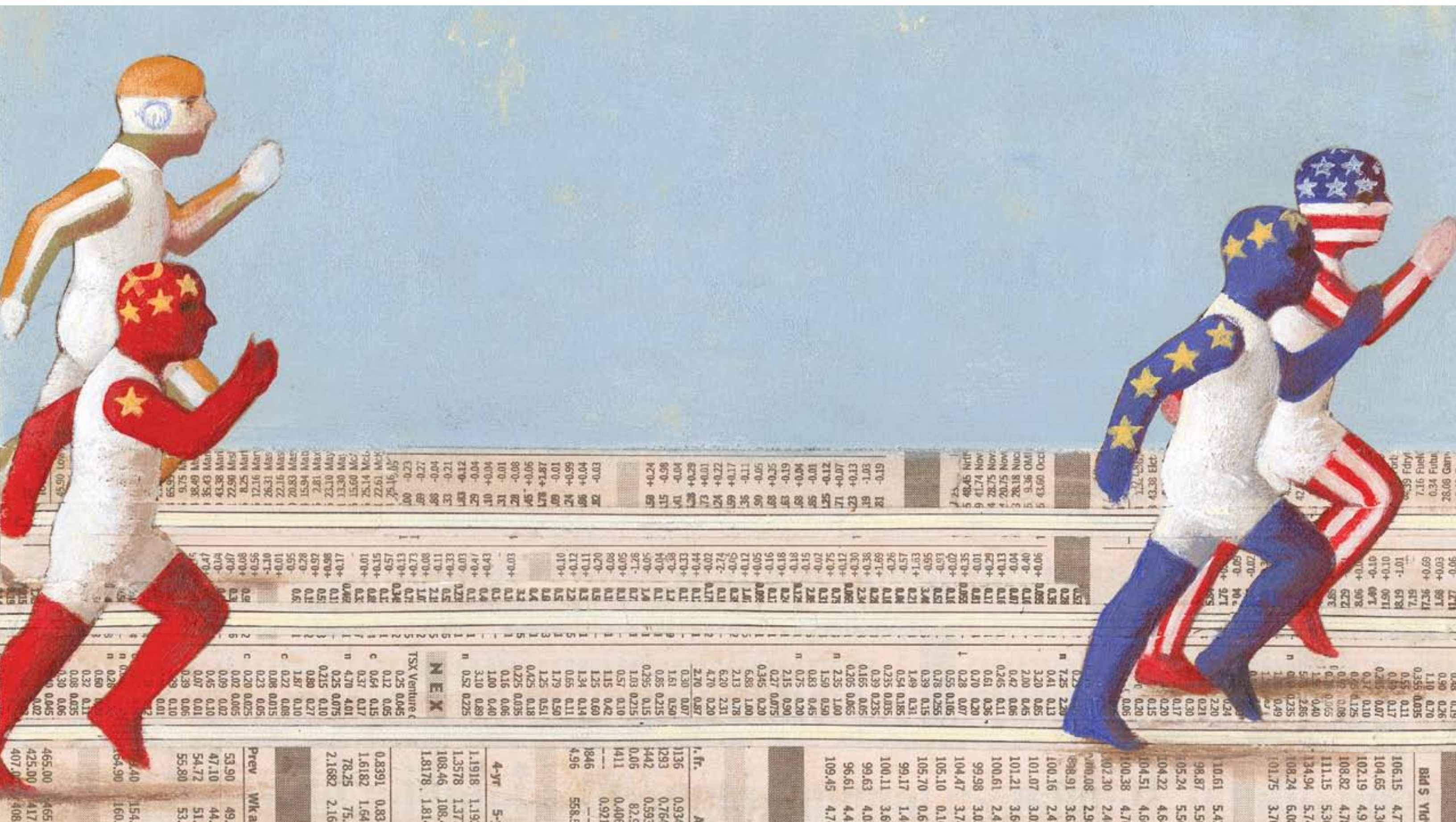
McKinsey on Corporate & Investment Banking



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Top trends in the global capital markets business

A new McKinsey study sheds light on the likely winners in the fast-growing global capital markets.

Markus Böhme and Matthieu Lemerle

Bank revenues from global capital markets rose 14 percent in 2005 and may exceed $250 billion for 2006, according to new McKinsey research. If current trends continue, Europe will overtake the Americas as the region with the biggest share of these revenues.

The first comprehensive benchmarking survey of capital markets business performance, jointly conducted by McKinsey and Coalition Index, exposes wide divergences in the performance of the main players, analyzes banks' various business models, and identifies the product areas driving growth.

The research findings suggest three key strategic issues: the European markets evolution, investment options in Asia, and the appropriate balance between client business and proprietary trading.

The Americas and Europe are running neck and neck as corporate and investment banks prepare to celebrate another year of bumper growth in global capital markets.[1] New McKinsey research shows that bank revenues from global capital markets rose 14 percent, to almost $215 billion, in 2005 and increased a further 40 percent in the first six months of 2006. Even though disappointing third-quarter results from some major institutions have injected a note of caution into 2006 as a whole, breaking through the $250 billion barrier seems likely.

With Europe and the Americas almost identical in market size at the end of 2005, Europe is set to take the crown if current

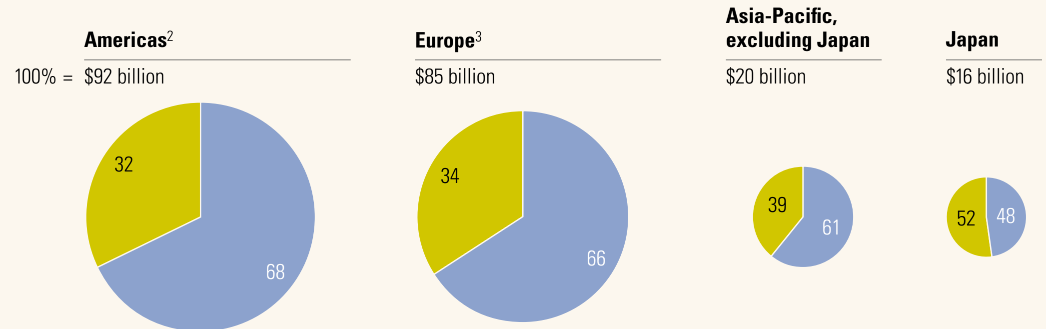
[1] For the purposes of this article, Europe comprises the Middle East and Africa, as well as Europe proper, and the Americas comprises North, Central, and South America.

Exhibit 1

Catching up

The size of Europe's capital markets is approaching that of the Americas.

Revenues for global capital markets[1] by region, 2005, %



[1] Includes primary equity and primary debt capital markets, all secondary (sales and trading) revenues; excludes M&A, loan syndications, asset- and liability-management activities, and principal investments.
[2] Includes North, Central, South America.
[3] Includes Europe, Middle East, Africa (EMEA).

Source: *Global Capital Markets Survey*, McKinsey and Coalition Index, 2006; McKinsey analysis

trends continue. Asia's share of the global pool remains significantly smaller than that of the other two regions—but its potential is large, especially in emerging markets outside Japan.

These headline findings from the Global Capital Markets Survey, the first comprehensive benchmarking of capital market business performance,[2] reveal the scale and strength of the corporate and investment banks' capital markets businesses. But a more detailed analysis of the data highlights how the incoming tide of capital markets activity is not lifting all ships equally. Some players have grown spectacularly, while others have stood still or even seen their revenues contract. The drivers of this growth—the nature of the product mix and the underlying formula for making money—vary considerably depending on the region and the type of market participant.

A tale of diversity

Until recently, news reports trumpeted buoyant market conditions almost across the board: from equities to fixed income and from primary capital markets to secondary sales and trading. What those reports omit is the fact that the pace of growth masks a surprising degree of diversity, not just across geographic regions, but also among different types of capital markets competitors. Two other striking variables are the product mix and the business model.

Regional dynamics: Europe and Asia set the pace

European revenues, which have almost caught up with those of the Americas (Exhibit 1), have been growing faster recently—at around 20 percent, versus high single digits for the Americas. Europe's catch-up potential is further reflected in a lower ratio between capital

[2] The Global Capital Markets Survey is an annual survey jointly undertaken by McKinsey and Coalition Index with the active participation of around 30 leading global, regional, and national banking institutions. The definition of *capital markets* includes primary equity and primary debt capital markets and all sec-ondary (sales and trading) revenues. Excluded are M&A, loan syndications, asset- and liability-management activities, and principal investments.

markets revenues and GDP (Exhibit 2). London and the Continent may soon become the world's financial powerhouse as measured by top-line numbers.

Asia's growth also has been impressive (in the high teens), and its catch-up potential is even greater than Europe's. But while everyone agrees that the gap between Asia and the other regional economic blocs will narrow over time, building a capital markets presence in Asia is clearly a longer-term play.

Different business models prevail

Contrary to conventional wisdom, the capital markets game is not just for the "bulge bracket" brigade—a fact sometimes overlooked in London and New York. As our research illustrates, several very different kinds of players manage to compete successfully and capture industry growth.

Truly global players, which we call the "globals," participate in most, if not all, product areas, are active in all three major geographies, and report revenues in excess of $8 billion. Globals accounted for 52 percent of all global capital markets revenues in 2005. However, while globals accounted for two out of every three dollars created in the Americas, they captured only 44 and 42 percent of European and Asian revenues, respectively.

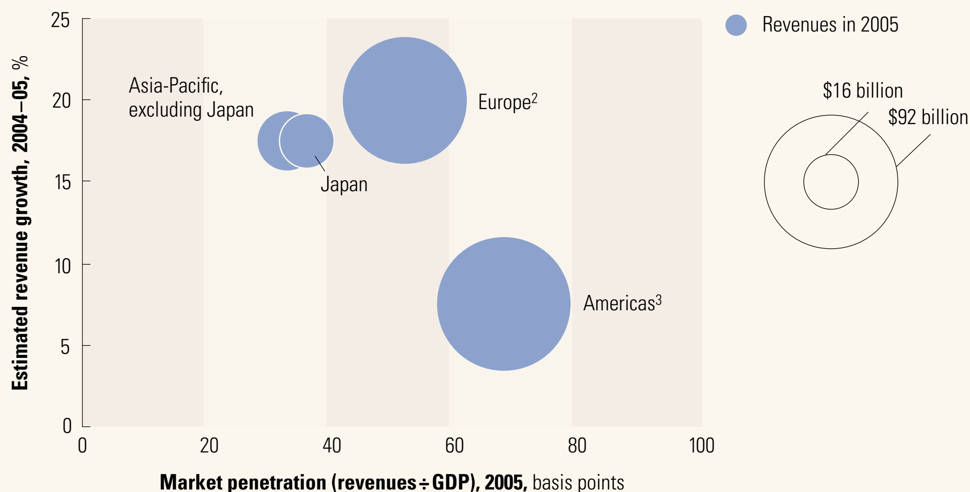
The remaining revenues—a sizable 48 percent—were captured by other types

Exhibit 2

Place your bets

Europe has almost caught up with the Americas; Asia-Pacific is showing more potential.

Average revenues for global capital markets[1] by region, 2005



[1] Includes primary equity and primary debt capital markets, all secondary (sales and trading) revenues; excludes M&A, loan syndications, asset- and liability-management activities, and principal investments.
[2] Includes Europe, Middle East, Africa (EMEA).
[3] Includes North, Central, South America.

Source: Global Insight (World Market Monitor, Aug 28, 2006); *Global Capital Markets Survey*, McKinsey and Coalition Index, 2006; McKinsey analysis

of players. These include what we call "aspiring globals," banks that have clear roots in Europe or the Americas, have built global franchises around a wide product and geographic base, and now generate a large proportion of their total revenues (typically $2 billion to $8 billion) away from home.

"Major regionals," meanwhile, often measure up to the global contingent on their home continents, where they focus their strength and revenue base. Some players in this category enjoy a truly world-class franchise in one or two activities (for instance, in equity derivatives) and a more regional franchise elsewhere. Other major regionals are category killers in domestic markets with a base across one region (generally Europe).

"National champions" are mostly from Asia and Europe—regions where they have captured 24 and 21 percent of the revenue opportunity, respectively. Players in this group command significant market share in their home countries and tend to leverage heavily their internal corporate-, retail-, or private-banking franchises. Such players typically generate less than $2 billion in capital markets revenues (Exhibit 3).

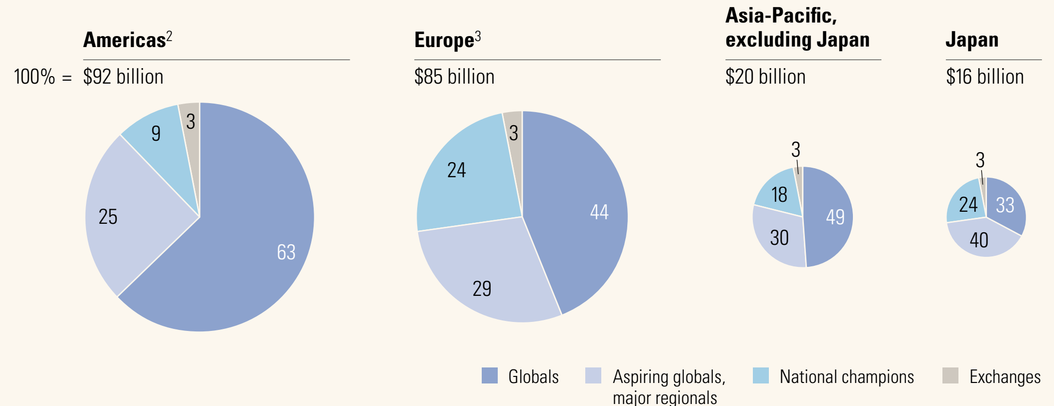
Product trends: Growth engines, cash cows, and laggards

With revenues derived from Europe approaching those from the Americas, a deeper look at the product split reveals further insights. Europe's fixed-income boom has been apparent for at least 18 months, a trend confirmed

Exhibit 3

The players

Large global players dominate the Americas; other regions are more balanced.



[1] Includes primary equity and primary debt capital markets, all secondary (sales and trading) revenues; excludes M&A, loan syndications, asset- and liability-management activities, and principal investments.
[2] Includes North, Central, South America.
[3] Includes Europe, Middle East, Africa (EMEA).

Source: *Global Capital Markets Survey*, McKinsey and Coalition Index, 2006; McKinsey analysis

by the 15 to 20 percent rise in 2005 revenues. In this category, Europe is outpacing Asia and, particularly, the Americas. The resurgence of global equities was felt most strongly in Asia and Europe, with growth rates well in excess of 20 percent.

However, the real story can be told only at the level of individual products, where growth and profitability trends significantly diverge (Exhibit 4). Structured products (exotic rates, exotic credit, structured commodities, fund-linked products and structured alternatives, and exotic equity derivatives) continued to march forward in 2005, displaying strong revenue growth and solid profits. Commodities, equity derivatives, securitization, and exotic rates made a strong showing, though exotic credit had an odd year: nominally, revenues stalled and profits were below average as correlations went out of line, and most players faced losing positions in April 2005. Discounting that anomaly, however, this product class enjoyed the same sort of growth as did structured products overall, and thanks to strong client volume it may be one of the biggest winners in 2006.

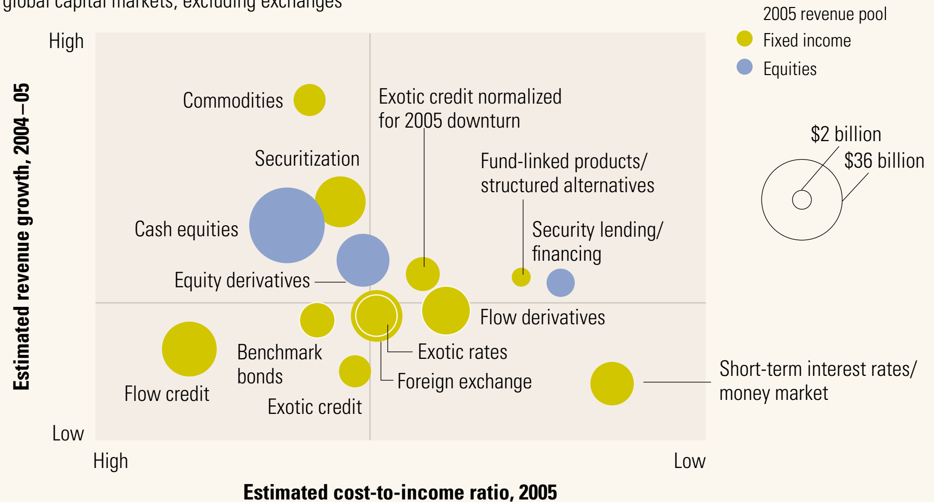
Foreign exchange performed strongly as well, and is an unlikely neighbor to some structured products seen in Exhibit 4. More than half of all global foreign-exchange revenues were generated in Europe, and risk-driven revenues grew more than twice as fast as client revenues, a trend particularly acute for globals, aspiring globals, and major regionals.

Exhibit 4

All over the map

At the level of individual products, growth and profitability trends diverge.

For global capital markets, excluding exchanges



Source: *Global Capital Markets Survey*, McKinsey, 2005; *Global Capital Markets Survey*, McKinsey and Coalition Index, 2006; McKinsey analysis

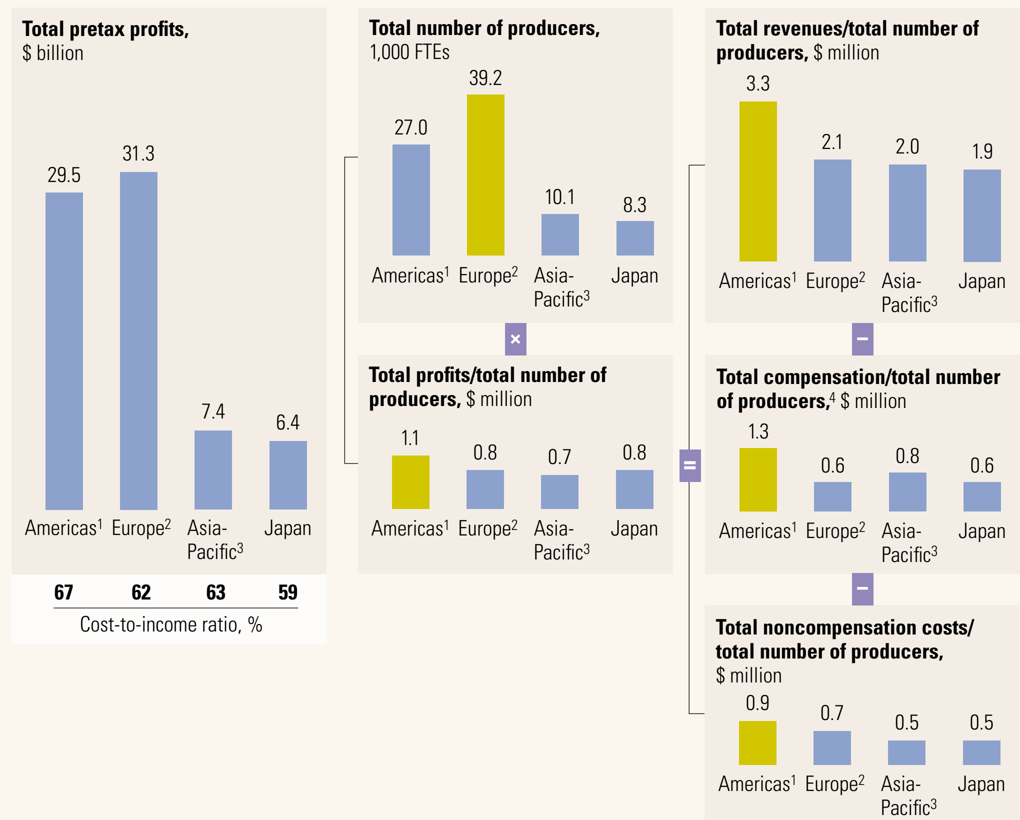
The growth in foreign exchange and many structured products was nevertheless eclipsed by the performance of cash equities, which continued to reap the benefits of the bull market on both sides of the Atlantic (although Europe ultimately enjoyed stronger revenue growth in cash equities than the Americas did). A higher-than-average cost-to-income ratio, albeit blended with associated securities lending and financing revenues, reflects the continuation of structural pressures arising from regulation—for instance, unbundling and the European Union's Markets in Financial Instruments Directive (MiFID)—technology, buy-side behavior, and new competition (see "Surviving the squeeze in cash equities," in this issue).

Exhibit 5

The economics

The Americas, Europe, and Asia-Pacific use different formulas to make money.

Global capital markets, 2005



[1] Includes North, Central, South America.
[2] Includes Europe, Middle East, Africa (EMEA).
[3] Excludes Japan.
[4] Includes nonproducer compensation, therefore does not equal compensation per producer.

Source: *Global Capital Markets Survey*, McKinsey and Coalition Index, 2006; McKinsey analysis

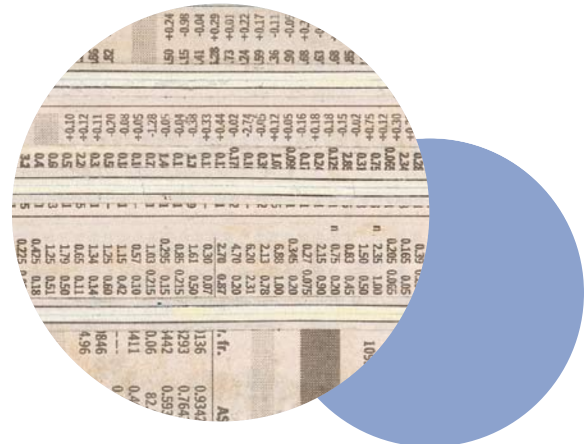
Flow credit struggled, ending the year as the only product category with a cost-to-income ratio in excess of 100 percent in Europe, notwithstanding the boost from flow credit derivatives. This poor result mostly reflects the labor-intensive but tight-margin debt capital markets and credit-bond-trading businesses in a complex European market.

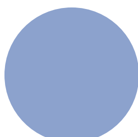
Surprisingly, benchmark bonds seemed to fare better, thanks largely to a healthier US market and the prominence of national champions in Europe. The latter can hardly be described as category killers, but they managed to leverage lower compensation costs, while globals, aspiring globals, and major regionals carried a less competitive cost structure.

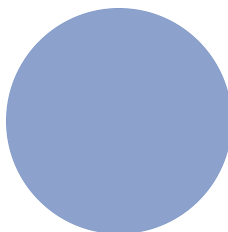
Finally, many players were able to extract significant value from two low-growth but highly profitable cash cows. European national champions, endowed with valuable midsize corporate franchises, were especially successful in flow derivatives. Short-term interest rates and money market products also remained highly profitable. Here, slowing growth in clients' revenues was at least partially offset by growth in risk-driven revenues, courtesy of links to the treasury activity of universal banks. Moreover, not only was productivity high, but compensation levels per head were the lowest of all product categories.

Different formulas for making money?

The impressive revenue performance filtered through to the bottom line of most survey participants, and average cost-to-income ratios of 64 percent gave the industry an overall pretax profit, excluding exchanges, of $75 billion in 2005. Europe's $31.3 billion in profits edged out those of the Americas, at $29.5 billion (Exhibit 5).







More intriguingly, the different regions used very different models to achieve a similar result. The Americas, for example, has far fewer producers than Europe, but they are far more productive. That said, compensation levels were sharply higher in the Americas, with producers there earning on average nearly twice as much as their European counterparts. Noncompensation costs were higher in the Americas too, with spending by the globals, especially for IT, skewing the overall cost mix.

Implications

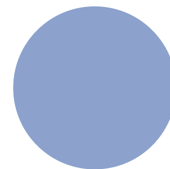
The Global Capital Markets Survey highlights many important strategic questions. In our view, three stand out as the most urgent.

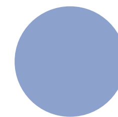
Evolution at work

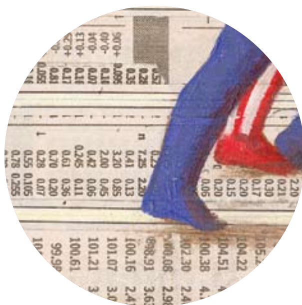
The Americas is a mature market where 63 percent of revenues are generated by globals that control major asset classes such as credit and cash equities. This market continues to grow through cutting-edge innovation, the development of low-cost platforms, and scale.

For a long time, analysts have wondered whether Europe would follow a similar evolutionary course. Despite Europe's fragmented structure and abundance of national champions, would the endgame be another oligopoly of giant capital markets powerhouses?

Recent history, confirmed by the survey results, suggests otherwise. Instead of the largest animals feasting on the small, national champions and major regionals have continued to defend their market shares. The past year might even mark a new direction with several high-profile mergers of European national champions, such as that of Bank Austria Creditanstalt, HypoVereinsbank, and UniCredit. These could eventually develop into European major regionals with an unusually broad home market franchise. A similar trend is apparent from the way Europe's major regionals are buying nationals (for example, BNP Paribas acquired BNL). These mergers effectively put major-league product capability to work in an extended franchise.







Will this new class of player be able to thrive and proliferate as the globals continue their quest for domination? The answer may lie in the economic makeup of the different types of banks. Our research shows that, thanks to sharply lower compensation costs, national champions have by far the lowest average cost base, with a cost-to-income ratio of 43 percent in contrast to 68 percent for the larger players. Of course, the revenues of these nationals were dramatically lower too: globals, as well as aspiring globals and major regionals, have been able to take their much higher earnings and invest heavily in more productive IT.

Early signs suggest national champions that combine forces are able to make a quantum leap in revenues by ***broadening their home market*** *across borders*

That could be a barrier to further growth for less technologically sophisticated companies. Early signs suggest national champions that combine forces are indeed able to make a quantum leap in revenues by broadening their home market across borders, but will they be able to preserve their low-cost formula? They may be forced to compete in a technology and compensation arms race with their larger competitors. The globals, in contrast, continue to build their distribution capacity in continental Europe, with some beginning to take bigger shares of national markets. New regulations, such as MiFID, may undermine some of the traditional advantages of national champions, to the benefit of the globals and Europe's major regionals.

Evolution is clearly at work in Europe. The reigning species of the next decade has yet to emerge.

Bets in Asia

The emerging-markets story, as indicated earlier, is one of building for the future. The question is where bets should be placed. Investments in Asia (mainly in Greater China and in India, but excluding Japan), Eastern Europe, Latin America, and the Middle East have been well publicized of late, but should globals and aspiring globals plant seeds in all of these developing markets or tactically invest only in regions where they feel their core competencies and competitive advantages can be exported? Here we explore the case of Asia (see also "A localization strategy for Asian wholesale banking," in this issue).

In Asia, many markets have been closed or partly closed by exchange controls and other regulatory restrictions. As a result, the Asian marketplace is fragmented, with a smattering of local banks and only a very few pan-Asian players, plus global giants that are focused on the major hubs (for instance, Hong Kong, Singapore) and large privatization programs (China).

That said, Asia (excluding Japan) now captures more than half of Asia's total capital markets revenues, and long-term market trends remain highly favorable. Most economies are experiencing rapid GDP growth, which should drive the expansion of capital markets. In other, more mature markets, for example, revenue pools typically grow at 1.5 to 2.0 times the growth of GDP. Future capital markets growth is also likely to be driven by the liberalization of domestic

markets where the most lucrative opportunities are likely to be found.

This development will favor a new breed of local competitor likely to emerge in the wake of the deregulations of individual markets. Global banks will no longer be able to rely solely on the traditional regional-hub approach. They will prosper only if they develop a clear localization strategy, especially in fixed-income, corporate-bond, and foreign-exchange trading.

Japan is an interesting anomaly—an economic powerhouse disguised as a developing capital market. Although Japan's GDP per capita is one of the highest in the world, its capital market revenue is only 36 basis points of GDP, placing the country midway between developed and emerging markets.

After a big sleep over the past decade, the Japanese equities market is coming back to life, accelerating interest in equity derivatives. The credit market is expanding, with an emphasis on solid credits rather than nonperforming loans (NPLs). Investments in credit derivatives and securitization products are also on the rise. Hedge funds, while relatively few, are growing, thus increasing the need for prime brokerage services. Local and global giants alike are bulking up to meet this demand, with Japanese banks controlling corporate relationships and foreign players leading the charge in niche markets, including securitization. Across asset classes, Japan is poised to grow at a pace in line with its less-developed neighbors.

How risky are trading revenues?

Risk is the lifeblood of the industry, and a general perception in the markets is that banks are assuming more of it. Many top players have recently stepped up their proprietary activities and overall levels of value at risk, and as a result, they appear to be earning higher returns. There may still be niches where risk-free or low-risk structuring gains and markups can be achieved, but conventional wisdom has it that the larger players are becoming more aggressive.

The research suggests that both client-driven and risk-driven revenues on the sell side enjoyed growth rates of around 20 percent, taking the latter to $17 billion in Europe in 2005 and the former to a surprisingly large $68 billion.[3] That split broadly reflects the position of globals, aspiring globals, major regionals, and some national champions, though other, smaller banks had a higher concentration of risk revenues.

Some banks are undoubtedly shifting a portion of their risk taking and revenue outside capital markets to areas such as proprietary investments (take, for instance, UBS's carve-out of Dillon Read Capital Management and the forays of Goldman Sachs and others into pension fund buyouts and investments in physical energy). Moreover, measuring client value remains more an art than a science, with many institutions seeking to improve the consistency of their methodology. But neither of these factors begins to explain the dominance of client revenues.

For most players, it would seem, capital markets are primarily a client business, not a proprietary trading shop. The survey results therefore show why client franchise building and delivery should be a central strategic imperative for any leader in capital

[3] Client-driven revenues are fees and commissions, but most of these revenues were captured as markups and spreads as measured through sales or production credits. Risk-driven revenues include dedicated proprietary trading that is delinked from customer business, as well as the substantial residual revenues beyond sales and production credits.

markets. Although client volumes and risk performance are both inherently volatile, a deeper question arises as to whether capital markets activities actually generate revenue streams that are more stable than usually assumed. Indeed, if the implied downside of risk revenues is not as great as everyone thinks, do capital markets activities not merit higher P/E multiples than the market is currently awarding them?

The Global Capital Markets Survey sheds light on the structure and conduct of a dynamic industry. It shows that multiple combinations of products, geographies, and business models compete to create huge value. It also shows that evolution is still at work in the competitive landscape, that new geographies present new opportunities and fresh challenges, and that this business is still primarily customer driven and needs to be managed as such. We will continue to track the industry's performance and investigate key trends with the 2007 survey. **MoCIB**

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