The Boston Consulting Group

The Next-Generation Investment Bank

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Introduction

Investment banks are being transformed by the unprecedented global credit and solvency crisis. Two of the five leading U.S. investment banks have collapsed, and the rest either have been bought or have changed form. Many universal banks in Europe and the United States have scaled back their capital-markets businesses. Relatively better-positioned Asian banks, by contrast, have sought to scale up their global capital-markets presence through opportunistic investments.

The painful truth is that losses at financial institutions approaching $1 trillion (and counting) have eroded investment banks' capital base and funding stability. Although government capital and central-bank liquidity have provided the industry with a short-term lifeline, investment banks are likely facing years of increasing regulatory pressure and severely weakened profitability. Absent radical restructuring, the industry's return on equity (ROE) could fall below 5 percent under realistic stress scenarios.

Confronted with so many constraints—a weakening business outlook, strict regulation, high capital costs, and reduced leverage—investment banks must rethink their strategies. They must review their business mix, target-client focus, risk appetite, capital allocation, operating model, and financial structure. These are daunting challenges.

New strategies must be fashioned at two distinct levels: the institutional configuration (universal bank versus pure-play investment bank) and the business model for capital markets activities. Many believe that the European-style universal-bank configuration will emerge as dominant following the crisis. Indeed, business diversity and captive liquidity have helped many large institutions survive the downturn up to now. What is more, regulators have encouraged this trend, despite the fact that forging ever-larger financial complexes is a dubious goal following the failure of some investment banks long deemed "too big to fail."

Needless to say, the universal-bank model is not without its challenges. Most mainstream universal banks, while largely able to ward off crisis-related bankruptcies, have recently fared poorly in terms of losses and total shareholder return (TSR). High management complexity has prevented them from realizing natural synergies across diverse businesses. In addition, they too are dealing with a sharp downturn in business prospects driven by the global macroeconomic slowdown. Thus, the question of whether investment banks can emerge from the crisis as viable universal banks is open to debate. Most investment banks have not yet fully examined this issue because they have been focused, understandably, on short-term survival.

This paper explores the issues and challenges currently facing investment banks and outlines specific, proactive measures that can help them shape a smaller, simpler, and more specialized next-generation business model for the postcrisis era in global finance.

A Brave New World

Over the past quarter century, investment banks have faced a half-dozen major crises. Their competitive landscape has been roiled by acquisitions, spinoffs, and even insolvencies. Through it all, they have largely responded well to changing conditions, developing innovative products and services and expanding into new businesses and regions. Their agility has been evident in the constantly changing mix of business and revenue levers that have driven growth and profitability. Many have learned that market turbulence is part of the game and, in fact, often leads to new opportunities.

The severity of today's financial crisis, however, is unprecedented. Compared with past upheavals, the current turmoil has lasted longer, caused more dramatic losses, and had a far broader impact on investor, consumer, and corporate confidence.[1]

In a less acute crisis, investment banks might have redeployed resources to emerging growth businesses, weeded out unproductive assets, and created new opportunities through innovation. But this crisis has weakened their resilience. New growth engines are not yet visible, and across-the-board business weakness has lowered the value of resource redeployment. Increased governmental activism and regulatory scrutiny are hampering innovation.

Industry growth in the most recent up-cycle was largely a consequence of leveraged expansion of the balance sheet. Proprietary risk-taking replaced risk-free intermediation as the core driver of revenue. This dynamic served to mask the ongoing commoditization of core intermediation businesses. Now the crisis is forcing banks to finally confront their subindustrial, subscale, and unprofitable presence in many activities. Addressing years of neglect will require a radical shift in the operating model, not merely a tactical redirection of resources.

A Tough Road Ahead

For years, investment banks benefited from structural trends such as globalization, deregulation, and convergence across financial sectors. Growth was also spurred by innovations in structured finance and a long-term decline in the cost of risk.

Yet some of these factors were responsible for creating, intensifying, and propagating the credit crisis across increasingly interconnected financial sectors and regions. As numerous banks ended up facing large losses, depleted capital, and dangerous levels of leverage, many tried to recapitalize by issuing public equity, seeking strategic investors, disposing of toxic assets, and even selling marketable franchises. But given the size of their losses and the consequent erosion of investor confidence, such steps proved to be inadequate.

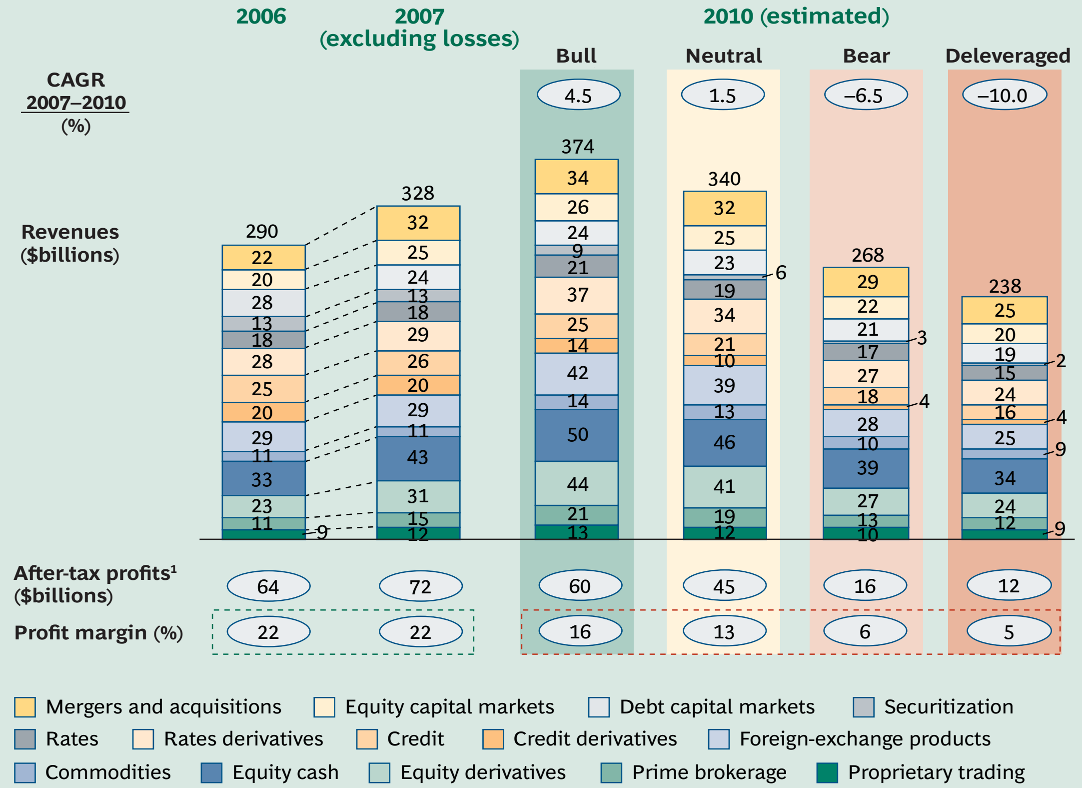
It is now clear that although the capital markets will remain vital to global finance, especially given the weakening of financial institutions' balance sheets, investor confidence will take years to rebound. In addition, the massive injection of liquidity into global markets by central banks could lead to structurally higher interest rates in the long term. Indeed, the quasi nationalization of many leading universal and investment banks, particularly in the United States and Europe, is a stunning development. By January 2009, government purchases of stock and illiquid assets, as well as federal guarantees of bank debt, totaled an extraordinary $4.9 trillion, or an average of 13 percent of the GDP of the nations concerned. Another wave of intervention is likely. (The Japanese government's purchase of bank capital during Japan's financial crisis in 1998–99 amounted to 2 percent of that nation's GDP.)

Still, although governments have provided banks with new capital to cover spiraling losses, they are only beginning to take meaningful steps to address the underlying drivers of these losses. In the United States, for example, such drivers include rising foreclosures in the housing market. What is more, governments are beginning to exercise tangible influence over bank activities. Many banks are already being forced to sharply reduce dividend payments, shave executive compensation, retrench expansionary activities, and pump credit into their domestic markets.

The Boston Consulting Group (BCG) has looked at diverse scenarios of how industry revenue could evolve over the next couple of years. (See Exhibit 1.) We created these scenarios by looking at the microdynamics that will affect the economics of various capital-markets businesses. Our intent was not so much to forecast events as to evaluate the potential consequences of the various scenarios.

1. See *Collateral Damage, Part 1: What the Crisis in the Credit Markets Means for Everyone Else,* BCG White Paper, October 2008; *Collateral Damage, Part 2: Taking Robust Action in the Face of the Growing Crisis,* BCG White Paper, October 2008; *Collateral Damage, Part 3: Asia, Advantage, and Action,* BCG White Paper, November 2008; and *Collateral Damage, Part 4: Preparing for a Tough Year Ahead: The Outlook, the Crisis in Perspective, and Lessons from the Early Movers,* BCG White Paper, December 2008.

Exhibit 1. Investment Banking Revenues Are Highly Uncertain



Source: BCG analysis.
[1]The effective tax rate is 30 percent.

The key point is that no matter how the revenue picture plays out, investment banking profitability will worsen significantly owing to the move toward commoditized businesses offering a lower return on assets (ROA). A higher cost of capital and reduced leverage will exacerbate this effect. Even in the highly unlikely event of a revenue rebound, profitability will fall below the peak of the recent cycle. Single-digit ROE is a distinct possibility. In this environment, investment banks will need to restructure their business models in order to achieve sustainable profitability.

Crisis Equals Opportunity

While the challenges ahead are immense, BCG does not think that the current crisis marks the end of the investment banking industry's resilience. Instead, we strongly believe that the crisis offers an opportunity for the industry to reinvent itself by becoming more efficient and innovative.

Indeed, a crisis of this magnitude creates an imperative for structural changes that would otherwise be impossible to achieve. Instead of focusing on aggressive revenue growth, for example, investment banks can shift to the management of risk-adjusted profitability. Instead of trying to be all things to all people, they can stop supporting unprofitable businesses, products, and clients. Instead of adopting technology incrementally, they can automate and outsource large parts of the trading value chain. Instead of viewing risk management as a support function, they can make it a competitive differentiator. Instead of being weighed down by excessively generous and volatile compensation policies, they can switch to a more rational and stable structure. Instead of operating in vertical product silos, they can industrialize operations through horizontal integration across businesses.

If developed with the proper rigor and foresight, the new investment-banking business model—by keeping a sharp focus on innovative solutions—can be stronger and even more resilient than the old. In fact, one can argue that the weakening of the global banking system necessitates an even larger role for capital markets. For example, there are opportunities to reverse engineer complex and illiquid structured financial products into simpler, underlying collateral. There are opportunities to benefit from significantly repriced credit risk and from capital markets expansion in places such as China and India, as well as to invest in large infrastructure and environmental initiatives being launched around the world. There will also be opportunities in strategic mergers and acquisitions as every industry adapts to the new business climate. But seizing the moment will require transforming the investment banking industry's business model in a radical manner.

An Imperative for Change

When Bear Stearns collapsed in March 2008, few viewed the event as a harbinger of doom for investment banks. But the systemic problems that felled that institution continued to intensify. By September 2008, the remaining pure-play investment banks were forced to either take extraordinary measures or succumb. By reincarnating as deposit-taking institutions, the survivors effectively conceded the debate to the European-style universal-bank configuration.

A Search for Stability

Regulators had a strong influence in shaping this outcome. It is now clear that the pure-play investment banks had been undercapitalized and insufficiently regulated. In addition, because of their size and interdependencies, they were widely seen as too big to fail. Merging the most vulnerable of these institutions with large banks brought them under a consistent and prudent regulatory framework, while mitigating the risk of institutional failure.

A key lesson from the credit crisis—particularly for U.S. and European institutions—is that investment banks need diverse sources of funding. In the past, they were excessively leveraged through unreliable wholesale funding. A deposit-taking capability could have helped stabilize their liability mix. Of course, a sizable deposit franchise also brings regulatory restrictions, such as reduced leverage. But given the increasing risk premiums in bank loans, such constraints are now being imposed by the market anyway.

Ultimately, while the credit crisis has prompted the surviving pure-play investment banks to embrace the universal-banking model, these institutions are seeking stability not so much through business diversification as through access to the central-bank liquidity that is necessary for their survival. In a sense, the universal-bank configuration has won out in more of a tactical than strategic sense. Nonetheless, this development is creating new opportunities, such as the synergistic combining of corporate and investment banking. Before the crisis, such experiments had met with only limited success, mainly because capital was effectively a commodity. Now the scarcity value of capital has the potential to drive corporate and investment banking much closer together.

Of course, there is no clear picture of what a universal bank should look like. Some universal banks were built on a foundation of wealth management, whereas others were built on retail or corporate banking. In the rush to stabilize the banking industry, regulators should not force a one-size-fits-all prescription on investment banks. Even if these institutions do come to operate effectively as universal banks, their specific configurations will vary considerably. The choices they make will reflect their geographic and market profiles, core capabilities, strategic motivation, and regulatory constraints. U.S. banks, for example, will look quite different from their European counterparts, which will not evolve in step with newer Asian players. (See Exhibit 2.)

The Universal-Bank Model: Not a Silver Bullet

Although pure-play investment banks have generally outperformed universal banks under favorable market conditions, it has always been assumed that business diversification would help universal banks in difficult times. In this context, it is useful to look at actual TSR across bank configurations as the current crisis unfolded.

Exhibit 2. Investment Bank Configurations Will Vary Widely

		North America	Europe	Asia-Pacific
Business climate	**2008**	◇ Equity capital markets slightly up ◇ Debt capital markets and M&A sharply down ◇ Equity derivatives and prime brokerage down ◇ Foreign exchange and rates moderately up	◇ Equity capital markets sharply down ◇ Debt capital markets and M&A down ◇ Equity derivatives down ◇ Foreign exchange faring OK	◇ Equity capital markets sharply down ◇ Japan: debt capital markets and M&A down the least across regions ◇ China: M&A up ◇ Foreign exchange up
	2010 revival	◇ Equity capital markets continue to pick up ◇ M&A begins recovery ◇ Debt capital markets experience slowest recovery ◇ Foreign exchange, rates, and equity derivatives show steady growth	◇ Equity capital markets and M&A begin to recover ◇ Debt capital markets recover more slowly ◇ Foreign exchange and rates show steady growth ◇ Basic equity derivatives recover	◇ China: recovery is fueled by IPOs and massive government spending on infrastructure ◇ Developing markets: trading volume rises as the number of listed securities grows ◇ Equity derivatives pick up
Regulatory climate	**Government intervention**		U.K. Germany France, Italy	
Business model	**Shifts in configuration/ scope**	◇ End of pure-play investment banks ◇ Transformation of two leading investment banks into bank holding companies ◇ Questionable future of select universal banks ◇ Retrenchment across the board	◇ Retrenchment of investment banking activities within universal banks ◇ Opportunistic moves by stronger banks facing less government intervention ◇ Pressure on rescued banks to focus domestically	◇ No shift in configuration ◇ Japan: opportunistic geographic and scope expansion by relatively strong universal banks and domestic investment banks ◇ Australia: investment banks folded into corporate banks

Source: BCG analysis.

From November 2006 to November 2007, a period that captures the onset of the crisis, the average TSR of the 126 largest financial institutions globally was 0 percent. Universal and commercial banks achieved a TSR of 5 percent over this period, while investment banks had an average TSR of –8 percent. From December 2007 to December 2008, as the crisis expanded, the average TSR of the same group of financial institutions was –51 percent, with investment banks faring somewhat worse than the rest (a weighted average of –68 percent versus –55 percent, respectively). Only one bank out of the total sample posted a positive TSR during 2008. This poor performance across the board suggests that the problem had less to do with bank configuration than with banks' ability to manage risk.

Another challenge for universal banks is the management of business complexity. Very few institutions have successfully leveraged the diversity of their franchises to drive revenue synergies. Most banks have failed to optimize client revenue potential and cost to serve, despite having a broad set of complementary capabilities. For example, while many claim to have created an originate-structure-distribute model, in reality they have been running a portfolio of nonintegrated businesses across the value chain. The inability to drive even obvious synergies diminishes the value of such combinations when compared with the cost of management complexity and risk.

Finally, universal banks have also been adapting their business models (particularly in corporate banking) to reflect the sobering realities of today's markets.[2] These banks have reduced costs, tightened underwriting standards, implemented client turnaround plans, and exited businesses such as real-estate lending and asset finance. Interestingly, even at the height of the recent credit cycle, credit-light business models generated the highest profitability. This suggests that merely combining corporate and investment banking without focusing on noncredit, fee-based revenue streams is a failing strategy.

These findings weaken the argument that adopting the universal-bank model will be a silver bullet for investment banks. Indeed, it is conceivable that one or more large universal banks will eventually spin off their investment banks. Clearly, there is a need for a new business-model paradigm.

A Smaller, Simpler, Specialized Business Model

Given the depth of the current market turmoil, investment banks are now focused on aligning their business models with the new structural realities. Two strategic requirements are shaping the industry's thinking:

- Stabilizing profitability in the face of a weakening business mix
- Managing increased regulatory and governmental influence

Responding to these requirements will put the industry on a trajectory radically different from that of the recent past. In many ways, we expect investment banks to return to a smaller and simpler business model—a throwback to the era that preceded the leveraged revenue expansion of recent years. Such a model will have to accommodate smaller profit pools, greater client demand for simpler financial solutions, and the specialized capabilities of individual investment banks.

Specialization will be critical. For example, a review of banks' publicly stated strategies suggests that most are now emphasizing "client centricity." This could mean either of two different approaches. Banks could reduce proprietary risk-taking in favor of facilitating client transactions. Or they could seek to create a business model that serves core clients across all of their capital-markets needs. Given that most banks will find it difficult to achieve best-in-class status in all businesses, competing across the full range of client needs may not be viable. Instead, banks will likely specialize in businesses in which they already have unique value propositions (such as scale, product expertise, and distribution). They will then create cross-product coverage teams aligned with profitable client groups.

Most banks will operate at a sharply reduced risk level compared with the previous cycle. For a limited set of banks, however, significant repricing of risk will be seen as an opportunity to profit from the continued acquisition and distribution of risk. The business model of these risk takers will increasingly resemble and converge with that of alternative-investment managers. Such banks are also likely to consider going private in order to avoid the costly requirements of public markets.

Stabilizing Profitability in the Face of a Worsening Business Mix

To create a structurally profitable business model, investment banks need to reevaluate their business portfolios. They need to balance factors such as the intrinsic opportunity in any given business, their core capabilities, their capital and liquidity requirements, and the challenges of aligning each business with client demand. For the businesses in which they choose to compete, they must develop a clear perspective on issues such as client coverage, risk tolerance, level of industrialization, product innovation, and performance measurement.

In particular, investment banks will need to rethink the underlying operating models for the commoditized businesses that will drive the bulk of their near-term revenue. Although these businesses will gener-

2. See *Thriving in the New Normal: Corporate Banking 2008/2009,* BCG report, December 2008.

ate low margins, they will potentially require less capital. To succeed, banks will need to drive greater efficiencies through increased scale and automation and reduced operational complexity. We expect that the creation of market utilities to reduce costs, increase transparency, and reduce systemic risk will result in a much higher level of industrialization in posttrade processes across all asset classes. This trend will increase the level of process standardization and automation for all market participants. We also believe that future operating models will reflect a higher level of resource and process sharing across asset classes and regions in the form of efficient processing factories and functional utilities.

Managing Increased Regulatory and Governmental Influence

Continuing capital erosion at investment and universal banks has forced governments worldwide to provide support to the banking system. This support has taken various forms, including direct injection of capital, guarantees on bank debt, and purchases of impaired assets. Even if true nationalization is avoided, governments are likely to act as if large parts of the banking system have effectively been nationalized. Banks will therefore have to anticipate and manage potentially intrusive influences as they shape their new business models.

As shown in Exhibit 3, governments, in return for their support, are likely to demand that banks work with them to achieve three objectives:

- Reviving the "utility" function of banks in the global economic system
- Preventing recurrences of systemic crises
- Protecting investments of taxpayer funds in the banking system

These objectives are not necessarily mutually consistent. Although governments want banks to resume corporate and consumer lending as a vital utility function, they want this done in a prudent manner in order to avoid additional losses. And although governments want banks to reemerge as profitable entities, they want this accomplished in a low-risk and highly regulated manner in order to prevent future crises.

Exhibit 3. Governments Will Demand Cooperation from Banks

Government goals...	...will lead to intense pressure on banks...	...which will have to engage proactively
1 **Reviving the "utility" function of banks**	◇ Grow consumer and corporate lending ◇ Maintain liquidity in money markets ◇ Support stabilization of the housing market	**Communicate ongoing actions consistent with government goals** ◇ Lending volumes and support for home loan modifications ◇ Leverage and value-at-risk (VaR) levels ◇ Aggressive cost reduction
2 **Preventing recurrences of systemic crises**	◇ Reduce leverage and risk levels ◇ Strengthen risk management practices ◇ Diversify sources of funding	**Initiate strategic dialogue with government** ◇ Balance sheet structure ◇ Business model transformation ◇ Regulatory reform proposals ◇ Improved risk management and prudent lending standards ◇ Incentives for continued innovation ◇ Executive compensation
3 **Protecting investments of taxpayer funds in the banking system**	◇ Rationalize executive compensation ◇ Reduce dividends to shareholders ◇ Develop next-generation business models	**Support government and regulators with asset valuation and risk management expertise**

Source: BCG analysis.

Indeed, absent proactive engagement with governments and regulators, banks are likely to find themselves caught between contradictory requirements that could prevent them and the governments with which they must deal from achieving their respective goals.

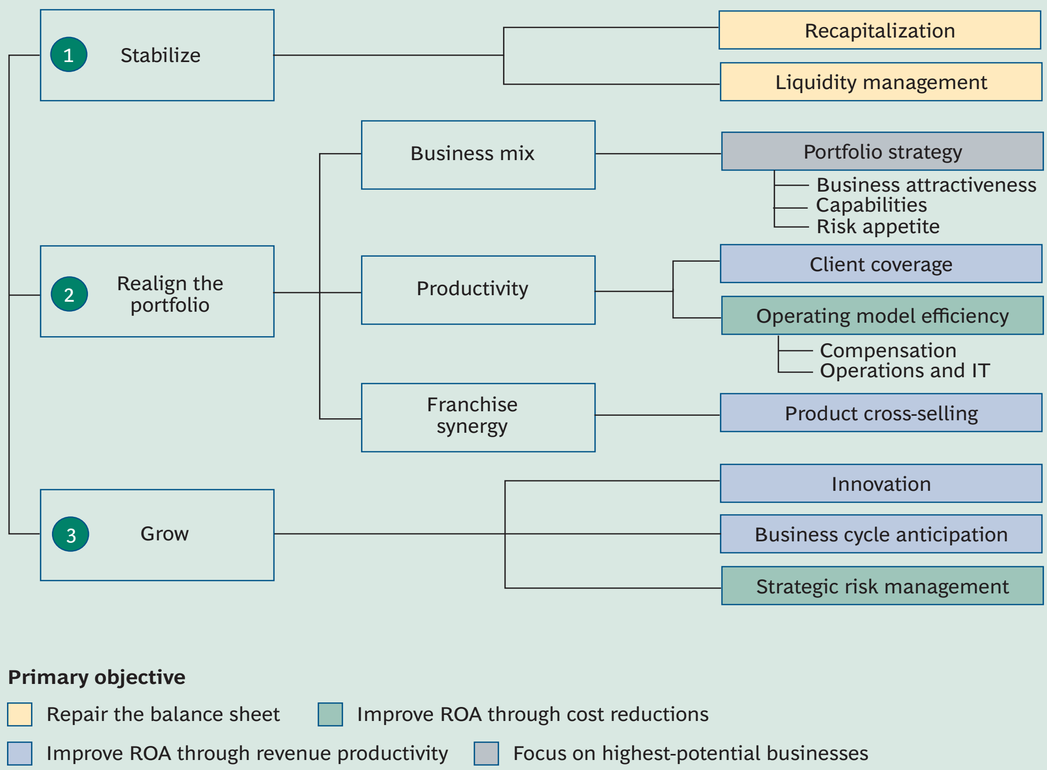
In the near term, banks will likely be forced to manage their utility businesses differently from other businesses. For example, as they lower risk in most businesses, they will face government pressure to extend scarce risk capital in the form of corporate loans, resulting in a further reduction in the risk-taking capacity of core businesses. This situation, coupled with constraints on product innovation, could severely impair overall profitability. Managing this dynamic is a key near-term imperative for banks, requiring them to demonstrate that their survival and growth strategies are consistent with government goals. Greater transparency in the near term can help limit intrusiveness over the long term.

A Call to Action

Realigning the business portfolio is probably the most pivotal decision an investment bank can make as it plots its way out of the financial crisis. This realignment may lead to divestitures. It will also, if properly executed, instill a renewed emphasis on core competencies.

Yet critical as it is, portfolio realignment is just one part of a comprehensive response to the crisis. (See Exhibit 4.) First, investment banks must stabilize their businesses, concentrating on recapitalization and liquidity management. Only then can they start to realign the portfolio, enhancing client coverage, improving the efficiency of the operating model, and increasing cross-selling opportunities. It is critical to shape a portfolio that takes all of the following into consideration: the growth prospects of various businesses, client needs and the capabilities required to meet them, funding, sufficient capital to compete successfully,

Exhibit 4. Investment Banks Must Focus on Three Imperatives



Source: BCG analysis.

and the bank's risk appetite. Finally, banks need to grow their businesses by focusing on innovation, the next phase of the business cycle, and strategic risk management.

Investment banks should also realign their client-coverage model with the new portfolio. Getting the coverage model right can yield significant gains in sales productivity. BCG's benchmarking work has shown that the productivity of best-in-class banks can be as much as four times greater than that of low-performance banks. A significant part of that superiority can be attributed to the coverage model. Coverage model design is a comprehensive process that includes initiatives in client planning, relationship manager assignment, sales practices, coordination with product specialists, client analytics, policies and governance (especially for credit pricing and allocation), metrics, and skills development.

Given the increasing share of revenue being driven by mature, low-ROA businesses, focusing on operating efficiency is another crucial imperative. This requires addressing both compensation and noncompensation costs. BCG's analysis shows that investment banks' compensation expenses are growing faster than other costs. The key is not merely to reduce head count but to recalibrate the overall compensation structure down to more manageable levels.

In addition to full-time-equivalent reductions of 15 to 20 percent (or 30 to 40 percent in merger situations), the greatest opportunities to generate near-term efficiency improvements are in operations, IT, and external brokerage. Together, these categories can account for up to 50 percent of investment banks' total costs. Operations and IT are obvious cost-reduction targets, but it is important not to cut costs to a level where core capabilities are impaired, which could result in increased operational risks and losses possibly far greater than the potential cost savings.

Given today's extremely challenging business environment, the importance of driving franchise synergies cannot be overstated. Successful banks will be able to take advantage of their client relationships, financial resources (such as captive funding), and operating infrastructure across the enterprise to improve overall revenue and cost productivity.

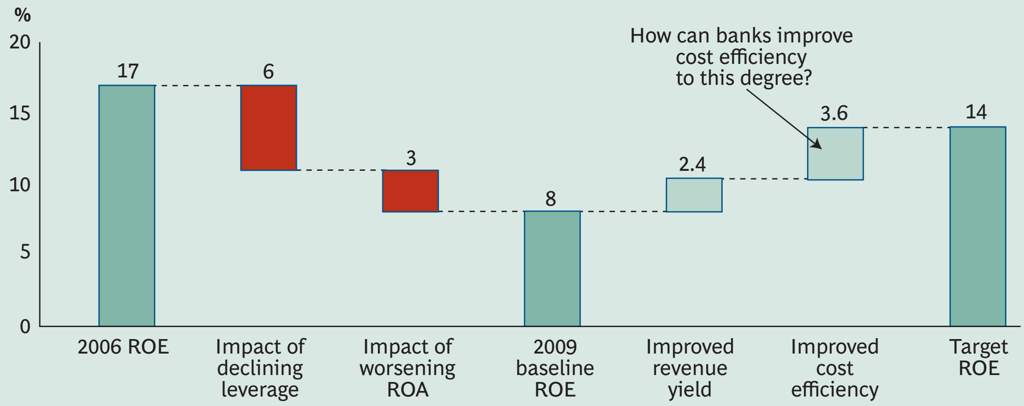
In terms of reviving growth, investment banks should renew their focus on innovation. After all, a strategy of hibernation is not really effective in long winters, and banks will do well to take advantage of the market dislocation to engage in responsible innovation.

Finally, strong risk management will be vital to ensuring that innovative growth strategies do not lead investment banks to stray beyond their true capabilities. Banks may need to fundamentally rethink the way they manage risk by increasing the connectivity of information and people, reducing the degree of separation between the risk taker and the risk controller, developing a strong risk culture along the value chain, and ensuring a proper tradeoff between risk and return.

BCG's experience suggests that most investment banks have yet to fully implement a comprehensive transformation of their business model. While many have cut back on the credit and securitization businesses that have been most damaged in the crisis, few have undertaken portfolio realignment in a systematic manner. Most important, there has been a reluctance to reduce client-related risk-taking for fear of impairing profitability. Yet pulling back on risk taking, while painful in the short run, is for most banks the only viable path to effectively restructuring the operating model of their various businesses.

Banks have also sought to cut back on their cost structures. But such initiatives do not appear to be linked to strategic assessments of their operating models. Given the business-mix-driven reduction in ROA, BCG estimates that investment banks need to cut well over $100 million in costs for every $100 billion in assets. Indeed, even if banks were to improve revenue productivity while achieving this level of cost cuts, their resulting ROE would still fall short of the 2006 level. (See Exhibit 5.) Absent a reduction in financing cost

Exhibit 5. Generating ROE Above 14 Percent Will Be a Tall Challenge



Approximately $100 million in cost reduction for every $100 billion in balance sheet assets would partially restore industry ROE to 14 percent

Sources: SNL database; BCG analysis.
Note: Leverage is assumed to fall from 26x to 15x.

or an increase in risk taking, investment banks will need to further restructure their costs in order to lift ROE into the high teens. Although many banks have tried to remove significant cost from noncompensation expenses, this approach can cut into operating muscle, creating operational risks that, in some cases, can cause losses far greater than any savings achieved by reducing salaries, benefits, and bonuses.

Although an incremental approach yields sizable and relatively painless cost savings, the result is a smaller version of the legacy operating model. This would be appropriate if the changes in the market were merely cyclical. But given the structural nature of the present crisis, failure to comprehensively reshape the operating model would not only be an opportunity lost—it would damage long-term competitiveness.

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