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Turning around investment banking

An agenda for reviving profitable and sustainable growth

pwc

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Executive summary

Investment banks have faced a series of challenges over the last several years. The new regulations that followed the financial crisis have changed the industry in a number of ways, making it difficult to profit from many traditional lines of business by creating onerous capital, funding, and liquidity requirements and increased costs and operational complexity. Although investor confidence and deal flow have recovered somewhat, the trading environment for previously very profitable business lines in fixed income, currencies, and commodities has remained challenging.

At the same time, advances in technology have upended client interaction models, execution platforms, and operational processes. Competitors and new entrants have seized ground across the banking industry's value chain. Innovative technology applications have reduced the barriers to entry for challengers, resulting in a real competitive threat. Although in principle established banks can retaliate, their existing technology platforms, outdated and inflexible as they are, can hamper the timely incorporation of new technologies.

These external forces notwithstanding, we believe that investment banks can regain profitability and competitiveness, but to get there they need to transform their business and operational strategies from within. Though nearly all investment banks have taken steps to revamp their business portfolios, build on their core strengths, and streamline operations, many of these efforts have been incremental. Few banks have undertaken genuinely transformational changes in the most important areas. We have identified five specific fronts that we believe will be the source of a winning strategy for most investment banks in the years ahead. Failure to enact an internal transformation, on the other hand, will lead to unsustainable business models and balance sheets.

The state of the industry

In the post-crisis environment, global banks — investment banking divisions, in particular — have struggled to make ends meet. In our most recent annual study of bank performance, we estimated that in 2014 the 29 global systemically important banks (G-SIBs) collectively missed their cost of equity thresholds by about 3 percent, thereby incurring an aggregate economic loss of about US$90 billion. (See "Appendix: Key findings from a review of banking industry performance in 2014," page 23.)

At the segment level, their investment banking businesses suffered the biggest profit slumps, with a weighted average economic spread (return on equity minus cost of equity) of –6.2 percent. In dollar terms (economic spread times equity), these businesses were the second-biggest economic loss makers, accounting for $27 billion of the total G-SIB economic loss. (Retail banking was the biggest dollar loss maker because of its scale.)

Banks are starting to look at more fundamental transformations.

For this reason, through announcements of strategy, organizational, and leadership changes — most recently by the likes of Deutsche Bank, Credit Suisse, and Barclays, preceded by an earlier move at UBS — one question has framed the discussion for all global banks, at least in the minds of their audiences: What is their strategy for the investment bank?

The answers from the banks are starting to go beyond the post-crisis patter of risk-weighted assets and cost reduction. For the past seven years, nearly all banking organizations have continued to take steps to de-risk, de-lever, refocus, simplify, and drive out cost. But now they are also starting to look at more fundamental transformations.

Some have chosen to pare their investment banking businesses back to the bare minimum needed to service the private, corporate, and institutional clients on which their core franchises depend.

Others — including those for whom investment banking essentially *is* their core franchise — see more of a future for investment banking in its own right. These banks are concentrating on the product, service, operational, customer, and regional niches where they believe they can win in the medium to longer term.

Those still committed to a universal banking model that offers a full range of products and services are looking to offer something that their more specialized peers cannot: a combination of best-in-class advice, global multi-asset execution capability, and aggressive pricing, all underpinned by technology and scale efficiency.

The regulatory demand for higher levels of capital continues to be both a focal point and a general concern of the sector, and is a particular handicap for certain investment banking product and service categories. However, there is an emerging dichotomy between, on one hand, the continued focus on capital efficiency and, on the other, a willingness to deliver strategies based on an unquestionably strong balance sheet. As Tidjane Thiam, CEO of Credit Suisse, has put it, "The penalty for having too much capital today is limited; the penalty for having too little [capital] in the banking sector is very material."[1]

In light of this, the capital efficiency agenda is less about maximizing return on equity through leverage — that game is up — and more about creating the balance sheet capacity, in combination with fresh capital issuance when necessary, to grow in areas where sustained economic profits can be made.

Though the best strategy for growth will, of course, differ from one bank to another, all investment banks are going to need to restructure and reposition their business if they are to achieve sustainable growth and profitability in the current environment. In the following pages we discuss the five key areas of transformational change that we believe are critical to all investment banks:

- Building strategic coherence
- Progressing from technical to strategic optimization
- Rethinking client profitability
- Accelerating operational efficiency and organizational change
- Focusing on change execution

Building strategic coherence

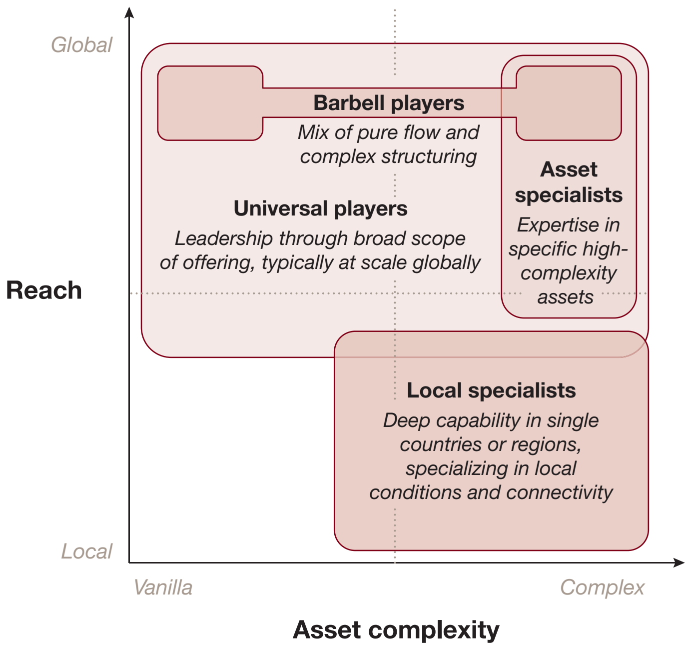
Many investment banks have pursued a variety of businesses that have different characteristics, require different capabilities systems, and do not work well together. Although a universal model may make sense for a few banks, most need to focus on a smaller, select group of businesses in which they can outperform. The businesses should have similar capability needs so that in combination they make up a coherent, winning strategy.

Winning companies achieve success through strategic coherence — the alignment of products, services, and capabilities with one clear way to play.[2] Strategic coherence requires a clear, logical articulation of how a company can create value better than its competitors and a willingness to divest businesses and capabilities that are not aligned. In the immediate aftermath of the crisis, and for many banks still, the industry has allowed strategic decisions to be dictated by regulatory considerations and notions of capital efficiency. As a result, many now find themselves with a set of businesses that don't function compatibly or support a coherent strategy. Looking ahead, banks need to focus on what they do best and choose a way to play built around strategic coherence and economic profit.

To illustrate this point, we outline four contemporary classic ways to play — in line with Strategy&'s methodology for capabilities-driven strategy[3] — and the archetypal capabilities systems that correspond with those ways to play (*see Exhibit 1, next page*).

- **Barbell players:** Investment banks pursuing a dual business model. They leverage their cost leadership position in flow businesses through high straight-through processing scale, as well as universal connectivity and efficiency. They are market makers in particular asset classes with capabilities to leverage their balance sheet and product inventory. At the same time, they have deep expertise in structuring specific solutions from a full range of underlying asset classes, focusing on higher-margin activity.

Exhibit 1
Ways to play in investment banking



Barbell players

- Combination business playing at each end of the asset complexity scale.
- At the low end, cost leadership through high straight-through processing (STP) scale, universal connectivity, and efficiency
- At the top end, building on low-end flow engine to deliver complex structuring with deep expertise in specific higher-margin solutions

Asset specialists

- Deep expertise in specific complex products, nonstandard exchanges/platforms
- Engage in higher-margin activity for returns
- May be market maker in chosen asset classes

Universal players

- Global reach and extensive asset and solution suite
- Require in-house scale for cost leadership on flow
- However, also need ability to attract talent to provide specialist solutions

Local specialists

- Deep capability in individual markets or regions
- Strong local knowledge, networks, and connectivity
- Expertise in the range of assets from chosen markets
- For flow products, cost leadership through efficient exchange-to-exchange operations and technology at scale; universal connectivity

Source: Strategy& analysis

- **Asset specialists:** Banks with deep expertise in specific complex products and nonstandard exchanges and platforms that engage in higher-margin activity for higher returns. They may be market makers in chosen asset classes.

- **Universal players:** Organizations with global reach and extensive asset classes and solution suites. Their business model requires in-house scale for cost leadership on flow. However, they also need the ability to attract talent to provide specialist services.

- **Local specialists:** Banks with deep capabilities in individual markets or regions, and strong local knowledge, networks, and connectivity. They are experts in the range of assets in their chosen markets.

To successfully implement its way to play, the investment bank must develop a distinctive capabilities system (the combination of people, knowledge, tools, and processes that enables it to outperform competitors in its chosen businesses). *Exhibit 2* (*next page*) outlines the archetypal capabilities systems required for each way to play.

These ways to play, of course, are neither definitive nor exhaustive. Banks might design their own variations or new roles entirely. The point is that clarity on the way to play is a crucial element when it comes to building a winning strategy.

Clarity on the way to play is a crucial element when it comes to building a winning strategy.

After banks have defined their roles as industry players, and formulated the capabilities systems they need to perform their roles, they need to transform themselves accordingly. There is an intrinsic iteration involved here: Whereas the term "capabilities-driven strategy" implies that your existing capabilities should dictate your strategy more than the other way around, the market, technology, and regulatory disturbances that have played out since the crisis mean that quite radical reinvention is needed on both fronts. Once that picture is clear, a disciplined execution of the strategy is likely to require a number of decisions. The bank will need to separate strategic from nonstrategic businesses, operations, technologies, people, partnerships, suppliers, and customers, and then either divest, close, outsource, or reassign the nonstrategic components and reengineer the strategic ones — all as quickly as possible. Meanwhile, new capabilities may need to be developed or acquired and integrated into the capabilities system in line with the defined way to play.[4]

The regulatory and financial constraints of the business model must also be optimized, aligning the organizational structure while minimizing regulatory complexity and mitigating its impact. Balance sheet requirements such as capital, liquidity, and funding must be optimized in line with analyses of economic profit for each business.

Exhibit 2
Required capabilities systems in investment banking

Way to play	Capabilities system				
	Clients, markets, and products	*Pre-trade*	*Trading*	*Product and trade control*	*Post-trade*
Barbell players	Mix of exchange-traded STP products and complex structured solutions leveraging flow products	High-touch relationship capabilities Strong understanding of complex offerings Full STP for flow	Specialist skills in structuring and client contact	Minimize head count as proportion of flow product increases	Balance insourcing and outsourcing Leverage scale to drive cost leadership
Asset specialists	Selected range of complex/ exotic assets	Market-leading research in chosen areas High-touch relationship model	Specialist skills (traders, quants, etc.) Specialist trading platforms and connectivity	Higher head count to manage non-flow products	Externalize where possible, maximizing use of external platforms, utilities, etc.
Universal players	Full range of assets and structured products, global reach	Full mix of skills required for all areas, requiring balanced investment across all functions, as well as supporting technology and operations			
Local specialists	Moderate or high complexity assets in selected markets or regions	Strong local networks and knowledge, with potential for higher cost in less developed markets	Build local capabilities across chosen mix of asset classes and country maturity	Maintain breadth of capability to support asset mix	Externalize where possible, maximizing use of external platforms, utilities, etc.

High investment priority
Medium investment priority
Low investment priority

Source: Strategy& analysis

Progressing from technical to strategic optimization

Banks need to invest significantly in the strategic optimization of their business portfolios. Doing so requires identifying the most effective ways to boost performance in each line of business and across the group, taking account of all performance factors including franchise and operational synergies as well as financial and other costs and constraints, while retaining or, ideally, enhancing the coherence of their business models.

Current optimization approaches often miss the mark by focusing on scaling back or divesting businesses and assets that are relatively capital-intensive in favor of those that are more capital-efficient, without fully considering what this does to the coherence of the business. Instability and multiplicity of overlapping rules covering risk, leverage, liquidity, and funding can also complicate the process. The rules often vary from one jurisdiction to another and can be highly sensitive to booking models, legal entity structures, and the status of internal model approvals — not to mention the fact that the rules themselves can be subject to change.

These challenges are often unavoidable, especially because the lead time it actually takes to recover losses and raise or generate new capital, restructure funding and liquidity positions, and adapt to other aspects of the "too-big-to-fail" reforms, all while keeping investors and other stakeholders on board, can be longer than allowed by regulators. And whatever the long-term strategy, there is clearly merit in making the portfolio as efficient in its use of capital and other resources as possible, not least to provide the flexibility to invest and grow where opportunities arise.

Strategy& research has found that the cost of equity attributable to global banking business segments (spanning retail banking, corporate banking, private banking, asset management, and investment banking) varies on average from 8.5 percent to over 12.5 percent, partly, ironically, due to differences in regulatory capital intensity. Other things being equal, greater capital intensity means less leverage and less risk to equity holders, and hence a lower cost of equity. The same is true of business lines within these segments.

Any optimization of a portfolio of businesses should begin with an assessment of their economic profitability, represented by the spread between their prospective return on capital and their cost of capital (their "economic spread"), where the latter is calibrated to the risk profile and capital structure of each business rather than by applying a group average. In this case, the optimization goal should be to maximize the portfolio's economic spread rather than its headline return on capital.

Moreover, banking businesses compete in markets and have complex franchise and operational interconnections that, ideally, fit together as a coherent whole. Portfolios of banking businesses are complex and costly to change, so any change needs careful consideration. Tampering with portfolios for the wrong reasons or in the wrong way can do more harm than good in the long run.[5]

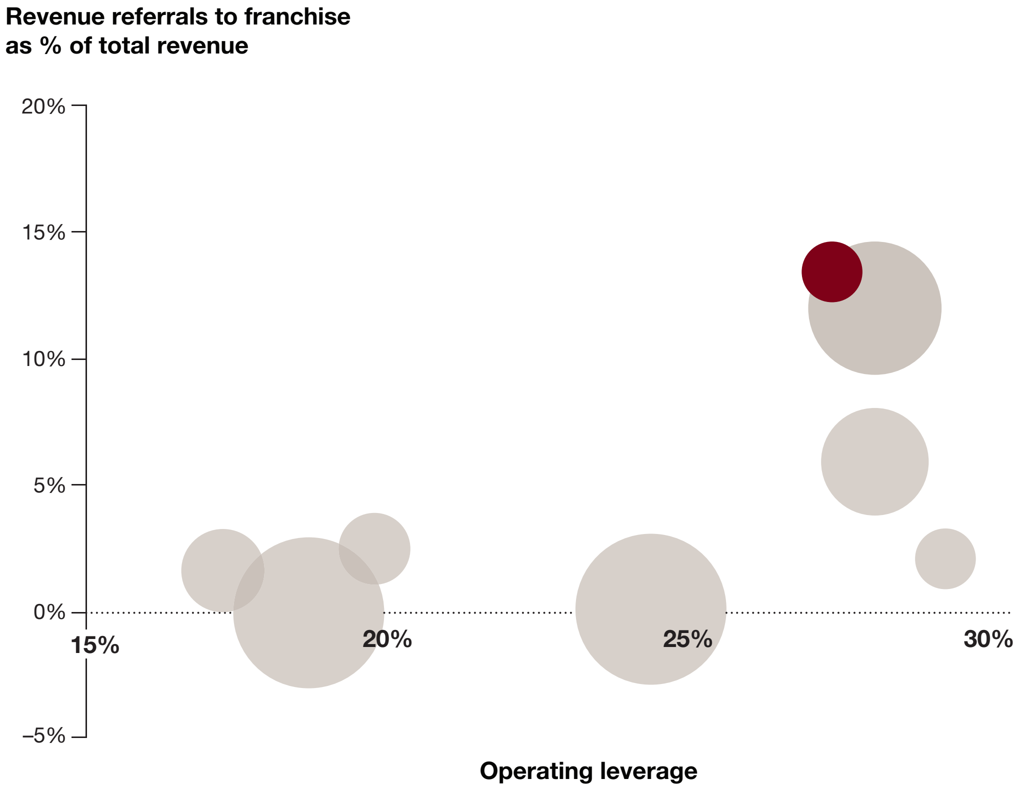
The analysis must therefore include the economic value of franchise connections such as revenue referrals, shared customers and cost platforms, scale efficiencies, brand considerations, and, ultimately, the ability to compete and grow in key markets. In *Exhibit 3 (next page)*, we illustrate how the extent of franchise connections on both cost and revenue axes can be evaluated against underlying economic profitability of business lines to indicate both their attractiveness and "stickiness" within the portfolio.

To the extent that optimization is driven by regulation, and to the extent that regulation applies universally, there is a tendency for banks to all lean the same way, with obvious implications for market stability, client servicing, competition, and profit margins. There are clear commercial risks and opportunities in this situation, and the optimization approach should therefore balance the artificiality of many aspects of regulation against economic fundamentals and the commercial realities of the marketplace.

Ultimately, the truth remains that many investment banking businesses are simply not delivering value, and despite almost a decade of restructuring, the signs of improvement are scant. Just as we reason that new regulatory capital, funding, and liquidity requirements are not entirely to blame, it is also not reasonable to suppose that optimizing the usage of these requirements offers much of a way out. Instead, we offer a broader diagnosis and a broader — though tougher — remedy. In the long run, the constraining factor is not so much about capital, because capital will always find its way to value-accretive opportunities. Rather, the constraining factors are the macro trends that are disrupting the opportunity set itself (low interest rates, low economic growth, technology, and — yes — regulation); an increasingly sophisticated and discerning customer base; and a marketplace that is more volatile and sharply contested than ever. This being the case,

The optimization goal should be to maximize the portfolio's economic spread rather than its headline return on capital.

Exhibit 3
Franchise connections vs. economic profit *(illustrative)*



Note: The size of bubbles represents economic profit of individual business lines (maroon for businesses showing an economic loss). The position on the chart indicates the materiality of franchise connections. Businesses with high franchise connections (e.g., those at top right) should benefit from scale and would be difficult to restructure or scale back, even with a low or negative profit.

Source: PwC and Strategy& analysis

the optimization challenge for a firm is really not much different from what we described in "Building strategic coherence": It is about defining the firm's niche in the market (its way to play), organizing its business and operating model (its capabilities system) to compete strongly in that niche, and — the "build" in this context — doing so on a financial foundation that is strong, efficient, and flexible and delivers maximum shareholder value in the short, medium, and long terms.

Rethinking client profitability

Years of high returns during the pre-crisis years masked banks' lack of attention to which clients were the main contributors to profitability and which weren't, as well as the inefficiencies in their approach to client segmentation and coverage.

Capital markets players have typically been less focused than purely consumer-oriented companies on analyzing the profitability of their customers and using client segmentation to determine which activities are creating or eroding value. However, a client-centric approach to profitability — understanding economic performance at the client level — is the best way to assess the effect of the external macro forces including changes in market structure, changes in counterparty behavior, and regulatory pressure that have been squeezing revenues and increasing business costs.

In the past most clients were perceived as counterparties, segmented based on relatively simple parameters of industry, geography, and historical revenues. Because client wallets were relatively big, coverage lists had a great deal of overlap across players.

Banks, meanwhile, were not differentiated in the market and offered broadly consistent menus of services to all clients in terms of sales interaction, trade execution, and access to research, as well as pre- and post-trade. The main exception, of course, was made for "star" accounts — such as multinational asset managers — which were lavished with more personalized attention. Meanwhile, understanding of individual clients' contributions to the firms' economic profitability was limited, with big challenges in reconciliation of sales credits and true revenues as well as allocation of costs and balance sheet.

In the post-crisis paradigm, this opacity and lack of differentiation are no longer acceptable. Across their business lines, banks need to create differentiated client value propositions that address the needs of each segment and that can be systematically applied across teams.

To design this more client-centric organization, investment banks need to emulate their retail counterparts and leverage customer insights to improve their business models. This involves the following:

1. More rigorous and analytically driven customer segmentation

2. Wider adoption of client profitability measures across the sales process as well as in management decision making

3. Differentiation of coverage and service models by client segments; greater institutionalization of approach

Value-driven segmentation

Client segmentation has traditionally been driven by three core dimensions: industry, geography, and historical revenues. Although these dimensions are important overlays, we believe that client segmentation should be value-driven. This means considering the client's current value, potential value, and, finally, behavior as related to interaction with the bank.

The end result of value-driven customer segmentation is, of course, a refined categorization of clients (*see Exhibit 4, next page*). The impact on star, or "priority," accounts is minimal — as it is quite obvious which clients are the biggest contributors to historical and potential revenues. The more important effect will be on the medium-sized and smaller clients. Segmentation will help distinguish the different groups and lay the foundation for differentiation of coverage and service models.

Embedding client profitability in sales and management decision making

System constraints have historically made it difficult for banks to accurately evaluate client-level profitability — from reconciliation of sales credits and revenues to allocation of operational and financial resource consumption. However, there is an imperative to overcome these challenges; opacity into the drivers of profitability is no longer acceptable when sales and trading divisions are operating below cost of capital. Institutionalizing more accurate client profitability measures allows for better insight into client value as well as behavior patterns. It also clearly highlights the levers banks have at their disposal to drive better profitability.

Exhibit 4
Refined approach to client segmentation

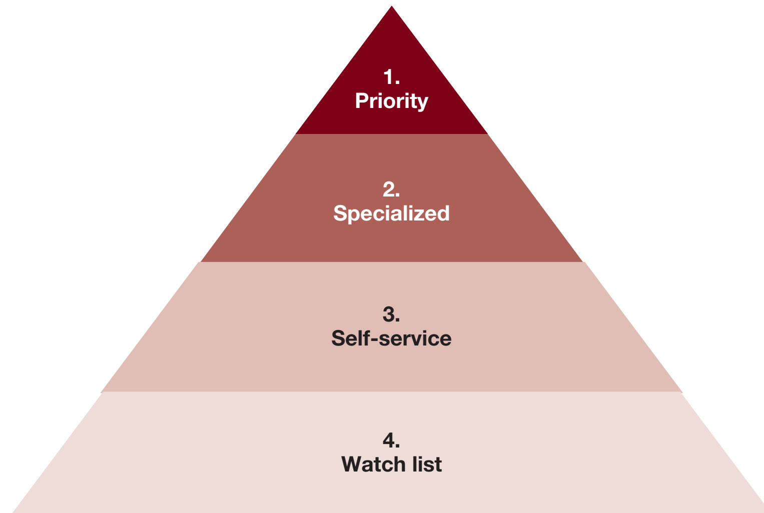
Clustering parameters for analysis

Behavior
Content consumption, execution preferences, services, financial resource consumption

Current value
Historical sales and trading revenues or client profitability

Potential value
Third-party market intelligence on share of estimated potential value

Refined client segmentation



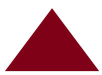
Source: PwC and Strategy& analysis

Differentiated coverage and service models

Optimization of coverage and service models should be tightly interlinked with more rigorous client segmentation, putting into practice the mission for client-centricity. This means distinct differentiation of approach across client segments and clear rules for coverage structure, content access, and execution and platform capabilities. A better handle on client profitability will provide transparency that will enable the front-office teams to drive better profitability (*see Exhibit 5, next page*).

Depending on the starting point, the transformation can be dramatic, with introduction of truly distinct business models for priority accounts versus smaller clients, potentially including distinct sales teams and new platforms. These actions may sound drastic, but they are necessary to deliver better client outcomes in a way that is cost-effective.

Exhibit 5
Differentiating client coverage and service model

Segment	*Coverage structure*	*Content capabilities*	*Execution capabilities*
1. Priority 	– Small, senior team – One-to-one coverage – Coverage is local to client HQ	– Bespoke ideas on demand – Tailored to client account – Specialist access to thought leadership, economists, research	– Level of "voice" execution higher – Access to specialist execution desks for large, complex trading requests
2. Specialized (and subsegments) 	– Subsegmented based on behavior (e.g., content consumption, price sensitivity) – Medium-sized, mid-level team – Coverage generally restricted to defined lists	– Tailored services delivered when requested/needed but not by default – Clients typically pay for bespoke service – Standardized "calls to action" guide interaction by subsegment	– Coverage is passive and electronic by default, but the ability to access voice coverage specialists is allowed when required – Standardized "calls to action" guide suggestions
3. Self-service 	– Small, more junior team – Coverage centralized – One-to-many coverage	– Content is delivered en masse at low cost – Content delivery and suggestions are automated based on client preferences and history	– Trading is almost entirely electronic – Trading is client-executed on an agency basis where possible – Human intervention minimal

Source: PwC and Strategy& analysis

Accelerating operational efficiency and organizational change

Outsized and unprofitable cost bases in many businesses are one of the legacies of the pre-crisis era, when profit margins were much higher, banks were expanding, and insufficient attention was paid to costs. Going forward, banks must improve their operational efficiency by aligning and transforming their existing infrastructure and technology platforms to fit the requirements of the businesses with which they choose to compete. In many cases, a fundamental transformation of the operating model is required.

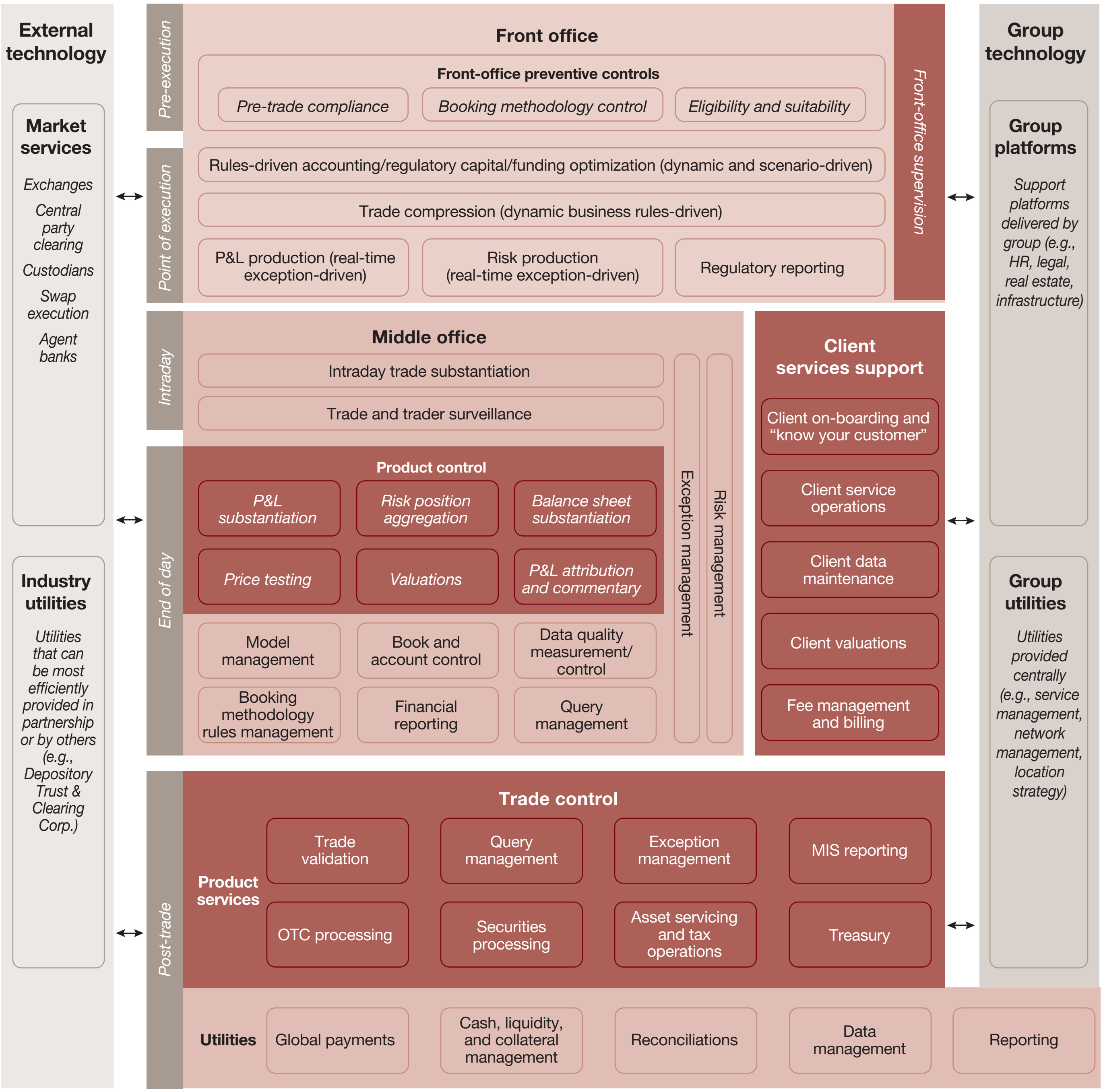
Most investment banks today need to implement a radical cost reduction program that is focused on operational effectiveness. They need to identify the major front-to-back cost blocks, and align their infrastructure and technology with the requirements of the core businesses. New technology can enable the required business transformation through a complete process redesign and the elimination of inefficiencies across the trade flow. For most banks, fragmented technology platforms and decentralized systems further augment the cost issues, requiring the complete redesign of the operating model.

Most investment banks today need to implement a radical cost reduction program that is focused on operational effectiveness.

The design of the new operating model should, however, take the business requirements as the starting point of the exercise. To increase productivity and efficiency, processes and technology must be simplified and streamlined. To attain the highest impact, flow (generic) and non-flow (highly bespoke) products should be separated in the process design. The goal is to eventually have the same process design for both product classes, by attaining the highest straight-through processing rate possible and eliminating breaks and errors caused by non-flow products.

The final target operating model (TOM) is heavily contingent on the IT architecture and technology design. The model moves responsibilities for booking and processing to the front office, while the middle office focuses on trade control, valuation, and profit-and-loss substantiation (*see Exhibit 6, next page*). The new capital markets TOM requires a centralized database for the underlying engines such as valuation,

Exhibit 6
New investment banking target operating model



Source: Strategy&

risk management, and P&L substantiation, while putting in place a governance structure with direct accountability. External technologies should be combined with industry utilities. Depending on the state of the institution's technology, internal platforms can be combined and outsourced. In many organizations, years of consolidating businesses and underinvesting in IT have created technology platforms that are fundamentally misaligned, and a more transformational "greenfield" approach is often required.

Focusing on change execution

Fundamental changes of the magnitude discussed here will require leadership and organizational structures separate from the management charged with running the business on a day-by-day basis. In all cases, it will be critical for the banks to select the right leaders and team personnel, set goals and expectations, and create momentum for change. In some cases, the transformation might require the appointment of a chief restructuring officer to take charge of a dedicated transformation effort.

Members of the core team should have deep business and front-office knowledge, as well as situational experience in delivering successful change, restructuring, and turnaround programs. Their initial objective will be to develop plans for the first 100 days, take control, and quickly establish authority for the implementation of the program. The team must identify top talent across the organization and demonstrate to those individuals how they will be central in shaping the future of the bank. Early delivery of results is critical, as is maintaining momentum throughout the restructuring. Speed of execution is essential. The "clock speed" for a company in a major transformation is much faster than for a company during normal operations, and the sense of urgency must be heightened throughout the organization.

Early delivery of results is critical. Speed of execution is essential.

In restructurings where transformational change is needed across several or all of the areas we have discussed, multiple teams will be required, and bank leadership should agree on a formal restructuring strategy and set up a dedicated restructuring office. The office manages the restructuring process centrally and holds the executive sponsors to account. A chief restructuring officer (CRO) should be chosen from the operating business, with delegated authority from the CEO. The CRO must be a senior executive who is familiar with all the techniques of large-scale change management, and who has the experience and knowledge needed to stabilize the business as the restructuring proceeds. Though there are many specific functions the CRO performs, the most vital include establishing credibility for the restructuring plan, managing key turnaround tasks such as stabilizing the workforce, keeping stakeholders informed in a way that enables them to be supportive, and communicating effectively with employees.

Everyone involved should be aware of the potential benefits of the restructuring program. Doing nothing cannot be an option, and the pressure to change must sit equally on all parts of the organization. Management must invest in change infrastructure to improve its internal risk appetite to move an ambitious plan forward and to be held accountable for its delivery.

Driving the changes necessary to optimize the balance sheet, improve strategic coherence, focus on client-centricity, and radically improve operational efficiency is a huge undertaking — reminiscent of the old saying about building an airplane while flying. We believe, however, that investment banks that want to regain profitability and competitiveness in the post-crisis era have no other viable strategic option than to pursue restructuring on this scale.

Conclusion

Over the past several years we have published a series of reports on the challenges facing challenges facing capital market participants. Recent reports include “Banking industry reform — a new equilibrium,” “De-leverage take 2: Making a virtue of necessity,” “Capital Markets 2020: Will it change for good?,” and “Post-trade services in financial markets: Moving from backstage to center stage.”

In recent months, based on our analyses of market conditions, regulatory initiatives, and discussions with clients, it has become clear that the challenges confronting the industry have increased in severity. We believe that banking organizations need to change in ways that are more structured and more complex than at any time in the past, and we have reached several conclusions about the transformation imperatives for 2016 and beyond.

During the next year we will follow through with a series of more in-depth studies on the different constituent issues, challenges, and potential solutions.

Appendix: Key findings from a review of banking industry performance in 2014

Our research into the banking sector's financial results in 2013 highlighted a very substantial performance gap, particularly in Europe. For the 2014 fiscal year, we noted a similar picture, with only six of the 29 G-SIBs studied generating a positive economic spread. The weighted average spread of the whole group was –2.88 percent. At a segment level, we calculated that the investment banking businesses of the G-SIBs generated the worst economic spreads. The global markets sub-segment was particularly weak at –7.5 percent. (*See Exhibit 7.*)

Exhibit 7
Economic spreads of different banking business lines

2014 rank	Business segment	Leverage (A/E)	Return on equity	Cost of equity	Economic spread
1	Asset management	2.28	12.92%	11.93%	0.98%
2	IB advisory and origination	1.90	12.82%	12.24%	0.58%
3	Corporate banking	12.67	8.23%	8.51%	–0.28%
4	Private banking	15.07	9.04%	10.91%	–1.86%
5	Retail banking	15.27	8.90%	12.76%	–3.86%
6	IB global markets	21.97	4.59%	12.13%	–7.54%

Source: PwC and Strategy& analysis

The performance gap has profoundly changed the commercial dynamics across the value chain

Some of the traditional "upstream" functions of the investment banking industry — originating and warehousing client assets and providing ancillary risk products — have started to be dis-intermediated by asset managers, while infrastructure providers, such as exchanges, electronic trading platforms, and clearing or technology providers, have gained market share by offering new post-trade client services.[a] In the future, industry utilities are likely to emerge, while regional and other niche players fill gaps by providing specialized and tailored services to underserved segments such as middle-market corporates and small and medium-sized enterprises. Finally, as investment banks become agency businesses rather than principals, the revenue split will change substantially, driven much more by commissions and prearranged fees than actual trading profits (*see Exhibit 8, next page*).

Although a number of strategic decisions have been rooted in shifting client dynamics, operational efficiency considerations, and balance sheet constraints, we also note that a significant proportion of the decisions have been colored by flawed short-term considerations about return on equity. These considerations run the risk of veiling material business model concerns — or highlighting issues where none exist.

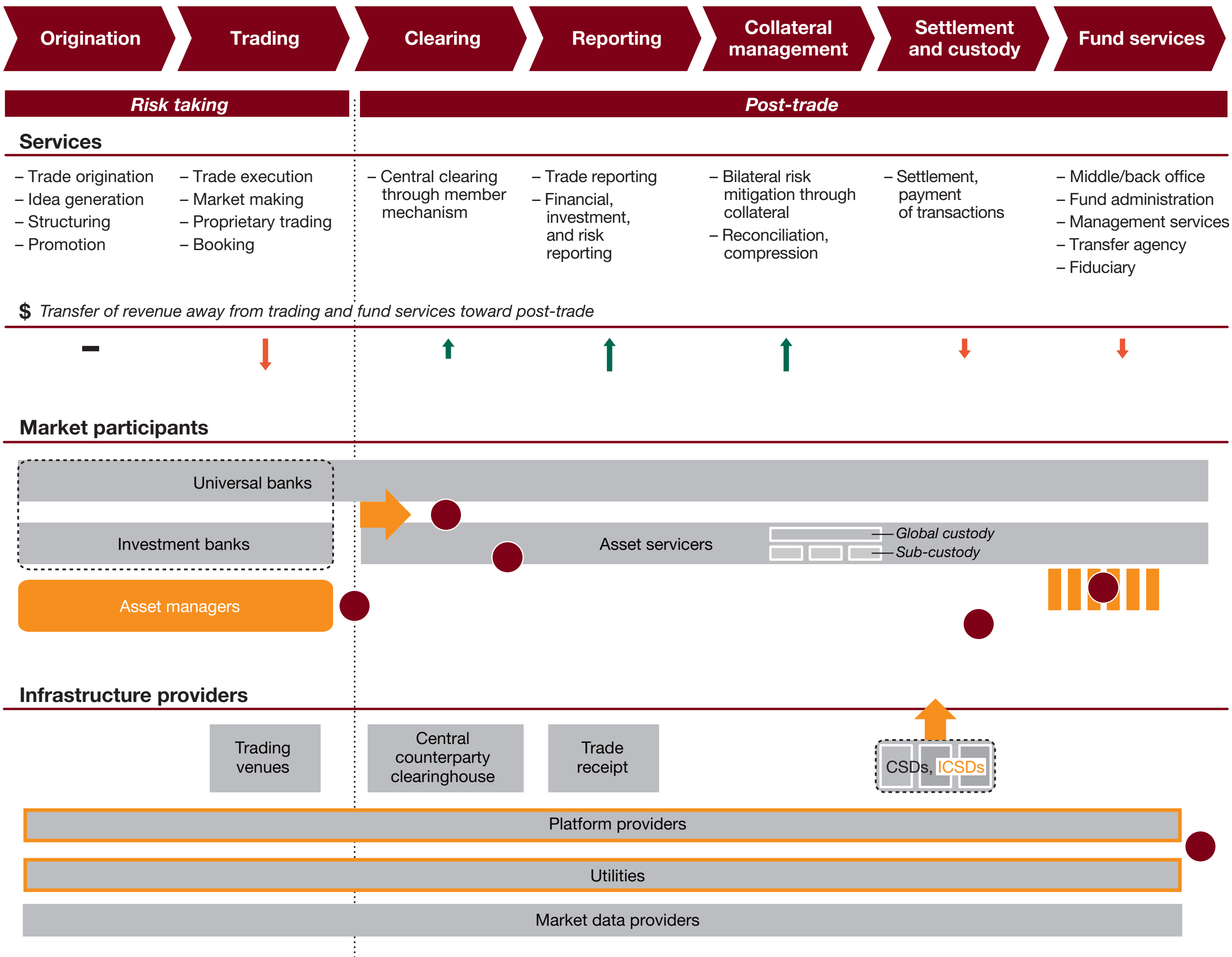
Meeting market expectations for global markets businesses requires a renewed focus on revenues and costs

For global markets, the current negative economic spread performance is a cloud with a silver lining: In the same study of G-SIB performance, we attributed a price-earnings multiple (a forward-looking performance indicator) of 11.36 times their global markets businesses. While still the weakest segment, it indicates that the market has confidence the segment will return to economic profitability in the foreseeable future (*see Exhibit 9, page 26*).

However, bridging the performance gap would require a significant focus on both operational efficiency and client and product margins. *Exhibit 10 (page 26)* sets out high-level estimates of the combinations of cost cutting and revenue growth that would be required to bridge the gap and restore economic profitability for G-SIBs in Europe and North America. This is the bankwide position, and given the current performance position of the IB segment, bank boards will be looking to their IB businesses to deliver commensurate improvements. Although this is clearly a formidable challenge, the market apparently has some confidence that it can happen. The sting in the tail, of course, is that the market stands to be disappointed if it doesn't.

Exhibit 8

Dynamics across the investment banking value chain



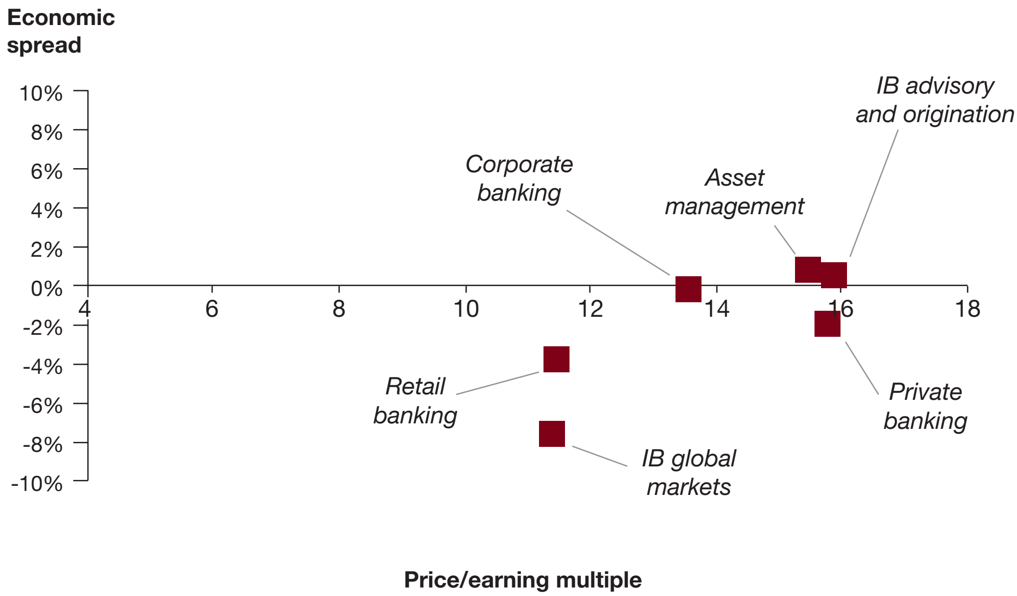
Competitor actions

- Move to technology and infrastructure solution
- Shift of risk taking to asset managers
- Global custodians bypass local custodians, enter clearing system, and challenge central securities depositories
- CSDs/ICSDs move from infrastructure to post-trade service provision
- New competitors enter markets
- Market participants establish industry utilities and center activities on technology platforms

Existing players
Competitive changes

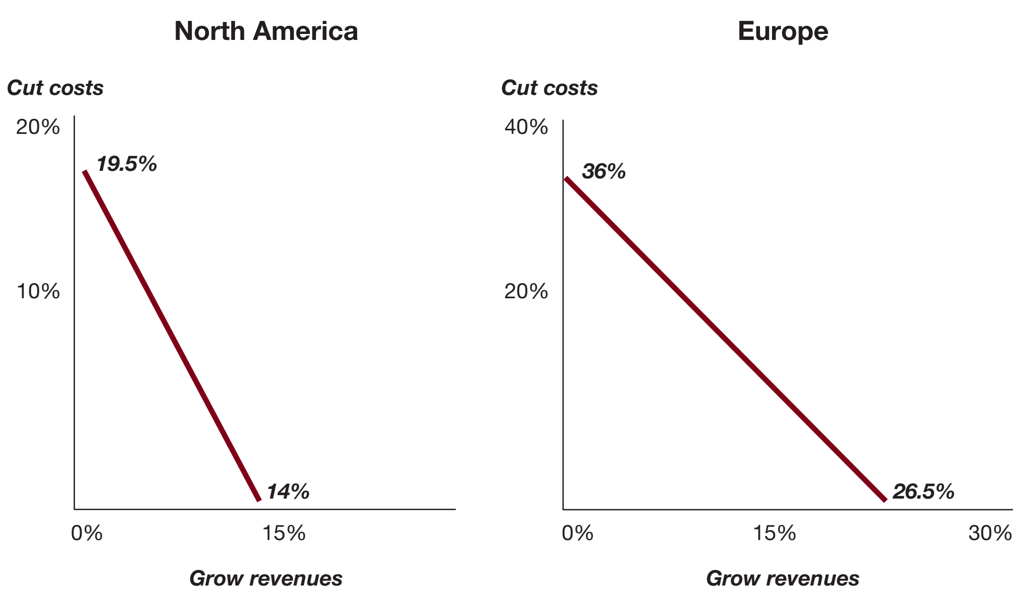
Source: Strategy& analysis

Exhibit 9
Benchmark business lines' P/E multiples



Source: PwC and Strategy& analysis

Exhibit 10
Economic profitability in Europe and North America (global systemically important banks)



Source: PwC and Strategy& analysis

Endnotes

[1] Tidjane Thiam, Credit Suisse Investor Day 2015.

[2] See Paul Leinwand and Cesare Mainardi with Art Kleiner, *Strategy That Works: How Winning Companies Close the Strategy-to-Execution Gap* (Harvard Business Review Press, 2016); strategyand.pwc.com/strategythatworks

[3] See Paul Leinwand and Cesare Mainardi, *The Essential Advantage: How to Win with a Capabilities-Driven Strategy* (Harvard Business Review Press, 2011).

[4] See Gerald Adolph and Kim David Greenwood, "Grow from Your Strengths," *strategy+business,* Autumn 2015; strategy-business.com/article/00354.

[5] For further details, see our banking reform study, "Banking industry reform — a new equilibrium," PwC, 2012; http://pwc.blogs.com/north/2012/08/banking-industry-reform-a-new-equilibrium.html.

[6] See Gagan Bhatnagar, Crispian Lord, Timothy Power, and Joerg Ruetschi, "Post-trade services in financial markets: Moving from backstage to center stage," Strategy&, March 2015; strategyand.pwc.com/reports/post-trade-services-financial-markets.

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