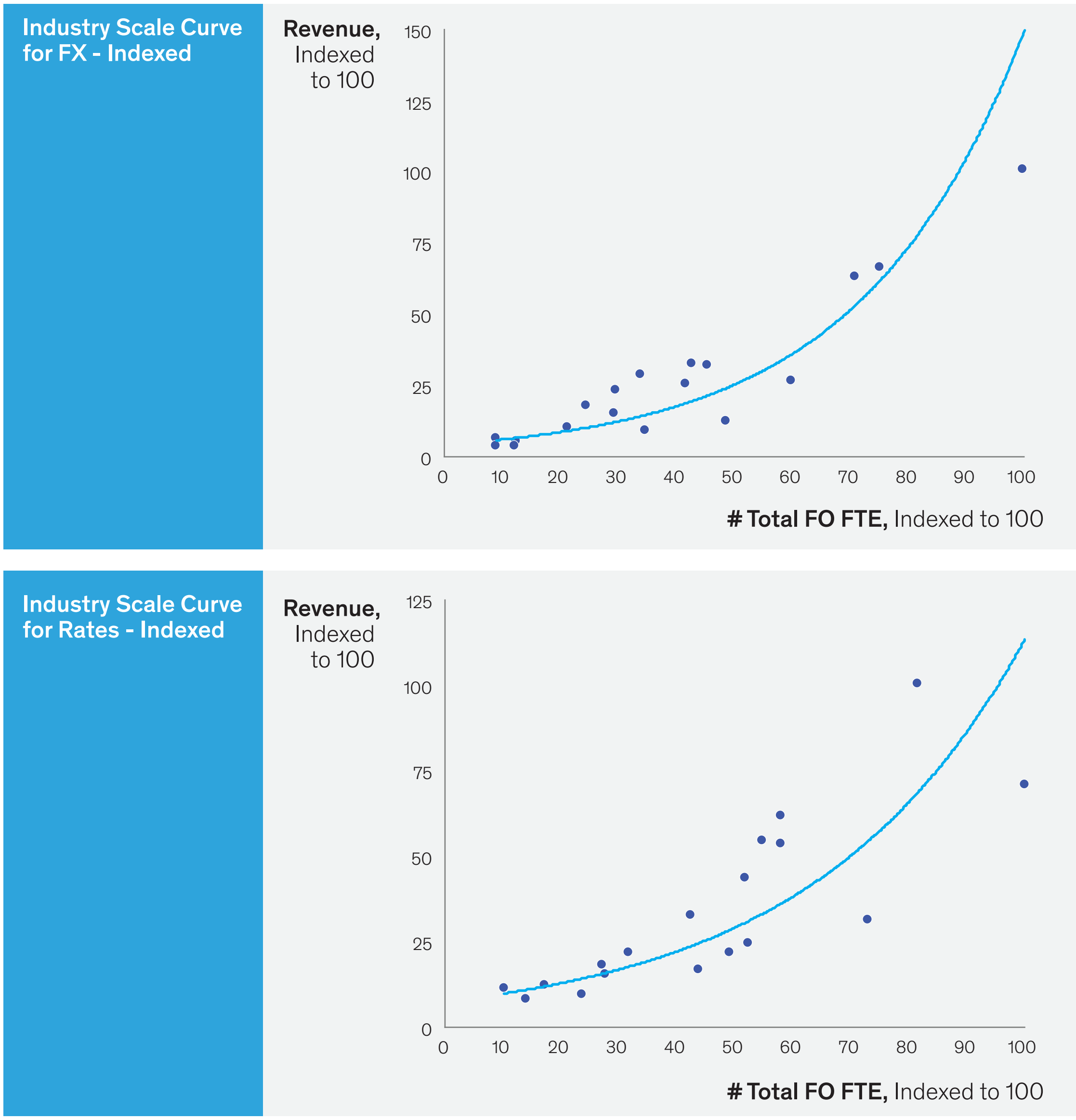
Example capital markets franchise

	Revenues, $ million	Costs, $ million	Cost-to-income ratio	Return on equity	Overview
Business overall	1,000	600	~ 60%	20%+	Very strong profitability overall
Internal flows	380	100	~ 25%		Flows from adjacent retail and wealth franchises, internal treasury activities
Macro sales and trading	210	190	~ 90%	< 5%	Core secondary trading business; capital intensive with substantial voice footprint and technology needs
Credit underwriting and distribution	260	150	~ 60%	> 15%	Debt capital markets and structured lending origination, distribution, and secondary trading
Equity underwriting and distribution	150	160	~ 110%	< 0%	Equity capital markets and associated distribution and secondary trading

Source: McKinsey analysis

Exhibit 3

Smaller banks often play at a fundamentally less productive part of the scale curve.



Source: CIB Insights Data 2019

2. Client needs are changing and raising the technology bar

Corporate and small and medium-size enterprise (SME) clients have increasingly sophisticated needs associated with global operations and ever-rising digital expectations. These companies have been forced to understand their cash flows and the risks to those cash flows at an ever more granular level. This has led to a demand for smarter, faster capital markets solutions that are available across channels, provide connectivity to multiple banks at once, and can access the latest fintech offerings across a range of areas, from visualizing FX hedging needs to settling cross-border payments. For banks, building or buying the required technology is expensive. As we describe below, these needs are also attracting new entrants focused on some of the most lucrative flows (e.g., in FX forwards).

3. Electronification is eroding margins and creating pressure to invest in e-trading technology

The trading of FX, equities, and areas of rates has become increasingly electronic, leading to tighter margins. Regional banks have been required to spend more on venue connectivity, and on auto-pricing and auto-hedging engines. Increasingly, the banks that win are those with scale, and regional firms typically lack this.

4. Margins have tightened in other asset classes as well
Revenue pressure is not restricted to electronically traded products. For example, the traditionally low-risk repo business was an area where regional firms exploited the regulatory capital advantages they had over larger firms, which were more balance-sheet constrained. They are now seeing substantial price pressure as competition has intensified once more.

5. New entrants emerging across the value chain
Market making has expanded beyond the traditional dealer community to a new breed of algorithmically driven market makers, in FX and rates for example. Further, the fintech community, initially focused on the retail banking space, is now building momentum in capital markets through services aimed at the poorly served SME segment; for example, currency exchange and payments propositions that are sold on the basis of greater accessibility and cost efficiency. Client flows that regional capital markets firms could previously take for granted are thus no longer guaranteed.

6. Regulation is driving capital intensity and regtech spend
Banks continue to manage the many impacts of regulation. Significant regulatory initiatives still being delivered include FRTB, BCBS 239, and MiFID II. In some geographies, banks are also required to separate capital markets activities from the rest of the bank's "ring-fenced" retail and commercial activities. The impact of all these efforts includes higher funding costs, reduced revenues, and increased capital requirements. These programs are also expensive and time-consuming to deliver. Some regional and national banks are spending up to 25 percent of revenues on change activities, the majority of which are regulatory in nature. Upcoming rule changes such as the shift away from IBOR benchmarks, as well as the still unknown impacts of Brexit, are likely to create further strain.

7. Relationships with the parent bank are becoming more complex
Regional capital markets businesses are often engaged in delicate ongoing negotiations over their revenue-sharing arrangements with the wider bank. A common point of debate is joint-venture arrangements concerning lucrative internal flows. These may either flatter the earnings contribution of the capital markets business, obscuring its less attractive "true" economics, or fail to compensate it for the coverage and technology resources required. Other subjects for negotiation include sharing of client lists and the operation of cross-sell arrangements, which often work less effectively than they could. Finally, some capital markets franchises are continually challenged to articulate their contribution and their fit in the context of the wider business.

In other cases, the position of the business is more secure, and the capital markets division is regarded as a utility, responsible for handing flows from retail, wealth, and treasury, as well as the classic corporate bank. However, the benefits the capital markets business brings in terms of profitability are seen as offset by technological and operating model complexity. Sometimes this is due to multiple legacy IT stacks and databases built over time. Re-platforming is one solution, but it's neither cheap nor simple given links into other critical areas, such as treasury.

8. For firms focused on expansion, the path to future sustained revenue growth is unclear
Capital market revenue pools have been roughly flat from 2016 through 2019, but some regional players initially capitalized on the post-2008 financial crisis retreat of the top 10 global banks to increase their market share. Now that gain is being eroded by the (re)emergence of a few entrenched "flow monsters." These global players increasingly dominate individual product verticals, operating at a lower cost per trade and amortizing technology spending across a much larger client and revenue base. The result is ever-deeper moats around their franchises, putting regional players under pressure to find client/product combinations where they retain a real edge. In addition, a number of these global firms are re-entering the mid-sized corporate space in search of growth of their own, further increasing competitive pressure on the regionals.

Taken together, these eight trends constitute a significant strategic challenge for the leaders of regional capital markets businesses. Of course, each trend does not apply to each bank, but we consistently see firms grappling with at least a few.

A customized playbook: Four key themes

For most regional franchises, the path to better performance will not be paved with grand strategic ambitions. Rather, it will require the astute application of tactical levers that can help them right-size their franchises, operate more efficiently, and bolster their earnings capabilities. These tactical actions can in turn create capacity for bigger bets. We see four areas in particular that require focus.

Optimize the front-office operating model

— *Redesign the front-office operating model on a clean-sheet basis to improve productivity.* Some firms have already taken steps in this direction, conducting end-to-end reviews of trading and distribution activities. A few have revised coverage models, increasing coverage spans and encouraging lower-value clients to use electronic channels. Others have conducted one-off reviews of their least productive desks and teams. In parallel, they have made tactical investments in customer relationship management (CRM) systems, the insights from which have informed moves to better track, intensify, and prioritize client outreach activities.

— *Exit non-core or peripheral products.* While regional firms typically have scale in core rates, FX, and DCM products, they sometimes try to compete (less successfully) in ancillary products (e.g., exotic options). At a number of firms, the client need for these products is less clear. They are also difficult to risk manage, sensitive to market volatility, and sometimes prone to large "unexpected" losses. Rather than retain the risk, some firms have opted to de-risk their activities through "back to back" positions or white-labelling arrangements with at-scale providers.

— *Reduce non-producer support roles.* Front-office teams are often over-supported by business managers, planners, COOs, analytics teams, and quants. In many cases, these teams are duplicating activities carried out in support functions and can be consolidated with them. Many firms have set clear guidelines on the number of non-producer roles allowed in the front office, and right-sized teams appropriately.

Drive front-to-back simplicity and efficiency in the middle and back offices

Leading regional capital markets businesses have aggressively cut costs in areas including operations, finance, risk, legal, and HR. They have focused on a number of key levers, including:

– *A leaner operating model* with a focus on widening seniority pyramids, optimizing spans and layers, and shifting roles to near- and offshore locations.

– *Automation with a focus on accelerating existing pilots* employing robotic process automation (RPA) and natural language processing (NLP) technologies into at-scale programs to achieve real savings.

– *Creating centers of competence* for cross-functional activities including stress testing and modelling, people planning and financial forecasting, and consolidating activities carried out across the bank.

– *Optimizing third-party spending* with a focus on supplementing traditional supply-side levers (e.g., renegotiating vendor contracts in line with industry standard rates) with demand-side levers. The latter include using lower-cost vendors for less complex work, enforcing resourcing pyramids and other provisions embedded in existing scopes of work, and eliminating unnecessary or under-used subscriptions, licenses, and devices.

– *Carefully monitoring change programs.* Leading banks are scrupulous about carefully managing change-the-bank spending. Large programs are reviewed on a quarterly basis to ensure they are being delivered in line with agile principles, on time, and within budget. Many have employed a one-off 10 to 15 percent reduction in non-revenue-related change-the-bank spending as a forcing mechanism.

Make targeted technology bets across the trade lifecycle, aiming to achieve a step change in economics. Firms have been exploring levers including:

– *Reprioritizing and rethinking technology "buy versus build."* Many firms have made much greater use of vendor software for activities including pricing, order management, risk, and post-trade solutions. In particular, they have been more willing to use third-party providers for the underlying "chassis" for a broad set of solutions including CRM, data warehouse systems, document and work-flow management, and analytics. The focus has been on pivoting scarce development resources to a more limited set of products that make a real difference internally or to the client.

– *Investing in digital front-end platforms.* These include dedicated platforms for middle market and SME clients; for example, for simple FX and rates transactions. Often the services have been integrated with broader digital offerings (e.g., corporate cash management and trade finance) to create a more seamless client experience. These platforms have the potential to substantially increase business volumes in the segments targeted.

– *"Self-disrupting" with sandboxed solutions.* A subset of firms could extend digital investments into a fully fledged "internal disruptor" as has already been done in commercial banking in areas like SME lending. For example, a clean-sheet platform for e-trading in equities, futures, cleared derivatives, or foreign exchange, offered via an attractive front end, can attract substantial incremental revenues, operate at a structural cost advantage, and even be white-labelled to other banks.

– *Alternatively, building partnerships with bank and non-bank market makers for specific products and geographies.* Some banks lack the technology budget, investment appetite, and time to make the types of investments described above. In products where they lack a real edge, such regional banks should explore partnerships to build the capabilities their clients require. They could do so in areas where the bank struggles to be consistently profitable (e.g., cash equities) or in non-core products (e.g., non-G10 FX, commodities). These partnerships can increase revenues and lower costs associated with trading expertise the bank no longer needs to maintain internally, as well as reduce spending on pricing, hedging, and market risk management technology related to the products in scope.

– *Outsourcing at scale in operations and technology to business process outsourcing/IT outsourcing providers, potentially with PE funding.* Partnerships don't just have to be in front-office areas. Third-party firms can take over areas like derivatives settlement and clearing, securities processing, or reference data, often at a lower cost per trade than the bank. They can also take over and operate offshore centers (e.g., in India) at lower cost and ensure the application of the latest RPA and NLP technologies. In some cases, these partnerships can be engineered to generate a large upfront payment to the bank and be partially funded through private equity investment.

Selectively pursue organic growth. Some regional firms are ready to pursue growth. Above we have discussed technology-enabled opportunities. In addition, firms should:

– *Maximize cross-sell to adjacent bank franchises.* Most regional capital markets franchises do not fully monetize flows from their "parent" retail, wealth, and lending businesses. In particular, they tend to miss the full set of capital markets opportunities at firms to which they extend credit. Leaders should act resolutely to capture the full opportunity.

– *Identify three to five priority product/client "pockets of opportunity" on which to focus balance sheet and talent.* In a flat revenue environment (which was the norm before COVID-19), it is unrealistic for most regional capital markets firms to assume they can compete across the full range of product segments and clients. We recommend that leaders map their franchises on two axes (product, client segment) and identify areas where they have sustainable

Exhibit 4

Tactical levers can lead to significant productivity boosts for regional capital markets firms.

An illustrative example

Source: McKinsey analysis

scale (e.g., revenues greater than 10 percent of total franchise revenues, at least 3 to 5 percent market share). The exercise should create the basis for prioritization. Depending on the particular bank, examples of potential pockets of opportunity include providing leveraged lending and merger advice to lower-middle-market private equity firms, or project finance and hedging for regional municipalities. Regardless of the areas chosen, it is critical that the bank allocates sufficient talent and balance sheet to these choices.

Potential impact

As capital markets leaders consider their options, we expect many will move toward a “save to invest” approach, using shorter-term productivity improvements to fund longer-term investments. The collective impact of even tactical initiatives can be substantial. An illustrative example (Exhibit 4) shows the potential impact for a typical firm with $2 billion of revenues and an 80 percent cost-to-income ratio. A mix of shorter-term productivity levers and no-regret investments in automation of support functions can create $150 million to $250 million of incremental P&L and improve the firm's cost-to-income ratio to roughly 70 percent. We estimate that the majority of these levers can be implemented in less than a year, and deliver bottom-line impact within two years.

Firms can use the headroom created by this kind of exercise to fund structural transformation, including aggressive hiring in priority product and client segments and transformational technology investments in client portals, electronic trading, and attacker models.

Implementing change

Implementation is always complex, especially over a relatively short two- to three-year time horizon. Successful transformations usually include the following elements:

A clear story. Leaders in the capital markets team and the bank as a whole must articulate a clear vision for improving productivity. They must be prepared to make a forceful case for change and spell out the importance of the capital markets franchise, both for the bank and clients.

Management team buy in. Too often, one or two business or functional leaders don't fully buy in to the strategy, particularly when it comes to hard decisions about cost reduction and prioritization. Management teams must be fully aligned before moving ahead.

A dedicated transformation lead, potentially supported by a transformation office. The business should appoint a full-time transformation lead with a mandate to maintain execution discipline and accountability. He or she might be supported by a small transformation office, which can set targets, monitors initiatives, analyze outputs, and facilitate support, including escalating key issues to the leadership team as necessary.

The capital markets business of regional banks face a unique set of challenges. After a period in which they have profited from restructuring higher up the value chain, many now face pressure on revenues, tech-enabled competition, and shifting customer behaviors. Others face strategic headwinds that are holding them back on their growth trajectories. Any respite from recent market volatility is likely to prove only temporary. In response, these businesses require a new playbook. This can be the catalyst for a more efficient operating model, a more focused proposition, and stronger revenue growth. To be fully effective, it should be accompanied by executive enthusiasm and a shared sense of mission across the business.

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