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# Capital markets and investment banking: Time for real change and bold actions

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The industry's restructuring has failed to help it fully recover from the global financial crisis, but new operating models can bring about transformational success.

Nearly a decade after the global financial crisis, the capital markets and investment banking (CMIB) industry remains under pressure amid weak profits, high costs, and lingering strategic uncertainty. The inescapable reality is that the industry's restructuring efforts to date have failed to produce sustainable performance. A more fundamental change is required, based on the realization that for most banks, the traditional model of global capital markets and investment banking is no longer an option.

Globally, the average return on equity (ROE) for the industry in 2015 was around 10 percent, unchanged from 2014. US banks outperformed, with the biggest banks generating an average ROE double that of their European peers (10 percent versus 5 percent). The top ten global CMIB banks posted declining revenues for the third straight year (exhibit). This decline was driven by fixed income. Equities and investment banking actually experienced some revenue growth in the last three years. Many national and regional banks were notable outperformers, winning clients and taking a bigger share of industry revenues.

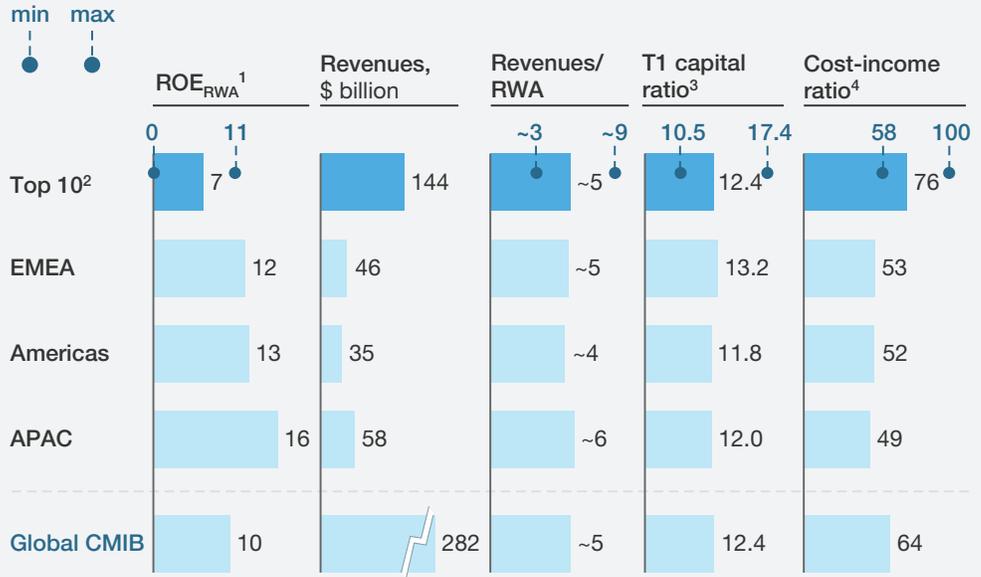
For global banks saddled with high operating costs and complexity, the macro environment is particularly challenging, with persistently low interest rates and slow economic growth undermining returns. The key fixed income, currency and commodities sector (FICC) is under particular pressure in terms of revenues, capital charges, and costs, and FICC accounted for just 46 percent of revenues for the top ten banks in 2015, compared with 61 percent in 2010. Across the industry, the FICC price-to-book ratio was about 0.6x at the end of 2015, implying value destruction of \$105 billion based on the book value of equity allocated to the business.

In the face of adversity, many banks have retrenched, scaling back some businesses and exiting others, which has led to liquidity concerns in some asset classes. Nonetheless, high costs continue to undermine performance.

## Exhibit

### ROE for top ten CMIB banks was a disappointing seven percent in 2015.

Global CMIB industry post-tax ROE<sup>1</sup> analysis, 2015E, based on nationality of banks, %



<sup>1</sup>Return on tier 1 capital (ROE<sub>RWA</sub>), assuming tax rate of 30%.

<sup>2</sup>Includes both core and non-core divisions (ie, bad banks) for Bank of America/Merrill Lynch, Barclays, BNP Paribas, Citicorp, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan, Morgan Stanley, and UBS.

<sup>3</sup>Group level ratio.

<sup>4</sup>Includes operating expenses, litigation and restructuring expenses, one-offs, as well as costs in bad banks.

McKinsey&Company | Source: Coalition data; McKinsey CMIB Revenue Pools; McKinsey analysis

New technologies remain underutilized, and many banks are struggling to make fundamental changes in their operating models and embrace the potential benefits of digitization. Moreover, CMIB clients are challenging the value added by banks today, with many reporting that they feel overserved by sales in an electronic/flow products world, and that banks are struggling to provide critical liquidity in products when it really matters.

Clients are increasingly unbundling their decision making and selecting the best provider in each product and region. Persistent and formidable headwinds continue to hinder CMIB performance, including lackluster revenue growth, relentless waves of regulation, entrenched product complexity, new competition, and increased uncertainty following the UK's vote to leave the European Union. Nonetheless, McKinsey sees some encouraging tailwinds beginning to develop.

These include a growing digital toolkit, the emergence of specialized fintech players with which the industry can collaborate, and new industry utilities that are poised to drive economies of scale. In addition, fines and litigation costs have fallen over the past year and may be set to decline further.

Based on proprietary data sources, including McKinsey's CMIB Revenue and Profit Pools, the most comprehensive data set in the industry encompassing 175 banks, and on interviews with 200 industry leaders, McKinsey sees a new market structure emerging for CMIB over the next three to five years. Four business models are likely to succeed as economic, regulatory, and technological trends play out:

- Global full-service players at scale across products and services (three to five banks)
- Focused global players with scale in chosen product bundles (eight to twelve banks)
- National and regional commercial banks with strong corporate franchises and CMIB product factories
- Non-bank competitors starting out in specific areas and then expanding into related businesses

Many banks will need to undergo transformative change to transition to a successful operating model, scaling back their aspirations for their CMIB businesses, and reducing their product set, client mix, and regional footprint, accompanied by a commensurate change in their cost structure. Hard decisions must be made, particularly with regard to costs and banks' commitment to the CMIB business. Amid increased price competition, banks must differentiate themselves based on value propositions that meet segmented client needs. Part of the solution is to make better use of data and analytics, along with financial technology and electronic execution and distribution.

There are eight key initiatives bank leaders need to implement regardless of which of the four operating models they choose to pursue:

- Defining the long-term business portfolio; for many players this means canceling the call option on revenue growth
- Optimizing the balance sheet, leveraging integrated tools to address multiple constraints simultaneously
- Developing a clear client value proposition and allocating scarce resources to clients that are willing to pay for them
- Implementing a new cost framework, fully leveraging digital technology across the organization
- Participating in industry utilities, including distributed ledgers (blockchains)
- Leveraging advanced analytics, machine learning and robotics

- Upgrading management skills and winning the war for talent
- Addressing conduct risk, risk culture and incentives

These eight areas together provide a framework for action, with implementation based on banks' individual resources and strategic purpose. The road to a sustainable future remains open for CMIB banks, but only if they make tough choices and take bold actions now. **□**

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