SURVIVAL OF THE FITTEST
The Boston Consulting Group (BCG) is a global management consulting firm and the world’s leading advisor on business strategy. We partner with clients from the private, public, and not-for-profit sectors in all regions to identify their highest-value opportunities, address their most critical challenges, and transform their enterprises. Our customized approach combines deep insight into the dynamics of companies and markets with close collaboration at all levels of the client organization. This ensures that our clients achieve sustainable competitive advantage, build more capable organizations, and secure lasting results. Founded in 1963, BCG is a private company with 78 offices in 43 countries. For more information, please visit bcg.com.

Founded in 2001, Expand Research is transforming the way the world’s financial markets make business and technology decisions by providing timely decision support and research services on business and technology strategies to leading financial institutions globally. In July 2011, Expand became an independent subsidiary of The Boston Consulting Group.
GLOBAL CAPITAL MARKETS 2013

SURVIVAL OF THE FITTEST

PHILIPPE MOREL
NICK GARDINER
ROBERT GRÜBNER
GWENHAËL LE BOULAY
JAMES MALICK
SUKAND RAMACHANDRAN
SHUBH SAUMYA
ERIOLA SHEHU
# CONTENTS

3 INTRODUCTION

5 OVERVIEW: KEY MARKET DEVELOPMENTS
   RDEs: Considerable Opportunity, but Value Creation Remains a Challenge
   Regulation: A Slippery Slope, but Banks Are Complying
   Market Electronification: Strong and Growing

16 MAKING CHOICES: THE CLIENT AND PRODUCT LENSES
   Applying the Client Lens
   Applying the Product Lens
   Implications for Operating Models

19 WINNING BUSINESS MODELS: THE BIG SIX

23 FOR FURTHER READING

24 NOTE TO THE READER
The capital markets and investment banking (CMIB) industry is in the midst of a multiyear transformation that necessitates tough strategic choices. In the fixed-income, commodities, and currencies (FICC) arena, for example, some players are pulling out of capital-intensive businesses and radically scaling back large parts of their fixed-income units. Other institutions are leaving the commodities space, providing opportunities for competitors—either existing or new—to gain share. In cash equity brokerage, some European players are either restructuring or exiting altogether. And the industry has still not recovered to its peak precrisis performance levels.

Indeed, after-tax ROE levels of 15 to 20 percent appear to be a thing of the past for most players. The industry average was in the 10 to 13 percent range at the end of 2012, and we estimate that a further 3 percentage points of negative impact from regulation has yet to be absorbed, which will push current ROE levels down to the 7 to 10 percent range.

This situation poses a fundamental question, one that is currently being debated in the market: with other financial-services sectors yielding higher ROE, is the CMIB industry likely to find enough support from impatient investors and boards of directors to survive in the long term? The answer is yes, but with caveats.

Overall, we believe that the central role of CMIB institutions in the global economy remains intact. Corporations and governments still need to raise capital for investments, investors still need to find adequate returns, and risk still needs to be assessed, intermediated, and transformed. Organizations will continue to need the strategic and financial advice that CMIB players, given their knowledge of clients and markets, are best positioned to offer. Providing such services may have become more expensive for the CMIB industry, but the structural need for these services will not abate. We also believe that some CMIB players, provided they make the necessary tough choices, can raise their ROE to a sustainable level of 12 percent, the minimum that investors will require.

Yet numerous pressures exist. Some issuers and investors, for example, are attempting to create a marketplace without intermediation. Certain less-regulated entities such as hedge funds and physical-commodity traders are venturing into the traditional CMIB space. On the resource side, the industry is experiencing cost pressures as well as capital constraints. As a result of these and other dynamics, although the market for CMIB services will remain vital, the value
that banks capture will continue to shrink. Some players may be forced to exit the industry entirely, and many more will leave certain asset classes or gradually reduce their exposure and investments in unprofitable areas. In brief, only the fittest will survive.

In this, our second annual report on the global CMIB industry, we explore key market developments and their impact on CMIB players, address the different choices that banks face today as seen through both a “client” and a “product” lens, and propose six business models that we perceive as the most advantageous. In their purest form, these models have the potential to generate ROE well above the 12 percent level that many players will struggle to achieve. But we emphasize that significantly higher ROE levels, those that are closer to the performance of other sectors of the financial services industry, will be attainable only by relatively few institutions within each of the six business models.
In 2012, revenues in the CMIB industry rose by around 2 percent—compared with declines of 13 percent in 2011 and 23 percent in 2010—with wide variation by asset class. (See Exhibit 1.) Although we expect modest revenue growth again in 2013, overall revenue levels will remain well below those of the peak precrisis years. FICC performance will be subdued, given the potential end of quantitative easing and largely full corporate coffers. Credit trading will be affected by tighter spreads and lower activity in the

### Exhibit 1 | CMIB Revenues Rose Slightly in 2012

<table>
<thead>
<tr>
<th>Year-on-year growth</th>
<th>Total revenues (% of total)</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Combined market share, top five players (share of revenues)</td>
<td>137%</td>
<td>47%</td>
<td>48%</td>
<td>47%</td>
<td>53%</td>
<td></td>
</tr>
<tr>
<td>52%</td>
<td>43%</td>
<td>45%</td>
<td>45%</td>
<td>47%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: Expand Research data; broker reports; annual reports; BCG analysis.
Note: Revenues are adjusted for writedowns, credit value adjustments, and debt value adjustments; 2008 and 2009 asset-class splits are based on broker reports. The sample consists of 28 banks.
primary market. The securitization business will continue to be hurt by regulation, notably in Europe. And the commodity market is declining owing both to regulation and to competition from vertically integrated nonbank players. Conversely, we expect equity brokerage, equity capital markets, and mergers and acquisitions (M&A) activity to pick up in line with improved stock-market performance.

On a regional basis, the Americas continued to lead CMIB revenue pools in 2012, followed by the Europe, Middle East, and Africa (EMEA) region and the Asia-Pacific region. (See Exhibit 2.) Roughly 50 percent of revenues in Asia-Pacific originated in rapidly developing economies (RDEs).

Total industry costs fell slightly in 2012, but cost-to-income ratios remained high compared with peak precrisis years. (See Exhibit 3.) We have already witnessed multiple waves of cost reductions, mostly on the head count side, which have resulted in slightly lower compensation costs as a percentage of total costs. IT costs have remained largely flat.

The picture looks more nuanced when we compare Tier 1 and Tier 2 banks. Indeed, the capability gap between the two groups continues to widen. The disparity in front-office productivity remains considerable, particularly in rates and credit (in sales) and in rates and equities (in trading). (See Exhibit 4.) IT spending was flat for Tier 1 banks in 2012, but fell 10 percent for Tier 2 institutions—whose IT budgets are roughly 40 percent of those of their larger counterparts—further widening the divergence in capabilities. (See Exhibit 5.) The need to make fundamental strategic choices appears to be more imminent for Tier 2 banks.

From a capital perspective, balance sheets have been reduced, but the proportion of risk-weighted assets (RWA) has remained fairly steady—a trend that has been noticed by the Basel Committee. (See Exhibit 6.) Conservative banks with strong balance sheets will clearly hold a competitive advantage for capital-intensive products such as financing and structured products. From a regional standpoint, U.S. banks may have an edge over European banks, which are more...
**EXHIBIT 4 | The Front-Office Productivity Gap Is Significant**

**Tier 1 institutions show distinct advantages over Tier 2 institutions**

---

**EXHIBIT 3 | CMIB Industry Costs Fell Slightly in 2012**

---

**Sources:** Annual reports; BCG analysis.

**Note:** Revenues exclude credit value adjustments and debt value adjustments but include writedowns; operating expenses exclude restructuring costs.

1Sample size = 17.

2Sample size = 10.

---

**EXHIBIT 3 | CMIB Industry Costs Fell Slightly in 2012**

---

**Sources:** Expand Research; BCG analysis.

**Note:** Revenues are for Q4 2011 and Q1–Q3 2012. The FX sample represents more than 55 percent of the market; the rates sample represents more than 70 percent of the market; the credit sample represents more than 40 percent of the market; the equity sample represents more than 60 percent of the market. Indexed to FX sales of Tier 1 institutions; equities includes both cash equities and equity derivatives.
**EXHIBIT 5 | IT Budgets Reflect the Disparity in Size Among Banks**

<table>
<thead>
<tr>
<th>Tier 1 banks</th>
<th>Tier 2 banks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Application development and support</strong></td>
<td><strong>Application development and support</strong></td>
</tr>
<tr>
<td><strong>Annual IT budget</strong>&lt;sup&gt;1&lt;/sup&gt; ( indexed)</td>
<td><strong>Annual IT budget</strong>&lt;sup&gt;1&lt;/sup&gt; ( indexed)</td>
</tr>
<tr>
<td>100</td>
<td>103</td>
</tr>
<tr>
<td>51</td>
<td>53</td>
</tr>
<tr>
<td>15</td>
<td>17</td>
</tr>
<tr>
<td>33</td>
<td>34</td>
</tr>
</tbody>
</table>

Discretionary CTB | Nondiscretionary CTB | RTB

**Sources:** Expand Research; BCG analysis.

**Note:** Indexed to 2010 IT costs of Tier 1 banks. CTB = change the bank; RTB = run the bank. Includes the following products: commodities, credit, emerging markets, equity, FX, prime, rates, and securitized products. Also includes back-office IT costs for compliance, finance, operations, risk management, and sales client research. Sample represents more than 60 percent of the market.

<sup>1</sup>IT spending includes application development and support (people, vendors, third-party software) and excludes infrastructure (application and hosting and end user technology) and overhead.

**EXHIBIT 6 | Most Banks Have Reduced Their Balance Sheets, but the Proportion of RWA Has Remained Fairly Steady**

**U.S. banks (indexed)**

<table>
<thead>
<tr>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>110</td>
<td>100</td>
<td>98</td>
<td>98</td>
<td>87</td>
</tr>
</tbody>
</table>

**European banks (indexed)**

<table>
<thead>
<tr>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>110</td>
<td>100</td>
<td>62</td>
<td>62</td>
<td>58</td>
</tr>
</tbody>
</table>

Balance sheet | RWA

**Sources:** Annual reports; BCG analysis.

**Note:** Balance sheet = investment bank total assets; RWA = investment bank RWA. Banks are allocated according to the most recent year of Basel reporting standards: U.S. banks on Basel 1 and European banks on Basel 2.5. The sample size in each graph stays constant. Basel changes according to the adoption of new Basel standards.
reliant on internal market-risk modeling and therefore likely to be under greater pressure.

We estimate the overall impact of regulation on bank ROE to be approximately 10 percentage points—more than two-thirds of which has already been reflected in current ROE levels, as many banks have anticipated regulatory demands and reached Basel III requirements before the deadline. Current ROEs, which are in the 10 to 13 percent range, will feel a further negative impact of about 3 percentage points, lowering them to the 7 to 10 percent range. This impact will differ by asset class and by bank. (See Exhibits 7 and 8.)

RDEs: Considerable Opportunity, but Value Creation Remains a Challenge

Despite their growing share of global CMIB revenues—11 percent in debt capital markets in 2012 compared with 3 percent in 2006, for example—significant value has yet to be captured in the RDEs. These markets share some common characteristics. RDE companies continue to raise equity capital to fund their growth aspirations. Retail investor bases are expanding. Governments are still issuing debt to finance their developmental and social goals. And constraints in bank lending capacity may lead to more corporate-debt issuance and accelerated development of debt markets in many RDEs.

Foreign exchange in RDEs is being boosted by the rise of local currency markets and trade growth. And there is strong demand in the commodities business, both physical and in derivatives, to support industrialization and infrastructure growth.

Still, there are hurdles to contend with. We have identified five specific challenges to value creation for global CMIB institutions trying to establish a meaningful foothold in RDEs.

Client Access. The number of corporate participants involved in capital market activities is growing rapidly in RDEs, but access to them can be difficult, particularly for global players. Many prominent companies are already well served by local and regional players, and other high-potential companies may not be rated or audited according to international standards.

EXHIBIT 7 | The Regulatory Burden Is Largely Reflected in Current ROE Levels

An additional 3 percentage points of impact is yet to come

Sources: JPMorgan; BCG analysis.

1Including systemic surcharges and specific RWA surcharges (e.g., securitization).
2On-exchange trading, post-trade transparency, and margin on OTC trades that are not cleared centrally.
3Various national restrictions on bank activities.
4Additional funding costs for trading entities from bail-in debt and resolution plans.
Client and Investor Expectations. Entrepreneurial and family ownership on both the investor and client sides is common in RDEs. Such stakeholders are not answerable to a broad shareholder base or board of directors. Thus, there is a need for customized relationships that are based on trust and reciprocity.

Government Influence. Governments in RDEs are even more complex stakeholders than are entrepreneurs or families. They are both the largest issuers and largest institutional investors in most markets, controlling state-owned banks and influencing major financing decisions.

Fragmentation. The competitive landscape is highly fragmented because numerous recent entrants have not yet captured a meaningful market share. With these players driving price competition, margins have thinned. In addition, the institutional base is also fragmented and underdeveloped, leading to a lack of both market depth and liquidity. Finally, the reliance on retail investors is disproportionate, leading to higher market volatility.

Talent Scarcity. Talent is in short supply in many parts of the CMIB value chain in RDEs. Institutions are currently trying to solve this problem with a hub-and-spoke market approach, but this method sacrifices client proximity.

More broadly, although the share of CMIB volume generated in RDEs will grow, these markets should not be perceived as an industry savior in the short to medium term. The reality is that RDEs, like all other parts of the world, suffer from CMIB overcapacity. Revenue increases, if any, will not compensate for this in the near future, so players will have to reexamine their local strategies—product by product and country by country. This process has already begun, and quite a few players have exited certain asset classes, such as cash equities.

Regulation: A Slippery Slope, but Banks Are Complying

Banks are making rapid progress with regard to new regulatory requirements, signaling the end of a fairly long period of deleveraging. Indeed, many banks are reaching Basel III–mandated capital ratios several years ahead of the deadline, and many have already achieved liquidity coverage ratios of...
100 percent or more, well above the minimum target of 60 percent by 2015. In Europe, the Liikanen proposals—urging separation of trading activities from deposit-taking activities if assets measured at fair value exceed a certain threshold—appear to be less restrictive than once feared.

However, as we have seen, compliance is being achieved at the expense of ROE. And the impact of regulation varies by asset class, with FICC more affected than equities and structured products more affected than flow products.

The impact of regulation on overall profitability is likely to be even greater as future regulatory developments create additional pressure on capital and liquidity, albeit in still uncertain measures. More specifically, capital requirements will likely be even stricter than envisioned under Basel III, as supervisors are now not only mandating such requirements but also questioning how banks themselves measure RWA for both market and credit risk. Modeling differences—variations in how banks do their calculations—can create huge discrepancies in RWA measurements on the same portfolio. Regulators will likely react by being more prescriptive with respect to modeling standards—for example, by specifying the extent of historical data to be used—and by increasingly using conservative, standardized measures as safeguards. European players will feel more pressure than U.S. players because the latter rely less on internal models for market risk (and are still operating under Basel I for credit risk).

Another major impact will come from the yet-to-be-finalized regulation of over-the-counter (OTC) derivatives under the Dodd-Frank Act in the United States as well as both the European Market Infrastructure Regulation (EMIR) and the Markets in Financial Instruments Directive (MiFID) II in the European Union. While banks have made plans to adapt to central clearing, initial margin requirements on uncleared OTC derivatives will significantly increase liquidity costs. (See the sidebar “OTC Derivatives Regulation.”) There is significant risk that the implementation and timing surrounding the new rules will not be consistent across regions, making the situation more complex, particularly for global banks.

Moreover, the European Commission’s Capital Requirements Directive IV—which mandates a ratio of bonus to base salary no greater than one to one (or two to one if a supermajority of shareholders agree)—will affect European players. In the short term, the directive will most likely require banks to raise base salaries to retain their best talent, a move that will also increase their exposure to revenue volatility. Yet such a move still may not be enough for banks to match top-level compensation in the industry. The directive may therefore help create a competitive advantage for non-European banks whose bonus levels are less restricted.

---

**Regulatory compliance is being achieved at the expense of ROE.**

---

Further, the implementation by some EU countries of a financial transaction tax could be disruptive for CMIB players in those countries because it undermines moves already made by some banks to adapt to previous regulations on capital and liquidity. The effects of the tax will be felt more acutely by low-risk, low-margin businesses with high turnover (such as listed derivatives) that were less affected by Basel III. The tax may also reduce business from institutional clients, which are also subject to it.

 Obviously, regulatory pressure—and the fact that roughly one-third of their overall impact on ROE has yet to be felt—means that banks will need to make considerable efforts to restore ROE to a level sufficient to cover their cost of equity. Notwithstanding the major initiatives already under way, banks would need to either cut costs by a further 10 percent and raise revenues by 10 percent (assuming a postregulation ROE of 7 percent), for example, or cut costs by 5 percent and raise revenues by 3 percent (assuming a postregulation ROE of 10 percent), all at a constant propor-
With banks on track to meet Basel III requirements, OTC derivatives regulation looms as an important area that banks have yet to tackle. Indeed, the main provisions of both the U.S. and EU regulatory packages will have a major impact on the profitability of derivatives businesses. Numerous issues are involved.

First, initial margins on nonstandardized, uncleared derivatives will create a major change in the economics of derivatives trading through increased liquidity costs. Estimates of initial margin requirements are as high as $1 trillion, or 0.8 percent of notional values, with strong variation by type of derivative and maturity.

Moreover, central clearing of standardized trades will create new costs for connecting to clearing houses, on-boarding clients, and managing the posting of collateral. Centralized clearing for OTC derivatives has been progressing rapidly since the 2008–2009 financial crisis and is expected to reach 70 percent of total volumes by 2014. And trading on exchange-like platforms such as swap execution facilities (SEFs) could be more disruptive as it will cause margin pressure as well as additional costs to connect to the SEFs. Trade reporting to central repositories will also raise costs.

At present, there is still uncertainty about the scope and timing of regulation, making it difficult to navigate the landscape. But the attractiveness of OTC derivatives appears likely to shift radically for some players. For instance, whereas swaps were once perceived as an item to cross-sell with financing products, some Tier 2 banks may now choose to offer only those derivatives that are required as part of a transaction (such as an interest rate swap linked to a project finance deal). Such banks will increasingly turn to white-labeling solutions to serve their clients.

For banks that choose to play an active role in OTC derivatives markets with financial institution clients, collateral management and access to liquidity (through collateral transformation and repos) will become even more critical. We also expect banks to work with client counterparties to reduce notional positions in order to cut costs. An example would be the “trade compression” practice of terminating contracts that are economically redundant (that is, those in which both parties pay and receive the same cash flows).

It is increasingly likely that the ability to clear OTC derivatives will become a key differentiator for banks. Indeed, clients are likely to select two or three OTC derivatives-clearing counterparties, then have the same banks execute and clear futures transactions as well. The second-order implications of this market-structure change should not be overlooked.

OTC DERIVATIVES REGULATION

Potential revenues in collateral management, including ancillary services, could reach $4 billion to $7 billion by 2016.

Market Electronification: Strong and Growing

As various asset classes mature and trading becomes more standardized (sometimes accelerated by regulation), the electronification of the CMIB industry is increasingly taking hold—and squeezing margins in the process.
(See Exhibit 10.) As automation progresses, the dynamic between IT and people capabilities will need to be rebalanced.

Of course, various asset classes are constantly moving through different stages of maturity. For example:

- **FX and cash equities** are the most electronified asset classes. They are reasonably transparent, with little inventory or collateral required. We therefore expect limited change here.

- **Government bonds** are currently the domain of multidealer platforms and operating in a highly competitive environment. We expect continuing maturity and increases in electronification.

- **Credit** will be slow to electronify and will likely require a strong push from either clients (for greater transparency) or regulators. But Tier 1 banks are increasing their investments in e-trading, in essence further raising fixed costs ahead of anticipated demand and hoping to capture an early-mover advantage.

- **OTC derivatives** have considerable capital requirements. However, regulation of central clearing will remove the extra workflow steps. We therefore expect rapid electronification once central clearing is established, eventually for as much as 70 percent of the volume.

Two asset classes in particular—credit and cash equities—illustrate the different choices that must be made by Tier 1 and Tier 2 banks as electronification dynamics play out.

**Credit.** In 2012, less than 20 percent of credit trades were electronic, far below the level of electronification in equities and FX—both of which are above 50 percent, with spot transactions being mainly electronic. Although we believe that credit will continue moving up the electronification maturity curve, full development will take many years, possibly decades, to achieve. The reasons are essentially twofold. First, there is high fragmentation in the corporate bond market (around 40,000 CUSIPs in the U.S. alone), and even the most comprehensive platforms today can cover only a fraction of them. Second, most asset classes have an information advantage over credit, making this market relatively opaque.

Yet there are still drivers of electronification in the credit space, such as the impact of regulation on holding inventory. Stricter capital requirements make it more expensive for a market maker to hold bonds, so agency-type solutions are increasingly attractive. Further-
more, client demands for greater transparency and self-service capabilities could drive both banks and nontraditional competitors with a limited share in credit markets to shape a new market structure going forward.

As the credit market matures, price transparency and tougher competition will constrain the total value that players can capture. Large IT investments will be required to create or maintain credit platforms, as was previously the case in equities and FX. Although the number of players in the credit space is currently high, we expect only a few to have a viable long-term business case with sufficient flow to match buy and sell orders, thus limiting inventory. Indeed, two large players have recently announced further investment in this space, joining a handful of established institutions.

With the probability of consolidation ahead, banks need to start thinking about positioning themselves in this market now. Tier 1 banks should consider whether they are willing to make the investment required to remain in this business in the long term. Tier 2 banks, given both the huge investment and the competition from Tier 1 institutions, must decide whether to continue with a limited niche position, partner with larger banks, or offer only a white label version of these products.

**Cash Equities.** Cash equity brokerage has the highest level of electronic volumes among all asset classes. Combined, cash equities and prime services already account for $200 million to $500 million of IT spending per year (per Tier 1 institution), driven by client market access, algorithmic trades, and mid-to-high-frequency trading. It is a highly competitive arena in which margins are decreasing—and the path to attractive returns is unclear.

Tier 2 players in this asset class face largely the same choice as in credit: partnering with bigger banks or developing white-label solutions. For Tier 1 banks, the choice is more difficult in cash equities because, unlike in credit, a huge IT investment has already been

---

**EXHIBIT 10: Electronification Is Squeezing Margins as Asset Classes Move Up the Maturity Curve**

<table>
<thead>
<tr>
<th>Development</th>
<th>Introduction</th>
<th>Growth</th>
<th>Maturity</th>
<th>Decline</th>
<th>Reconfiguration</th>
</tr>
</thead>
<tbody>
<tr>
<td>NA</td>
<td>Lower</td>
<td>Higher</td>
<td>Lower</td>
<td>Lower</td>
<td>Higher</td>
</tr>
</tbody>
</table>

**Illustrative**

- **U.S. cash equities are about 90% electronic**
- **Corporate bonds**
- **Credit default swaps**
- **Client-driven U.S. government bonds**
- **Interdealer markets are mainly electronic: ~90% for Tier 1 and ~50% for Tier 2**
- **~60% FX spot**
- **~75% Cash equities**

**Sources:** Expand Research; press clippings; broker reports; BCG analysis.

**Note:** NA = not applicable.
made. Some Tier 1 banks are considering pulling out of the market. After consolidation, however, the remaining players will absorb volume from exited institutions, form partnerships, and offer products for white labeling.

More broadly, IT front-office budgets as a proportion of revenues vary widely by asset class, and players will focus their largest IT investments in areas where they can deliver competitive advantage. For example, there is a wide discrepancy in spending on e-commerce as a proportion of IT front-office budgets. (See Exhibit 11.) There is also the potential for increased use of scalable infrastructure—an opportunity for Tier 1 players—which allows absorption of greater market share and volumes at low marginal cost.

Electronification will also drive changes in sales force capabilities and skill sets, and potentially in compensation structures as well. We will see greater emphasis on selling the IT platform (and internal support of the IT platform) and less on the direct, voice-based sales relationship. We have already seen some institutions create e-sales units, although spending on e-commerce as a percentage of front-office IT budgets varies considerably among players. As a consequence, players will have to revamp their “voice” sales forces to focus more on value-added activities.

Overall, it is clear that the electronification trend will continue to gain momentum. It will force institutions to either make the required investment or fall behind, and will contribute to increasing fixed costs in the industry. The field in highly electronified products will gradually consolidate to three to five players for each product—particularly in FX, vanilla rates, and cash equities. The winners will be those players that can afford the required IT spending, are smart and innovative in how they invest, and can attract large volumes to cover their fixed costs. Banks that occupy a Tier 2 position from an asset class standpoint will need to decide whether they want to tackle this challenge or move out and offer white-labeled products only.

Finally, while electronification levels the playing field, commoditizes product classes, and increases transparency—thus squeezing margins—it also creates opportunities. Data-mining information specialists and aggregators could emerge and compete against the more traditional transactional players.

EXHIBIT 11 | E-Commerce Spending as a Proportion of IT Front-Office Budgets Varies Widely

<table>
<thead>
<tr>
<th>Tier 1</th>
<th>Equities¹</th>
<th>FX</th>
<th>Rates</th>
<th>Credit</th>
<th>Commodities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>100</td>
<td>31</td>
<td>21</td>
<td>9</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>E-commerce spending as a share of front-office IT spending</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

E-commerce spending (indexed to Tier 1 equities¹), 2012

Sources: Expand Research; BCG analysis.
Note: Sample represents more than 60 percent of the market.
¹Includes both cash equities and equity derivatives.
MAKING CHOICES
THE CLIENT AND PRODUCT LENSES

To position themselves optimally for the future, CMIB players will have to make tough choices. These decisions are no longer optional—they are critical for survival. We apply two different perspectives—the client lens and the product lens—to highlight the most important aspects of these choices.

Applying the Client Lens
Client centricity has become a key lever that CMIB players can use to unlock value. Institutions must first identify the highest-priority clients and then determine the type of value that these clients expect from the bank—thereby defining the capabilities that the bank itself needs to develop.

For instance, large financial institutions and large multinational corporations tend to especially value trade execution, customized structuring, market knowledge, and innovation. The majority of these clients act as counterparts to the bank, a dynamic that fosters reciprocal relationships. Such clients also are key providers of volume and are thus crucial to the formation of liquidity pools.

Smaller clients—such as small to midsize financial institutions and corporations—have different characteristics. They particularly value deep and long-term relationships, the convenience of a one-stop shop, access to financing and investors, and highly tailored advice. The portfolio of CMIB products, particularly on the corporate side, is typically focused on financing, FX, interest rate hedges, equity capital markets, debt capital markets, and M&A—backed by strong credit-distribution capabilities. Additional capital-markets activities can serve to cement these relationships.

Given the trends described above, applying a client lens highlights key choices, examples of which include the following:

- Which types of value should the bank provide to its clients?
- What is the minimum product range that the bank needs to offer?
- What is the right people and skill-set mix?
- What is the optimal amount and focus of IT investment?

The players that make such choices decisively, and that follow up with an operating model that is fully aligned with their chosen strategy and product portfolio, will be best positioned.

Applying the Product Lens
Applying a product lens also highlights important choices, particularly in the current
environment in which many players are polarized with respect to all three principal resources: IT, people, and capital. Indeed, there is both an IT investment gap and a productivity gap between Tier 1 and Tier 2 institutions in most product areas. As for capital, some banks have emerged with much stronger balance sheets than others. This polarization creates natural competitive advantages in certain products for certain players (such as in electronified products for those with strong IT capabilities), and therefore creates pressure for other players to exit.

Making Portfolio Choices. CMIB players must decide which asset classes—and which products within those asset classes—give them the opportunity to be a top-three player. They must also face the fact that exiting products has long-term implications. Indeed, returning to any product in a meaningful way, once it has been abandoned, will typically take at least five years. It is also important to acknowledge that adding multiple products—which involves specialized market expertise, risk models, management skills, trader tools, front- and back-office processes, and the like—creates complexity and increases costs.

We recommend a two-step approach to making portfolio choices. First, banks need to perform a five-angle screening: economic, by assessing the level of return on equity and liquidity; operational, by understanding the front-to-back complexity behind each product; strategic, by identifying cross-product dynamics and key client needs; size, by analyzing share relative to the market leaders (in revenues as well as in IT and staff costs); and future outlook, by evaluating growth, cyclical-ity, and regulation.

Second, banks need to classify products or desks into three categories: fully fledged, presence, and exit. Fully fledged activities are those in which the institution has significant size relative to its competitors and can create true competitive advantage. Most human resources and IT investments should be focused on this category. Presence activities are those in which the product is a must for core clients (and for cross-selling) but for which differentiation opportunities are minimal and critical size cannot be reached. Front-to-back setups should be extremely lean in this category, and sourcing from other entities through white-labeling agreements should be considered. Exit activities are those that should be struck from the portfolio, as a number of institutions have already done for commodity derivatives, for example.

Implications for Operating Models

Strategic and portfolio choices have strong implications for banks’ operating models. Of course, banks have already been through waves of restructuring. In the front office, they are realigning their business units to be more client-oriented, and pressures on compensation have led to a more systematic focus on performance evaluation. In the back office, banks are optimizing support-function costs through both delayering and consolidating infrastructure into shared services across asset classes (or across business units outside CMIB). Many institutions have reduced their consumption of market data tools and have optimized brokerage and clearing fees.

CMIB structures designed for booming markets are still suffering from overcapacity.

However, as we have seen, industry cost levels remain high and banks are under ongoing pressure to reduce them. CMIB infrastructures that have been designed in (and for) booming markets are still suffering from overcapacity. Further, banks require additional investment to implement new industry standards. Incremental cost optimization does not appear to fully address the many cost challenges, and we therefore believe that structural change in operating models will be necessary. Outsourcing certain elements of operations or pooling activities with high returns to scale are important levers to consider.

Clearly, we have already seen outsourcing activity in multiple parts of the CMIB ecosys-
tem. Most of it has been focused on full infrastructure services in such areas as customer insight, after-trade technology, middle- and back-office activities, and elements of IT application management. We have also witnessed emerging areas of discussion in market data services, regulatory and compliance reporting, and IT infrastructure sharing. The landscape is constantly evolving.

One key question is which additional activities should be pooled rather than controlled in-house. For high-volume, IT-intensive core products—for which a competitive edge is achieved through crisp execution on both the front and back ends—it is important to retain control of critical elements of the value chain. In higher-margin products, banks can better afford to outsource back-office operations, sacrificing some degree of control and efficiency.

A second key question involves how this process will be carried out by various players in the CMIB ecosystem. For some core products, Tier 1 banks may well decide to keep most elements of the value chain in-house. Still, they will need to increase volumes to cover their large fixed-cost bases. They can do this by, among other things, absorbing volume from Tier 2 banks that decide to exit certain asset classes and turn to white labeling.

At the same time, business process outsourcers (BPOs) such as software vendors and data service providers are willing to invest heavily in the outsourcing of CMIB operations, and are moving fast in this space. They seek to capture new revenue sources through standardization, automation, and consolidation. The largest Tier 1 banks, familiar with the scenario of external vendors breaking into the market, may try to prevent their entry and keep the value themselves. Hence, BPOs will need to demonstrate strong efficiency gains to their clients in order to gain traction.

Existing utility providers, for their part, are uniquely positioned to enlarge their scope in the CMIB landscape. They know how to manage complexity and establish strong governance, and can define common standards and rules effectively. But utilities will have to act fast if they hope to capture value before BPOs have entrenched their positions.
MAKING CAREFUL CHOICES WILL enable some players to achieve a sustainable ROE of 12 percent after the full negative impact of regulation has been felt. However, substantially higher returns are still possible for the very top performers.

Indeed, as CMIB institutions make their strategic choices and the industry rebalances, we believe that six winning business models will emerge: powerhouses, haute couture institutions, relationship experts, advisory specialists, hedge funds, and utility providers. (See Exhibit 12.) Some players have already aligned themselves solidly with one of these models, while others are still finding their way.

Broadly speaking, we believe that the best way to define CMIB business models is
along two key dimensions: value proposition and scale. The value proposition dimension consists of four fundamental sources of value:

• Trading margins, or the gap between bid and offer, which ranges from real-time bid-offer margins (created purely by intermediating markets) to alpha-seeking margins (created by keeping open positions for market-making and proprietary trading)

• Trading fees, which reflect two sources of value: structuring and client relationships (including the pricing of credit risk)

• Advisory fees, such as in M&A

• Services provided to CMIB players, typically regarding IT, operations, or research

The second dimension, scale, is also essential because some business models require a large scale in order to justify the investment in IT and human resources—which sharply distinguishes them from small-to-midscale models.

The top two or three powerhouses can achieve ROEs of 15 to 16 percent.

We believe that the six most advantageous business models have the right elements not only to survive but also to generate ROE comparable to that in other financial-services sectors. But we emphasize that the ROE estimates presented below are based on “pure” business models and can potentially be achieved only by relatively few players within each model. Further, we expect only a small number of institutions in each category to remain strong, with many businesses that fall outside these models exiting the industry. Obviously, it will take decisive action, senior management commitment, and team execution to emerge as a winner and achieve ambitious targets.

The first four models are to a considerable extent the result of heavy electronification in certain products, which involves high startup expenditures and ongoing IT costs—and necessitates high-volume businesses. We expect powerhouses to emerge as the winners in this space. We further expect some industry revenue currently dominated by these types of players to be transferred to the last two models, which are in many aspects the offspring of regulation on the front and back ends, respectively.

Powerhouses. These institutions will be the largest capital-market players, with dominant share in one or more asset classes. They are generally active in flow products but may also be active in structured products. Their main value proposition is in leveraging their liquidity pools to generate volume—and in offering front-to-back execution excellence in which they retain control of the entire value chain.

With flow products, the key is to achieve sufficient volume to reach scale, gain market depth, and be profitable in a low-margin, high-fixed-cost business. These institutions, which use their flows to create value in structured products, have made (and will continue to make) significant IT infrastructure investments to ensure best-in-class operations. Their core products will need to be sharply defined and alternatives will have to be found for noncore products. We believe that the top two or three powerhouses can achieve ROEs of 15 to 16 percent.

Haute Couture Institutions. These players will focus on creating sophisticated products for hedge funds, private banks, and sovereign wealth funds. If permitted by local regulation, they can leverage this capability to generate alpha within the bank. Theirs is a high-margin business that places less focus on lean back-office operations than do powerhouses.

In addition to best-in-class products with high margins, these players need specialized structurers, quants, and traders who know how to formulate and work with complex offerings. Banks with high-quality balance sheets will obviously have an advantage in the haute couture space, but these institutions must
also have a strong ability to manage counterparty and market risk. We believe that the top two or three haute couture players can achieve ROEs of 16 to 18 percent.

**Relationship Experts.** These institutions will leverage proximity and customized knowledge to build deep, long-term ties with clients—usually corporate and small to midsize financial institutions. With empirical evidence showing a strong correlation between client satisfaction and share of wallet, successful relationship experts will be the ultimate client-centric organizations. They will possess a deep understanding of client characteristics (client insight) and offer tailored value propositions (client service) that are aligned with each client’s specific value to the bank. Needless to say, a robust understanding of client profitability is critical. Acting as one-stop shops, these players are able to source all products that their clients need. They use high-quality balance sheets as a competitive edge—because financing is often the key to opening a client relationship—and they typically use capital-market offerings to cement relationships rather than to drive them. Relationship experts also benefit from cross-selling, greater integration with their corporate banks, and bringing CMIB product expertise to midmarket clients. Further, they can increase sales productivity by leveraging corporate-banking relationship managers.

Relationship experts face their own “make or buy” decisions—first in determining the products that their clients want most, then in choosing the operating and sourcing models that can deliver those products. Their investment capacity in proprietary CMIB IT platforms is limited, and alternatives such as multidealer platforms and white labeling should be used. We believe that a relatively small number of relationship experts can achieve ROEs of 13 to 14 percent.

**Advisory Specialists.** These players will provide premium advice to their clients’ top management, particularly in M&A and capital structuring. Such activities can operate as independent businesses within an investment or universal bank and can be sustainable at different scales because the market is fragmented and relationship-driven.

Advisory specialists need deep product and sector expertise (especially in M&A) as well as relationship depth. With a variable revenue structure, their cost structure is also highly variable—driven by talent as opposed to technology—and has a low salary component and a larger bonus component as a percentage of total compensation. We believe that a handful of advisory specialists can achieve ROEs in excess of 30 percent. This unusually high potential is largely owing to the fact that, from a regulatory viewpoint, capital requirements for advisory specialists are minimal.

**Hedge Funds.** The focus here will continue to be on creating superior alpha, particularly over long time horizons. Hedge funds will also continue to benefit from significantly less-stringent regulations than banks are subject to, and will use their financial leverage to target higher returns. The increasing role of hedge funds is the result of new regulation, which has forced proprietary trading activities into shadow banking. Yet hedge funds have an essential role in creating superior returns (when they succeed in doing so). They will also continue to be key clients for the banks that serve them.

Hedge funds especially need scale to develop market depth—and adequate capital to absorb market and credit risk. They must possess sufficient agility in the back office and in IT infrastructure to take on new products and asset classes within short time frames. They must have top traders who are capable of beating the market (at least some of the time) and who are compensated on the basis of both trades and return on RWA. Operational excellence, standardized internal proc-
esses, and seamless integration throughout the front, middle, and back offices are also crucial. We believe that the top hedge funds can achieve ROEs of 20 to 25 percent.

**Utility Providers.** The final winning business model involves insourcing from investment banks and providing them with IT, operational, and (potentially) accounting solutions. Being outside the core CMIB businesses, these players build scale to reduce costs by consolidating volumes across investment banks and by developing a model that is more industrialized than that of banks.

Utility providers must drive and own industry standards. They must also have sufficient investment capacity to build platforms—which need to be configurable to the varying needs of both Tier 1 and Tier 2 banks. End-to-end operational excellence, including IT, is required to manage business continuity risks and to sustain healthy margins. A best-in-class utility provider has strong relationships with banks that allow it to acquire and sustain volumes. A key question will be whether banks let these value-added services escape to third-party providers or are able to partner and keep the services within the industry. We believe that the top utility providers can achieve ROEs of 15 to 17 percent.

That said, within the limits of the paths that each player can reasonably pursue, there are still tough decisions to make. The industry will reconfigure itself in the near to medium term, pushing out the weaker banks and forcing others to exit certain business lines. The survivors will be those that make the right choice of core business model, undergo a rigorous portfolio review, and revamp their operating models to reduce costs and increase efficiency. Also, some degree of repricing will be necessary, because the additional cost of doing business imposed by regulators must be passed on to clients. Finally, banks will be reviewing the social and cultural aspects of their businesses and taking steps to enhance their public profiles.

Ultimately, making the right choices in a number of areas will enable some players to achieve ROEs of 12 percent after the full negative impact of regulation has been felt. For the very top institutions in each of the six business models described in this report, far higher returns are possible. Naturally, the road will not always be smooth. But those players that act now will be far better positioned than those that fail even to attempt the journey.

**Note**
1. Because of market evolution, these models differ slightly from those described in our previous report, *Tough Decisions and New Directions: Global Capital Markets 2012* (April 2012).
FOR FURTHER READING

The Boston Consulting Group has published other reports and articles that may be of interest to senior financial executives. Recent examples include those listed here:

**Distribution 2020: The Next Big Journey for Retail Banks**
A Focus by The Boston Consulting Group, March 2013

**Committing to Customers in the “New New Normal”: Operational Excellence in Retail Banking**
A Focus by The Boston Consulting Group, February 2013

**The New Challenge for Hedge Funds: Operational Excellence**
An article by The Boston Consulting Group, January 2013

**An Inflection Point in Global Banking: Risk Report 2012–2013**
A report by The Boston Consulting Group, December 2012

**Capturing Growth in Adverse Times: Global Asset Management 2012**
A report by The Boston Consulting Group, September 2012

**The Battle to Regain Strength: Global Wealth 2012**
A report by The Boston Consulting Group, May 2012

**Tough Decisions and New Directions: Global Capital Markets 2012**
A report by The Boston Consulting Group, April 2012
**NOTE TO THE READER**

**About the Authors**
Philippe Morel is a senior partner and managing director, Sukand Ramachandran a partner and managing director, and Eriola Shehu a project leader in the London office of The Boston Consulting Group. Nick Gardiner is a partner and managing director in the firm’s Hong Kong office. Robert Grübner is a partner and managing director in BCG’s Hamburg office. Gwenhaël Le Boulay is a partner and managing director in the firm’s Paris office. James Malick and Shubh Saumya are partners and managing directors in BCG’s New York office.

**Acknowledgments**
Within The Boston Consulting Group, for their valuable contributions to the conception and development of this report, our special thanks go to the core team of Francien Akkerman, Mandeep Soor, Valeria Bertali, and Vincent Grateloup. In addition, the following BCG colleagues provided valuable insights and assistance: Colleen Lally, Chandy Chandrashekhara, Tjun Tang, and Gregory Petros.

We would also like to thank the following members of Expand Research: Michael Aldridge, Rupert Bull, John Doonan, Raza Hussain, Damian McCarthy, and Franck Vialaron.

Finally, grateful thanks go to Philip Crawford for his editorial direction, as well as to other members of the editorial and production team, including Katherine Andrews, Gary Callahan, Kim Friedman, and Janice Willett.

**For Further Contact**
If you would like to discuss with The Boston Consulting Group the challenges and opportunities facing your company, please contact one of the authors of this report.

Philippe Morel
BCG London
+44 020 7753 5353
morel.philippe@bcg.com

Nick Gardiner
BCG Hong Kong
+852 2506 2111
gardiner.nick@bcg.com

Robert Grübner
BCG Hamburg
+49 40 30 99 60
gruebner.robert@bcg.com

Gwenhaël Le Boulay
BCG Paris
+33 1 40 17 10 10
leboulay.gwenhael@bcg.com

James Malick
BCG New York
+1 212 446 2800
malick.james@bcg.com

Sukand Ramachandran
BCG London
+44 020 7753 5353
ramachandran.sukand@bcg.com

Shubh Saumya
BCG New York
+1 212 446 2800
saumya.shubh@bcg.com

Eriola Shehu
BCG London
+44 020 7753 5353
shehu.eriola@bcg.com