Transforming investment banks

Building a better working world

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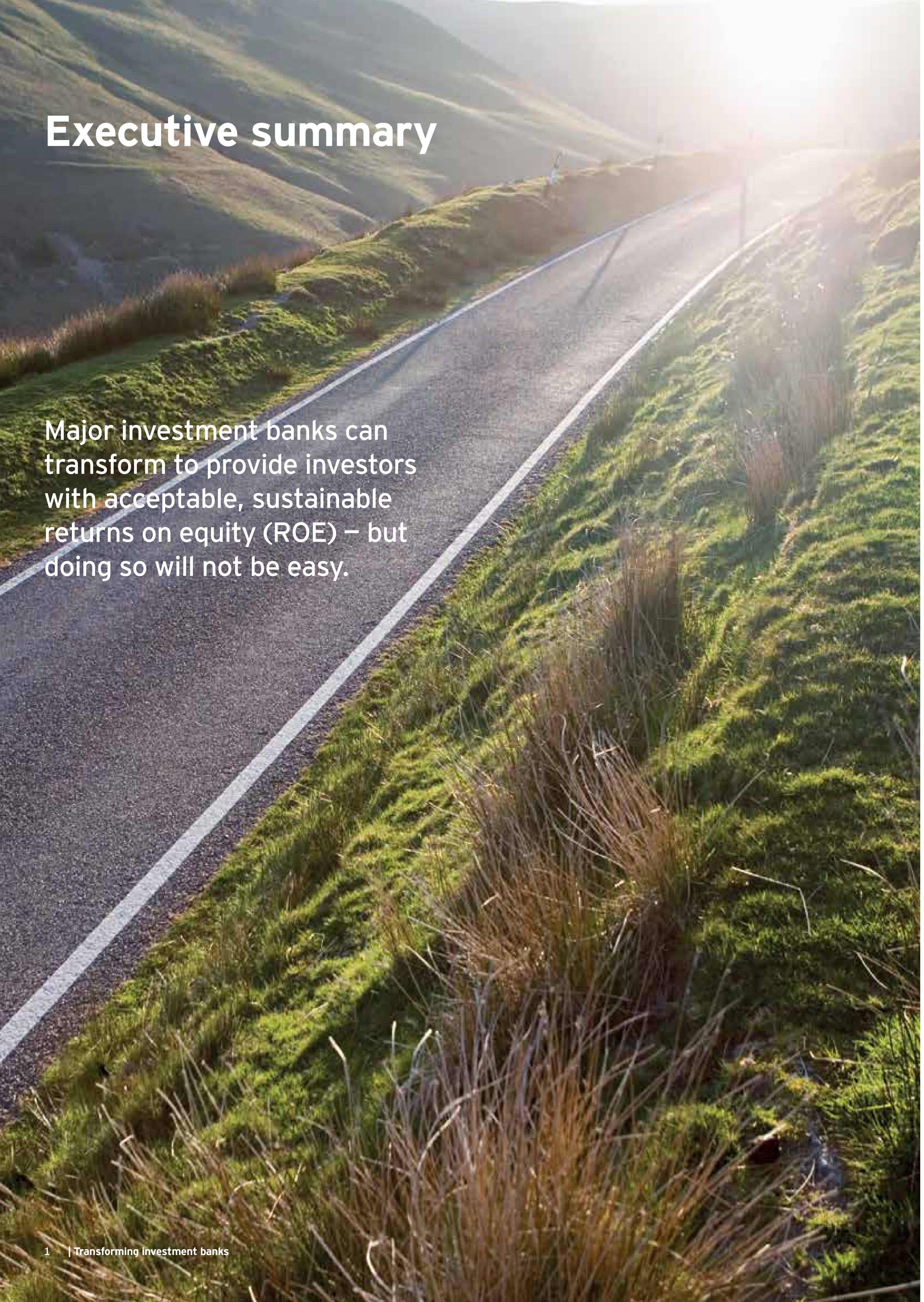
Executive summary



Major investment banks can transform to provide investors with acceptable, sustainable returns on equity (ROE) — but doing so will not be easy.

The industry's current approach to change is tactical and piecemeal. It is not enough to rebuild the industry.

Investment banking[1] is an industry in turmoil: it faces an efficiency and productivity crisis, with low ROEs, rising costs and stagnant revenues. It faces a cultural crisis, with little evidence banks have taken all the necessary steps to address controls issues and change employee behaviors to prevent future charges of misconduct. It faces a crisis of trust, with claims that banks have put their profits before the needs of their customers.

A raft of incremental change programs has done little to address these issues, and investment banks are a long way from solving the complex array of challenges they face. To do so, they will have to be more strategic and sharply focused on transforming their business.

The boost to industry ROEs in the first half of 2015 — a result of temporarily increased market volatility and quantitative easing by the European Central Bank — may prove short-lived. In fact, ROEs may fall further still, with regulatory pressures driving up costs and little prospect of sustained revenue growth. At the same time, competition is intensifying as commoditization and technological advances open the market to new, more nimble institutions able to deliver better service to clients that are now less loyal, more demanding and more sensitive to price.

By focusing on the four pillars of change, the leading investment banks of tomorrow will be:

- **Efficient —** with industry-leading cost-efficiency and productivity levels and optimized use of capital, liquidity and leverage
- **In control —** minimizing fines and losses, with leading compliance and risk capabilities
- **Trusted —** with a reputation for exemplary conduct and putting clients first
- **Digital —** with improved client technology and more digitalized processes, enabling superior service levels to win new clients, and increasing the profitability of existing clients

Only by adopting a more transformative approach will it be possible for the industry to thrive once again.

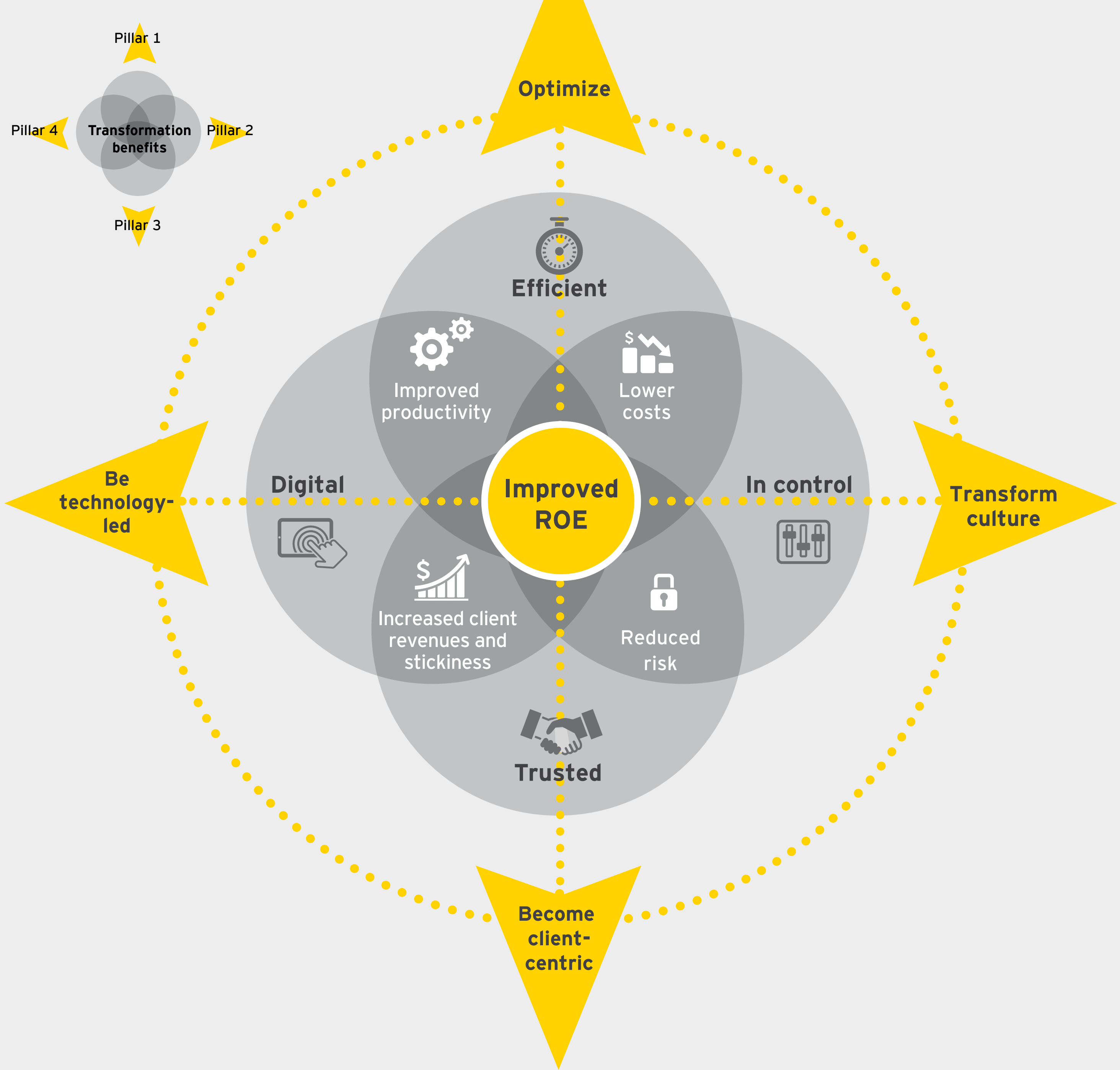
We believe the industry should be able to achieve sustainable returns on equity of 12% to 15%, but delivering this will require an unremitting focus on transforming existing business and operating models, focusing on four pillars of change:

1. **Optimize —** both assets and operations — by better utilizing balance sheets and radically reducing costs
2. **Transform culture —** by providing incentives for the behaviors that will deliver value for shareholders and clients while meeting regulatory expectations
3. **Become client-centric —** moving away from product-centric approaches by putting the client at the heart of business and operating models
4. **Be technology-led —** embracing innovation that will enable the transformation of legacy processes, re-architecting to support business model change and enabling a central focus on clients

1 This report defines investment banks as bulge bracket investment banks, including the investment banking (i.e., sales and trading, advisory and origination) arms of large universal banks.

Pillars of change

Figure 1: The pillars of change support the path to improved and sustainable ROE

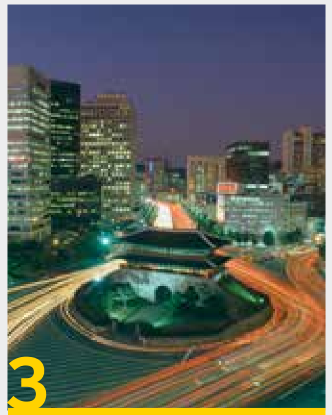


Pillar 1: optimize assets and operations

- **Business-line and entity optimization**
  - Rebalance portfolios
  - Exit non-core business lines
  - Rationalize legal entities
- **Asset optimization**
  - Further risk-weighted asset optimization
  - Review collateral systems and processes
  - Examine third-party collateral services
- **Cost optimization**
  - Review and re-engineer key processes
- **Sourcing optimization**
  - Review existing sourcing
  - Determine role of utilities
  - Undertake vendor assessment and supply chain review

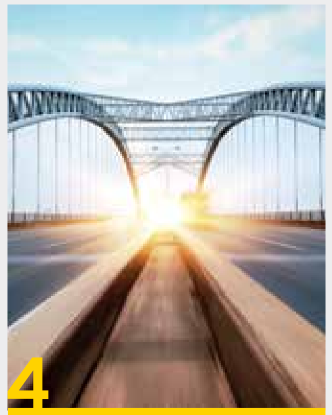
Pillar 2: transform culture

- **Identify drivers of behavior**
  - Reassess employee incentives
- **Establish best-practice behavior**
  - Set tone from the top
  - Establish clear accountability
  - Reward "good" behaviors
- **Reform hiring practices**
  - Enhance non-financial employee proposition



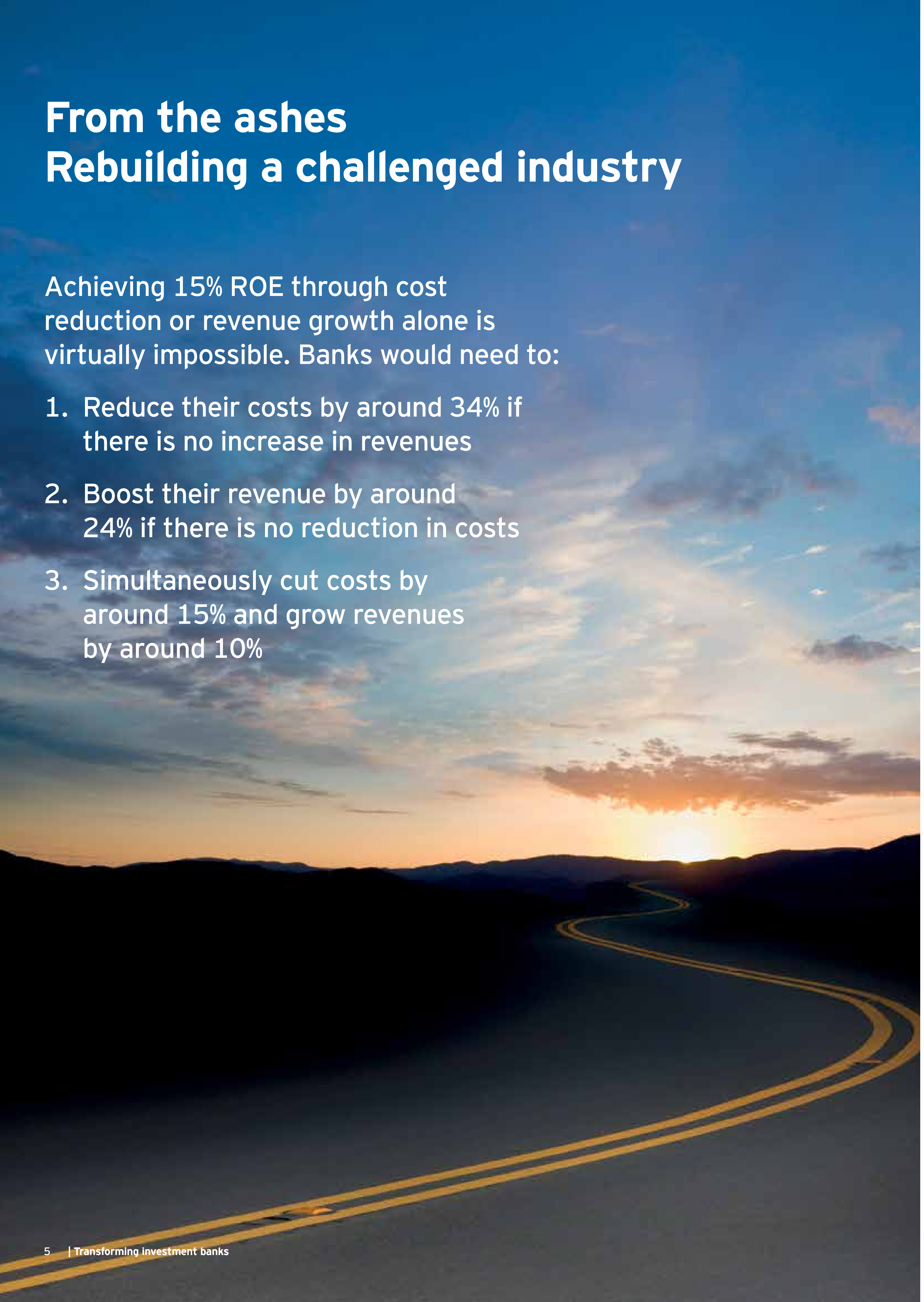
Pillar 3: become client-centric

- **Identify core clients and needs**
  - Undertake profitability analysis
  - Qualify what the most profitable clients need
- **Deploy client-satisfaction systems**
- **Enhance client experience**
  - Create "single shop-front"
  - Explore single portals



Pillar 4: be technology-led

- **Deal with legacy IT**
- **Optimize technology investment**
  - Reassign staff costs to technology spend
  - Re-invest savings on legacy technology
- **Invest in transformation of business**
  - Collateral and capital management
  - New trading systems and processes
  - Customer-centric solutions
  - Security and surveillance
  - Improvements in data quality and analytics



From the ashes
Rebuilding a challenged industry

Achieving 15% ROE through cost reduction or revenue growth alone is virtually impossible. Banks would need to:

1. Reduce their costs by around 34% if there is no increase in revenues
2. Boost their revenue by around 24% if there is no reduction in costs
3. Simultaneously cut costs by around 15% and grow revenues by around 10%

Transformation is not just about process and products; it is also about shifting mind-sets and cultural values.

The halcyon days of investment banking are over

The days of leverage-inflated, 20%-plus returns on equity are long gone [see Figure 2]. The once-lofty ambitions of management teams to deliver ROEs in excess of 15% have been moderated considerably. In some instances, banks are now targeting a 10% ROE — barely above their cost of equity. In others, banks have moved to a softer return on tangible common equity (ROTCE) measure.

Profitability is being destroyed

The commoditization and the move of many products to exchange trading are squeezing margins, while complex, high-margin products are falling out of favor and proprietary trading has diminished. Although investment banking revenues have stabilized around pre-crisis levels, a return to a more normal macroeconomic environment may see a further drop in revenues in business lines that have benefited from the extraordinary monetary policies of major central banks. Moreover, there is limited scope for growing new revenues to compensate for this. For example, new, non-modelable, products are virtually out of the question from a capital perspective.

Regulatory and compliance change has resulted in a structurally higher cost base

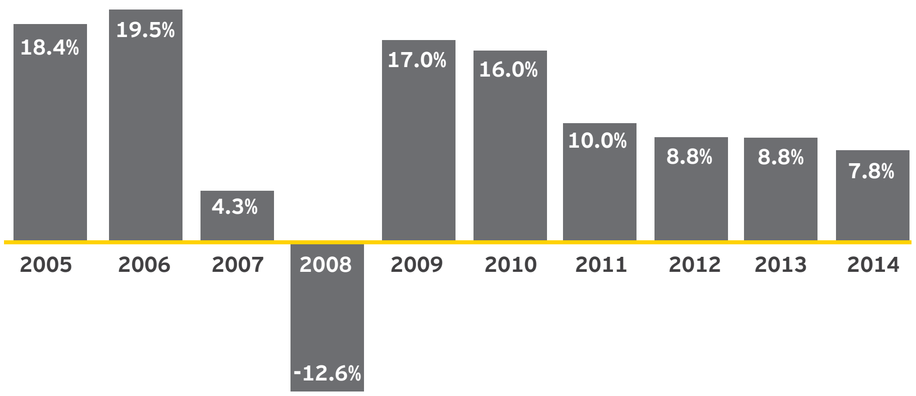
Aggregate costs for major investment banks were 25% higher in 2014 than they were in 2005 [see Figure 3]. Much of this additional cost has been driven by a tougher regulatory environment. Banks must adapt to a new capital and liquidity regime, over-the-counter (OTC) derivatives reform, structural change and transparency requirements, and to new investor protection provisions. The implementation costs of the Volcker Rule alone could be up to US$4.3b.[2] Regulations are having functional impacts on legal entities, business conduct, trade execution, reference data and trade reporting, yet all too often these new rules are not consistent across national borders.

In addition, banks have faced increased costs due to fines and significant trading losses as a result of a historically weak controls environment. Reducing costs by one-third would be an immense task.

And major investment banks are threatened by new competition

Institutions are now competing with buy-side clients such as hedge funds and private equity houses. They are also competing with boutiques and global custodians, and with financial markets infrastructure in the trading, clearing, settlement and reporting spaces.

Figure 2: Low ROEs highlight the significant challenge IBs face



Source: Company accounts, EY analysis

2 "Analysis of 12 CFR Part 44," the Office of the Comptroller of the Currency, http://www.occ.gov/topics/laws-regulations/legislation-of-interest/volcker-analysis.pdf, 2011.

Investment banks have entered "protect and survive" mode

Banks have responded tactically to regulation by trying to optimize capital, liquidity and costs – but this can hardly be considered efficient. Maximizing flow efficiency and establishing controls have emerged as priorities, with many investment banks significantly reducing asset costs and lightening the balance sheet. There has, however, been relatively little in the way of strategic response.

At a high level, institutions have redefined their priorities, with a broad industry shift away from capital-intensive fixed income trading activities toward fee-based M&A advisory and underwriting business lines [see Figure 4]. Those banks that were swift and bold in doing this have started to see some benefits. For others, there is still more work to do. However, whether retreating from non-core areas and aligning priorities to core capabilities can be considered a genuinely strategic decision remains debatable. For the most part, business portfolios are very similar to those of 2007.

Furthermore, most investment banks are still delivering tactical solutions that are often founded on broken models. A model in which the front office pursues revenues and profit in the hope that strong oversight from powerful control functions will protect the organization is no longer viable.

Delivering double-digit ROE will not be possible without more radical reform

Given the triple pressures of declining profitability, structurally higher costs and greater competition, traditional incumbents cannot hold back from more radical business reform. The next 24 months will be a critical time for strategy and change functions as they coordinate planning across business and technology. It is time to ask key questions about what institutions aspire to do and to be.

Investment banks must reassess their strategic objectives ...

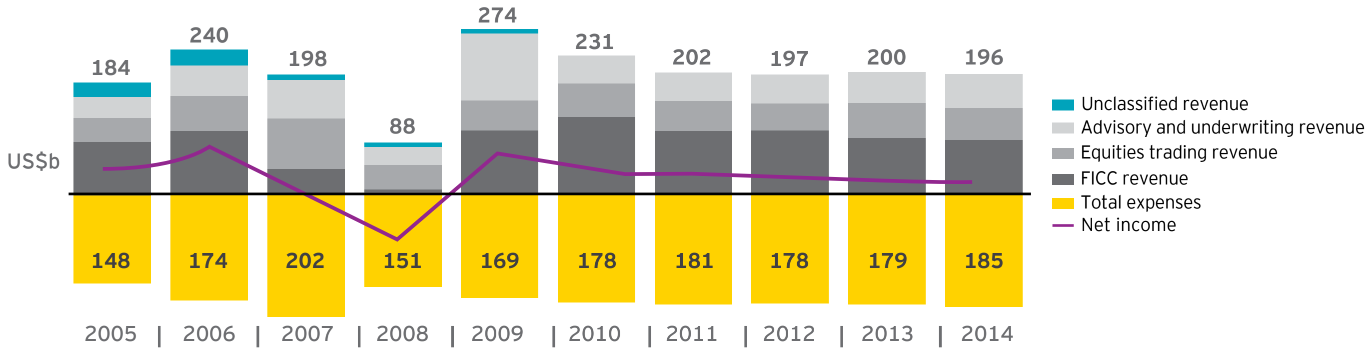
Investment banks must think about where they can obtain a competitive advantage in a world in which a full-service model is no longer a significant differentiator. In essence, investment banks need to ask, "What do we want to be?" and they need to answer in terms of the key principles by which they operate and the businesses they will serve.

... and focus on the four pillars of change to transform their business

Once investment banks have defined their strategy, they must optimize both assets and operations to ensure they are maximizing efficiency, productivity and returns. They must transform the culture of the organization to ensure that employee behavior does not incur the risk of fines or major losses and that staff are motivated by serving clients rather than by high salaries. They must become client-centric. Only by bringing an end to current operating models, which are designed to serve internal needs rather than those of their customers, can banks bring an end to the common perception that they tend to put their own interests before those of their clients. Finally, but critically, they must be technology-led. Banks must re-engineer their legacy technology and processes in order to deliver their strategic objectives. In an increasingly commoditized world, it will be speed and quality of execution that differentiate a bank across most business lines, rather than the skill of a star employee.

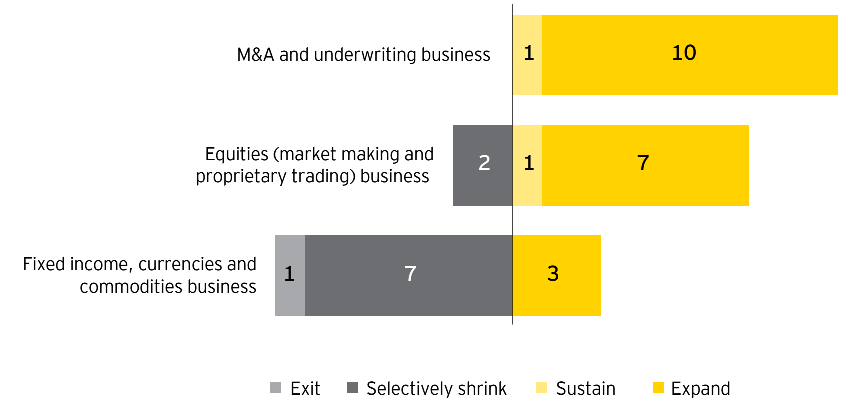
This program of transformation is not just about process and products; it is also about shifting mind-sets and cultural values.

Figure 3: Aggregate investment banking revenue and expense



Source: Company accounts, EY analysis

Figure 4: Announced changes in strategic direction for leading investment banks



Source: IMF Global Financial Stability Report, *October 2014, EY analysis*

Pillar 1
Optimize assets and operations

Though a handful of investment banks noticeably outperform their peers most banks struggle with productivity and efficiency.

The investment banking industry is suffering a cost and productivity crisis

By optimizing business lines and legal entities, assets, costs and sourcing, leading investment banks will be able to significantly enhance efficiency and productivity.

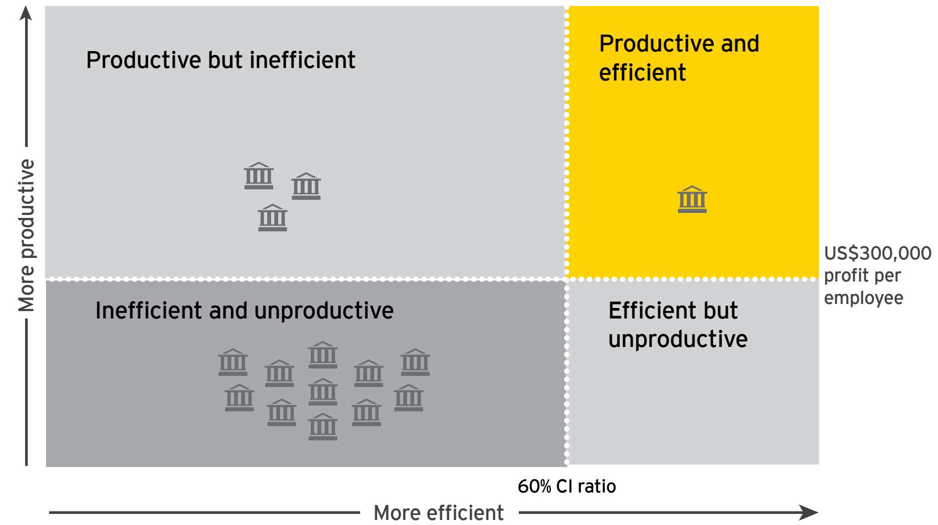
Over the last three years, only one investment bank has managed to achieve an average cost-to-income below 60% and annual profit per employee in excess of US$300,000 [see Figure 5].

This is because investment banks have traditionally preferred short-term approaches to cost reduction. But that is no longer enough [see Figure 6]. Faced with a structurally higher cost base, firms must be more creative and radical in their attempts to enhance efficiency and productivity.

There are four areas of optimization that banks must focus on:

1. Business line and entity optimization
2. Asset optimization
3. Cost optimization
4. Sourcing and shoring optimization

Figure 5: Investment banking productivity and efficiency, as measured by average profit per employee and cost-to-income FY12–14 (illustrative)



Source: Company accounts, EY analysis

1. Business line and entity optimization

Business-wide simplification will help improve performance

Many institutions have taken initial steps to simplify their business, rebalancing their focus across portfolios and exiting non-core or poorly performing business lines (although the full runoff of legacy businesses may take time).

The clearest example is banks' refocusing on the less capital-intensive primary markets (advisory and underwriting). However, as competition intensifies in this space, banks must do more to demonstrate their particular expertise in advising and underwriting. Not only must they show evidence of sector-specific expertise across various geographies and segments, but also their capabilities in capital allocation, syndication and distribution, and book-building. To circumvent balance-sheet constraints, underwriters must form alliances with more "sources of funding," including private equity houses, sovereign wealth funds, boutiques and insurers. Limiting balance-sheet risk will also require enhanced securitization capabilities, which will require investment in risk modeling.

Figure 6: Investment banking savings ambitions

	Savings ambitions (% of the running cost base)	
	Up to 20%	More than 20%
Short-term options (6 to 18 months to implement)	Budget cuts and cost avoidance Zero-based budget	Restructuring and perimeter change
Long-term options (18 to 36 months)	Lean and continuous improvement	Operating model change

Preferred investment bank options (yellow): Budget cuts and cost avoidance; Zero-based budget

Source: EY analysis

Legal entity rationalization can significantly reduce costs and risk

Further legal entity rationalization — of both special purpose vehicles (SPVs) and booking entities — can save banks millions each year. With investment banks operating tens of thousands of legal entities (including SPVs), at a "carrying cost" of up to US$600,000 per entity per year, rationalization can yield huge savings, including audit and filing costs, as well as governance, administration and operating costs. It can also reduce the cost of quality by reducing IT architecture costs and helping firms avoid unnecessarily rolling out new systems and performance improvement agendas across entities. Rationalization can also drive operational synergies through thoughtful placement of an institution's human capital, assets and operations. However, perhaps the most important driver for legal entity rationalization is the reduction of risk and complexity. It enables improved governance by enhancing transparency and developing a safer internal control framework, while a simpler entity structure is likely to better satisfy regulators that senior executives have a firm grasp of the overall business.

2. Asset optimization

Existing asset optimization initiatives will gather pace but are insufficient to improve performance differentially

Most investment banks have initiated portfolio optimization programs and the unwinding or restructuring of certain positions, or the sale of specific non-core, capital-intensive assets. In addition, banks are making efforts to rationalize product sets — although our experience suggests that many institutions still have too many variants of similar products, whose cost is too high and revenue too low, to justify them.

While we expect these initiatives to gather pace, we believe that banks need to go further to differentially improve their financial performance in an era of new capital constraints. Investment banking models must refocus existing finance functions to better manage capital and collateral requirements.

Banks must push the optimization of RWA further …

In our experience, even when institutions have already delivered risk-weighted asset (RWA) optimization programs, we have found that further savings of 15%–20% of RWAs can still be made. To date, we have seen organizations adjust their business models by resizing or removing parts of their business that are balance-sheet heavy, as well as internally rebalancing customer types, product portfolios and collateral eligibility as improvement levers. However, we believe that the optimization opportunity is undervalued by many investment banks, and our RWA benchmarking data confirms that a number of organizations still stand to realize significant improvements. We see three key areas that should be explored further for institutions to capitalize on savings.

1. **Data:** the finance and risk architecture of most banks has seen significant changes over the last decade, with decisions on change often favoring tactical fixes. This has resulted in issues with the quality and accuracy of data used in RWA calculations, which means the RWA values do not accurately reflect risk. For instance, missing or poor collateral data could lead to valid securities being considered ineligible and removed from RWA calculations. This will inevitably result in a higher RWA than the risk of loss from the counterparty defaulting.
2. **Models:** banks have always accepted that a proportion of their book would not be covered by their internal models. There could be legitimate reasons for this, such as data privacy laws preventing the collection of historical data, but in most cases, the reason is poor cost-benefit. The cost-benefit equation changes with the introduction of new permanent capital floors based on revised standardized approaches for the major risk types. Most banks have a portion of their book outside the advanced Internal Ratings-Based (IRB) approach and could explore the merits of extending their internal models to those assets.
3. **Regulatory and business process:** in a rush to comply with new regulations, banks have made compromises in their processes, such as manual interventions at various points, around RWA calculations. If, for example, a bank has a convoluted process to identify whether counterparties should have Credit Valuation Adjustment (CVA) RWA against them, generating a false positive result, this could result in the bank holding additional RWAs where they do not need to. This issue could be addressed with relative ease and would result in more accurate RWA values.

… review collateral systems and process capabilities

Banks are currently debating whether there is likely to be a shortfall in collateralized assets over the coming five years. By 2020, new regulations could increase demand by as much as US$5.7 trillion, in normal market conditions, and US$11.2 trillion in stressed market conditions.[3] Furthermore, the clearing system will need to attract about US$4 trillion more in collateral a year.[4]

Perhaps more significantly, however, institutions are likely to encounter difficulties due to a lack of collateral fluidity. Inefficiency in collateral management is a serious challenge for banks, exacerbated by poor collateral management technology and supporting processes. Although not a new challenge, this is one that has not seen a real step-change in practice. Consequently, we believe there are still opportunities for banks to reduce costs and even to use collateral as a revenue-generating lever.

Firms need to achieve collateral optimization and efficiency and clear trades in a manner that maximizes portfolio and trade offsets and aligns with effective counterparty credit risk management. Tools must identify the cheapest-to-deliver (CtD) collateral by looking up documentation, haircuts and so forth and then optimizing posted collateral. Our experience suggests that firms' processes (or algorithms) sometimes misinterpret eligible collateral or do not always post the CtD collateral or consent to collateral switches from counterparties looking to optimize their collateral. Collateral optimization engines must survey all current collateral requirements and the inventory of available assets, taking into account collateral eligibility, haircuts, substitution rules and concentration limits.

The reality is that many investment banks lack a well-established operating model and governance for collateral. Business and operating models need upgrading before collateral hubs can be developed and industrialized. Lines of business, products and trading desks will need to develop additional capabilities for margin modeling, netting and collateral optimization. There is a need for a common data and technology

3 *Office of Debt Management 2Q13 Report,* United States Dept. of the Treasury, http://1.usa.gov/1ISVvhn.
4 *Asset encumbrance, financial reform and the demand for collateral assets,* Bank for International Settlements, http://bit.ly/1ISVM3Q, 2013.

infrastructure for collateral, with monitoring of intra-day collateral use and maximum outflows.

In our view, the drive to optimize collateral inefficiencies will require significant investment from investment banks over the next 36 months as they overhaul existing technology and processes.

... and examine third-party collateral services

Optimization of collateral management will continue to be critical to enhancing the financial performance of banks. It is also true that the demand for high-quality collateral will remain high, but supply (access to and availability) of high-quality collateral will be more limited. We believe this will drive changes in the collateral business model and an increase in the types of collateral services offered by both existing and new players, such as utilities and consultancies.

While existing settlement-service providers will continue to provide new offerings and means of accessing collateral pools, we expect a new wave of market entrants to connect institutions with collateral globally, allowing them to track, manage and access their collateral across entities and across assets held at multiple venues. Though there are a number of investment banks and custodians offering new services, the market is yet to fully mature. A financial market utility that can offer such comprehensive service will see a sizable revenue opportunity and will acquire significant market share. Now is the time for investment banks to decide whether they wish to be such a service provider.

3. Cost optimization

Banks can release savings by reviewing and re-engineering key processes across the enterprise

We believe there are four key levers that banks should focus on to drive down "run-costs" across their organizations.

1. Adaptation levers: firms must ask whether they need to continue conducting particular activities and abandon or re-engineer them if necessary.
2. Quality levers: banks must consider the appropriate level of service for internal and external clients. If necessary, they should adjust the service quality, reduce the number of clients or reduce the frequency of interactions.
3. Productivity levers: banks need to ask who should be executing particular tasks and whether these can be pooled, decentralized or outsourced. Banks should also consider whether tasks can be simplified or automated and should do so wherever possible. In addition, they should look for opportunities to deploy technology as an enabler for staff.
4. Resourcing levers: institutions should explore whether the resources carrying out tasks are overqualified or underqualified, to maximize productivity and efficiency. On the basis of that analysis, they should consider training or redeploying certain staff or hiring new personnel if necessary.

4. Sourcing and shoring optimization

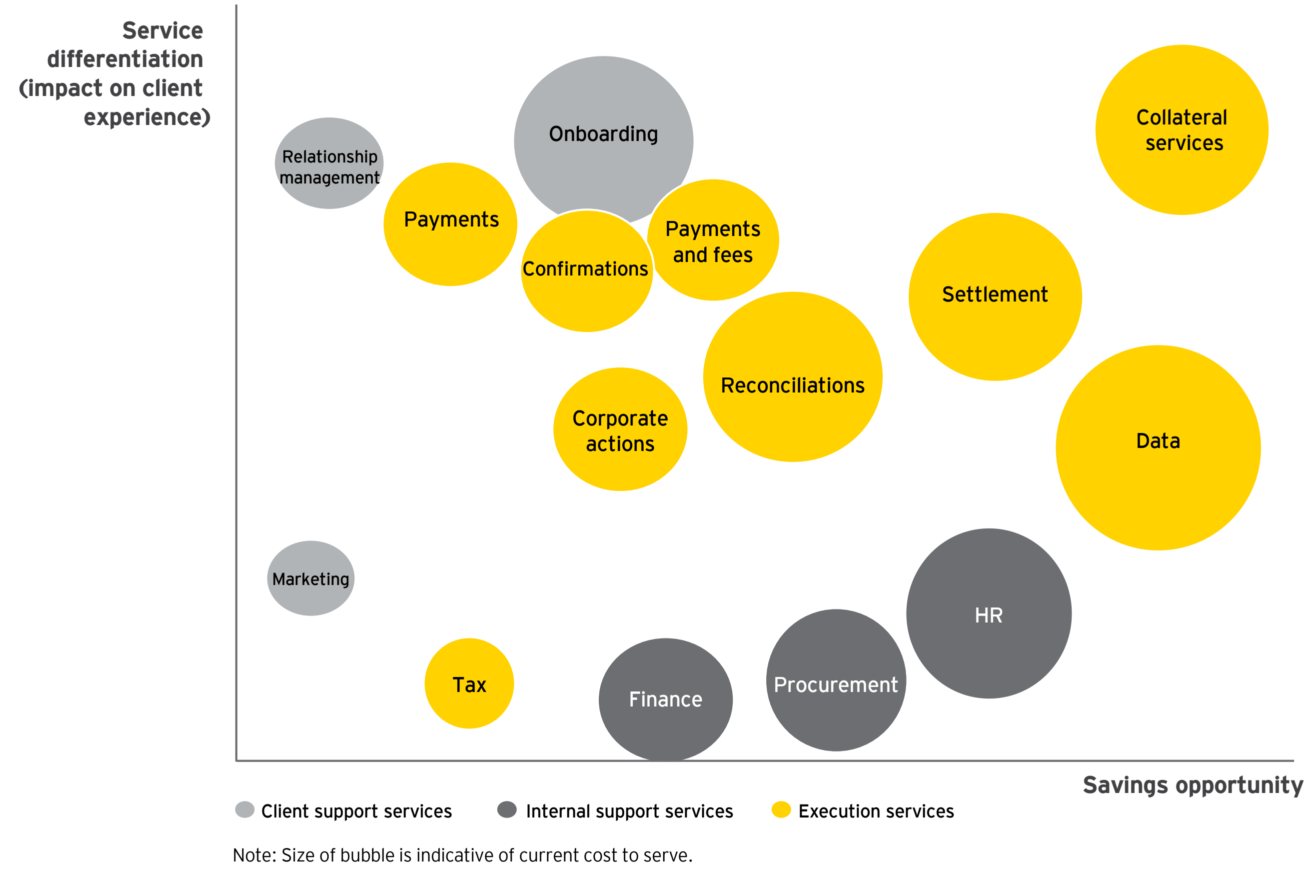
Revisiting existing sourcing options can help investment banks transform performance

Firms should consider whether certain activities are non-core and, if so, whether they really need to be delivered in-house. This should also include analysis of whether investment banks can better utilize group resources rather than relying on investment bank-only functions. Shoring strategies (on/off/near) should continue to be explored as viable means of reducing cost, but these strategies must also support the institution's ability to deliver a controlled, trusted and digital environment, as well as slimming down the organization. We have already seen a number of institutions relocate both back- and front-office activities from their head offices to lower-cost onshore locations where oversight is greater than with fully offshored alternatives. We expect this trend to accelerate.

Determining the role of utilities in the supply chain will also be critical to driving efficiency

We believe that cost constraints and an increased awareness that many services do not provide differentiation mean that banks will increasingly look to switch from a fixed-cost model for internally delivered services to variable, volume-based-cost services provided by a third party. This will lead to a range of common, "high-maintenance" areas, such as Know Your Customer (KYC) qualification, being undertaken by utility functions. Some banks may even generate revenue opportunities by establishing sector utilities themselves.

Figure 7: Supply chain opportunities



Source: EY analysis

At a minimum, investment banks should undertake a comprehensive vendor assessment ...

Firms should review their core and non-core processes to determine what overall efficiencies can be gained from reorganizing the supply chain. Simplifying a complex web of third-party relationships offers the potential to reduce both risk and cost significantly [see Figure 7]. We believe there are three key areas where supply chains should be reviewed as candidates for change.

1. **Client support services:** these are typically pre-trade front-office support activities that, while not directly revenue-generating, do have an impact on customer experience and thus can influence buying behavior. Such activities include onboarding, KYC, anti-money laundering (AML), customer relationship management and marketing.
2. **Internal support services:** these are activities that support the internal workings of the organization only and do not touch the client. Among them are HR, procurement and finance.
3. **Execution services:** these are activities that support the booking model and post-trade activities such as settlement, confirmations, collateral, data and tax.

… assessing each process to determine where and by whom it should be delivered

Banks should assess each process according to its level of industrialization, fragmentation, client sensitivity, need for proximity and operational risk. Understanding these aspects will allow investment banks to determine utility functions that can be outsourced or provided as a managed service and "sticky" functions that should remain in-house. Depending on the desired level of ownership and control of processes, a variety of sourcing models may be selected. For example, organizations may choose to offshore functions to third parties or establish their own captive centers. Alternatively, they may decide to use platforms developed in collaboration with peers, such as with the KYC utility shared-service model we have seen emerging.

Institutions must balance cost control with operational efficiency. In an attempt to strike this balance, we are now seeing near-shoring gaining ground. This approach to sourcing can reduce the complexity and risk of traditional offshoring, with reduced language barriers and cultural issues, closer collaboration between teams and better control of data security [see Figure 8].

Figure 8: Potential alternative sourcing models and ownership

		Pure offshoring	Captive offshoring	Joint venture	Build-operate-transfer	Outsourcing
Business processing		Exclusive	Exclusive	Shared with a local business partner	Owned, then transferred	Transferred
Infrastructure		Exclusive	Exclusive (with local partner assistance)	Shared with a local business partner	Transferred	Transferred
HR		Exclusive	Exclusive (with local partner assistance)	Shared with a local business partner	Owned, then transferred	Transferred
IT		Exclusive	Exclusive	Shared with a local business partner	Owned, then transferred	Transferred
Procurement		Exclusive	Exclusive	Shared with a local business partner	Owned, then transferred	Transferred
Costs	Set-up					
	Run					

Source: EY analysis

Pillar 2
Transform culture

Since the crisis, banks have suffered combined fines, litigation and major trading losses of US$104b.

Banks face a cultural crisis ...

Weak controls and employee behavior unaligned with delivering client and shareholder value have proven costly for investment banks [see Figure 9]. Furthermore, cultural issues mean banks are struggling to attract leading talent to their organizations. A recent survey showed that while 48% of the Wharton Business School's class of 2007 took finance jobs, only 25% did so in 2013. The investment bank of tomorrow will be one where culture and behavior are afforded the same importance as revenue generation.

Figure 9: Cost of control

US$104b

combined investment banking fines, litigation and major trading losses, 2007–14*

This is equivalent to:

2.8% reduction in annual ROE, 2007–14

6.6% of aggregate revenues, 2007–14

37% of aggregate 2014 revenue

*Additional fines have been incurred in 2015

Source: Company accounts, EY analysis

... but most attempts to change culture have been reactive "point" solutions

Senior executives are beginning to recognize the importance of transforming culture. In 2014, 66% of banks globally (and 84% of global systemically important banks) were working to change their culture.[5] However, it is unclear whether these exercises – generally launched in the immediate wake of fines, settlements and scandals – will be truly transformative or will merely address "optics." Reforms instituted by investment banks include admonishing employees for bragging and vulgarity on social media and banning employees from using expletives in instant messages, emails and texts. Furthermore, in an attempt to stem the loss of talent, investment banks have also resorted to tactical initiatives. "Lifestyle" programs that restrict the time employees can be at work appear out of touch with the millennial generation.

Banks need to look more closely at what is driving behavior

Although some banks are going further – establishing internal review committees to understand poor practices and establishing board-level committees of internal and external experts to address specific problems – truly transformative change must be founded on employee incentives. It is worrying, therefore, that while 74% of banks globally are focusing on enhancing communications about behavior, only 26% are thinking about adapting compensation to reflect softer cultural issues [see Figure 10]. This point was reiterated in EY's *2015 European Banking Barometer*: although 78% of the corporate and investment banks surveyed saw dealing with reputational risk as a key agenda item for the coming year, just 37% thought developing new remuneration systems, which are central to shaping behaviors, was particularly important.

Transforming culture – including employee incentives – is critical to winning back shareholder trust. This is particularly important at a time when

5 *Shifting focus: risk culture at the forefront of banking – 2014 risk management survey of major financial institutions*, EY, 2014.

estimates suggest that for every dollar paid to staff at a global bank in 2013, shareholders received just 25 cents, compared to 65 cents pre-crisis.[6]

Furthermore, EY analysis suggests that current incentive structures are not driving performance effectively. At an organizational level, pay per head is not correlated to employee productivity [see Figure 11]. Investors are asking when returns will go to the owners of the capital, rather than the providers of labor. However, changes to remuneration shouldn't mean cuts in pay merely to mollify investors and regulators, nor be a response to poor organizational performance. They must be an attempt to offer incentives for the right organizational culture.

Figure 10: Top initiatives to strengthen risk culture

Source: Shifting focus: risk culture at the forefront of banking – 2014 risk management survey of major financial institutions, EY, 2014.

Management teams must lead by example …

It is evident that investment banks must look beyond high salaries for ways to engage, motivate and retain talent and must transform their culture to align employee behaviors to clients' and shareholders' interests. This starts with the tone from the top. Top executives should articulate – and model – desired behaviors. Standards should clearly identify unacceptable behaviors and clearly communicate expectations firm-wide.

… hold people accountable for misconduct …

Words must be followed by actions. To embed cultural change throughout the organization, the right environment must be established. This requires accountability and clear definition of roles and responsibilities. Alongside strong risk governance practices, banks must establish a clear – and safe – protocol for escalating breaches. A culture of silence can no longer be tolerated. Therefore, banks must define specific and meaningful controls with consequences for culture breaches. Furthermore, consequences must be enforced, even if that means making someone an example where he or she might previously have gotten away with misconduct. Banks must establish robust internal communications and training programs to reinforce the culture and desired behaviors.

6 "Regulatory reform and returns in banking," speech given by Jon Cunliffe of the Bank of England, October 2014.

… and reward "good" behaviors

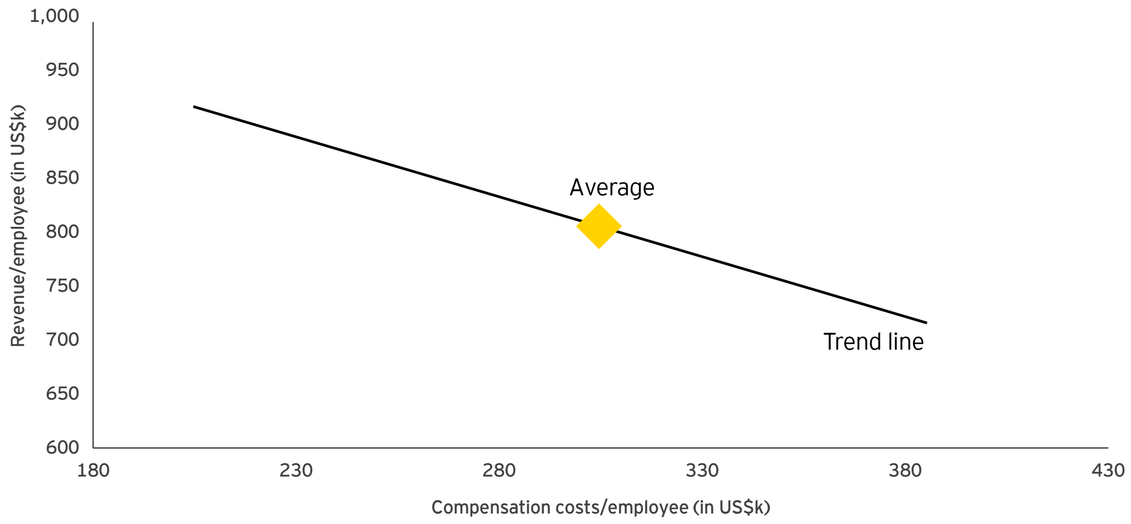
These changes are the bare minimum for banks. To truly change the culture, we believe banks must assign value to ethical behavior and attributes. They must replace the definition of the "successful" employee from one who generates revenues to one who generates revenues while also demonstrating ethical behavior, responsibility and accountability, as well as an ability to advocate for staff, collaborate and communicate. It is imperative that ethical leadership not be sacrificed for revenue generation. This will require banks to support desired behaviors. They must establish a clear link between desired behavior, promotion criteria and other incentives. This includes greater decoupling of bonuses and incentive compensation from front-office sales practices.

Finally, banks should reform hiring practices

Institutions must develop an employee proposition that will attract talent motivated by new cultural attributes, rather than pay, to make cultural transformation sustainable. Instead of increasing starting pay for junior bankers, institutions should explore other incentives, including internal recognition programs, mobility, secondments, education and training, as well as the time and opportunities to develop innovative ideas or work on cross-functional teams. The critical question for banks is whether they want employees who desire high salaries or employees who want to serve clients and deliver value to shareholders?

Only by transforming employee propositions are banks likely to rebuild the trust of stakeholders – to satisfy regulators and investors that their culture is being transformed.

Figure 11: Compensation costs per employee vs. revenue per employee FY12–14 (average)



Source: Company accounts, EY analysis

Pillar 3
Become client-centric

Investment banks are facing a crisis of trust.

"Investment banks do not operate in the interests of their clients."

Regrettably, that is a common perception of the industry [see Figure 12]. Although the public's view may not be the same as that of sophisticated investment banking clients, trust in investment banks has generally been eroded. Institutions have been criticized in high-profile investigative articles highlighting claims that banks willfully misled mortgage security investors, that the interests of clients have been sidelined, and that institutions are still ignoring conflicts of interest. This perception of large investment banks is impacting their business, and boutique firms are gaining prominence in some of the largest merger and acquisition deals. Boutiques advised on 22% of M&A deals globally in 2014, up from just 16% in 2007.[7]

We know that the global financial crisis and attendant scandals have eroded the relationship between clients and their investment banks. We also know that clients have diversified their relationships on the sell-side and often spread business across multiple firms as a means of securing the best price, as well as managing risk. Furthermore, it is clear that clients are demanding a much higher service level but are not willing to pay a premium for offerings that do not provide a clearly differential experience.

Figure 12: A crisis of trust?

In the UK, just 13% of people believe that those who work in investment banks in the City of London generally behave honestly.

"Public Trust in Banking," YouGov, http://bit.ly/1in8vhe, 2013

To regain trust, banks must put their clients at the heart of everything they do

To rebuild public, regulatory and client trust, investment banks must reflect on their primary purpose — serving clients.

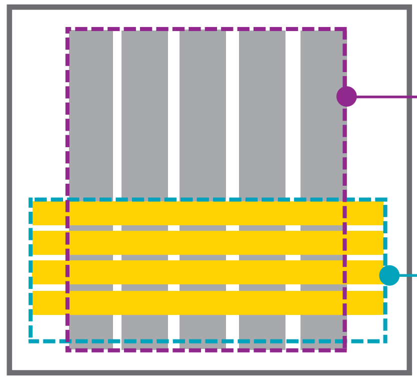
The challenge for banks in achieving this is that their traditional operating model, with its vertical asset classes and horizontal functional support lines [see Figure 13], is losing its relevance. It is a model drawn to reflect product priority and a business based on product innovation to drive the bottom line — a model unlikely to meet the future needs of the investment banking business. As we enter an era when client service and customer needs must be king, inflexible business models that serve internal needs, rather than those of clients, have no place if banks are to survive.

The key challenge for banks is how to shift from being product-centric to being client-centric while retaining the ability to innovate.

To start solving this problem, investment banks must first answer another question: which clients should we be serving? Many investment banks are already beginning to answer that question — in some instances, encouraged by pressure from politicians and regulators — by exiting certain businesses, such as physical commodities. Of course, reshaping a business on the basis of external factors and top-down pressures is one way to design a future business model. But we believe the question is best

7 Thomson One, EY analysis

Figure 13: The traditional investment banking operating model evolved from a focus on product innovation and business capability



(1) Product innovation:
- Evolving products to support revenue-making capability
- Innovation results in lack of price transparency
- Emergence of silos to support flow vs. non-flow booking requirements

(2) Business capability:
- Capabilities emerge to optimize increased support of greater product portfolios
- The need for flow optimization drives efficiency

Source: EY analysis

answered from the perspective of clients: it is the buying behaviors of clients that must inform the service model and front-office proposition of the future.

Banks must identify their core clients and their needs ...

To win and retain business, investment banks need to develop client-centric models that deliver what their clients want. To truly understand this, we believe institutions should analyze strategic lines of business to determine the top 20% of clients that typically account for 80% of profits. Having identified this client pool, they must determine, for each of those clients, what they need to do to retain and strengthen the relationship.

Institutions may argue they already do this. However, in our experience, banks are traditionally poor at understanding client profitability. Frequently, they use client revenues as their benchmark. This has led to a view that the industry should offer high-touch service to a small pool of large clients and degrade service levels for the remainder. We believe that a focus on the bottom, rather than the top line, may reveal that the dispensations banks have offered some of their larger clients have severely eroded their profitability.

Banks should recalibrate their services according to profitability, but should also recognize that if they can deliver lower-cost, higher-quality services to mid-tier clients, they may be able to acquire market share and grow revenues.

... improve systems to monitor client satisfaction ...

In our experience, unlike other industries that actively measure satisfaction, investment banks do not have a solution to do this. Tools like Heartbeat or Temper do not exist in the investment banking environment. Therefore, we believe that for investment banks to build enduring relationships with clients, it is critical to install permanent ways of measuring client satisfaction.

... and enhance the client experience by creating a "single shop-front"

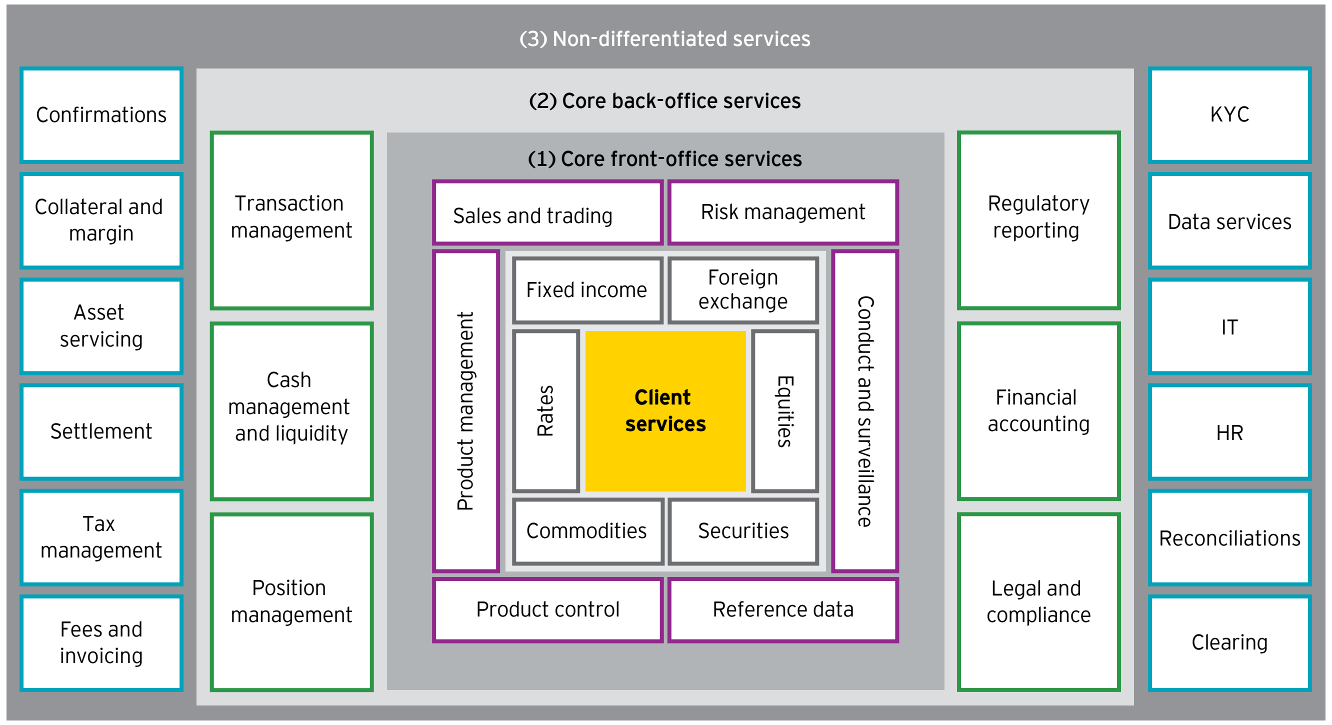
We believe that all clients will come to expect a single customer experience. Although a single customer experience has been discussed within the industry for a long time, it is difficult to see any radical changes that have occurred. Nevertheless, it is only a matter of time before customer demand forces change. There can no longer be traditional asset silos to serve clients individually. It is essential for banks to enhance internal communications across systems and processes to create a "single shop-front."

Some banks are beginning to move in this direction; however, they tend to be installing "veneer-only" solutions. For their customers, there is a feeling of connectedness as client portals visually represent cross-product portfolios. But underneath the veneer is a web of tactical fixes and solutions across systems, "grey" apps and manual processes to produce a pretty external picture. While, on the face of it, this begins to deliver the connectedness that clients are seeking, it is not a scalable approach. In the long run, such an approach is likely to be costly and introduce unnecessary risks resulting from the degree of manual intervention required.

Although not suitable for all, we believe some clients should be able to log into a single portal and see their cross-asset portfolios, monitor performance, access research and drill down to understand likely risk scenarios and predictions. Investment banks should look to other industries to learn lessons from their customer interfaces. For example, just as customers of large online retailers can see what other customers like them have purchased, risk management logic for investment banks should not be limited to individual portfolios but should provide a window into market activities, decision-making and predictive logic. Developing these abilities will require investment banks to invest further in analytics and offer clients predictive risk management functions. In the longer term, portals could even be connected to enable clients to link across bank portfolios.

Only by understanding their existing profitable clients and creating propositions that offer an enhanced customer experience will investment banks be able to build enduring relationships in an era when clients are less sticky. Those banks that evolve their business models from the outside in will be those that are truly client-centric and innovative [see Figure 14].

Figure 14: Future operating models must be client-centric (illustrative)



Source: EY analysis

Pillar 4
Be technology-led

Today, banks are people-led businesses. Tomorrow, they will be technology-led.

Employees are currently seen as a key differentiator for investment banks

One-half to two-thirds of costs typically are spent on staff. We believe that, with the exception of a handful of staff, technology will be the real differentiator in the future.

The traditional investment banking model has highlighted the importance of staff as a differentiator. In a more commoditized risk-averse future, the capacity of staff to innovate to drive revenues will be limited. Instead, cost-to-serve, speed of execution and quality of service will distinguish the leading investment banks. As a result, we expect that, beyond advisory and underwriting businesses, the largest share of costs in the future will be technology.

The transition to a technology-led business will not be easy, and budgets will be stretched

Investment banking systems are creaking at the seams. The last 15 years have seen some significant market restructuring, takeovers, business exits and volume increases, but investments in technology have lagged behind and IT departments continue to be under pressure to do more for less every year. Although industry IT spending typically rises by around 4% a year, the scale of the challenge for investment banks is so great that they will continue to be forced to do more with less. Furthermore, global banks typically spend about three-quarters of their IT budgets on systems maintenance rather than on investment.

We believe that through salary optimization, operating model efficiency and supply chain enhancements, banks can free up a further 5%–10% of their staff costs to reinvest in technology.

Even so, they must look for additional opportunities to reallocate spend from technology maintenance to investment. Moreover, as budgets continue to be stretched, investment banks need to make coordinated strategic decisions about where to invest in technology — which is critical to support changes in the business and operating models. Many of these decisions will have a knock-on impact on how the supply chain will be composed going forward.

Banks must invest to transform the business ...

We believe there are a number of key areas in which banks must invest over the next one to three years to support business transformation as they seek to optimize, transform culture and become client-centric and enhance profitability [see Figure 15].

Figure 15: IT investment pipeline (36-month budget horizon)

Spending theme	Dealing with legacy IT	Collateral and capital	New trading systems/ processes	Customer-centric solutions	Security, resilience and surveillance	Booking/ business model optimization	Improving data	Other
Expected budget spend	20%–25%	15%–20%	15%–20%	15%–20%	10%–15%	10%–15%	10%–15%	5%–10%
Expected profit impact*	5%–10%	15%–20%	5%–10%	10%–15%	1%–2%	8%–12%	8%–10%	3%–5%

*Potential cost reduction or revenue opportunity

Source: EY analysis

As already described, banks will need to invest in new collateral and capital systems and client-centric solutions. But they must also increase investment in improving data to give them a better understanding of the efficiency of processes and behaviors of clients. Furthermore, we believe there must be significant investments in controls technology, including investment in internal monitoring systems to track staff activities and communications to detect indicators of conduct breaches.

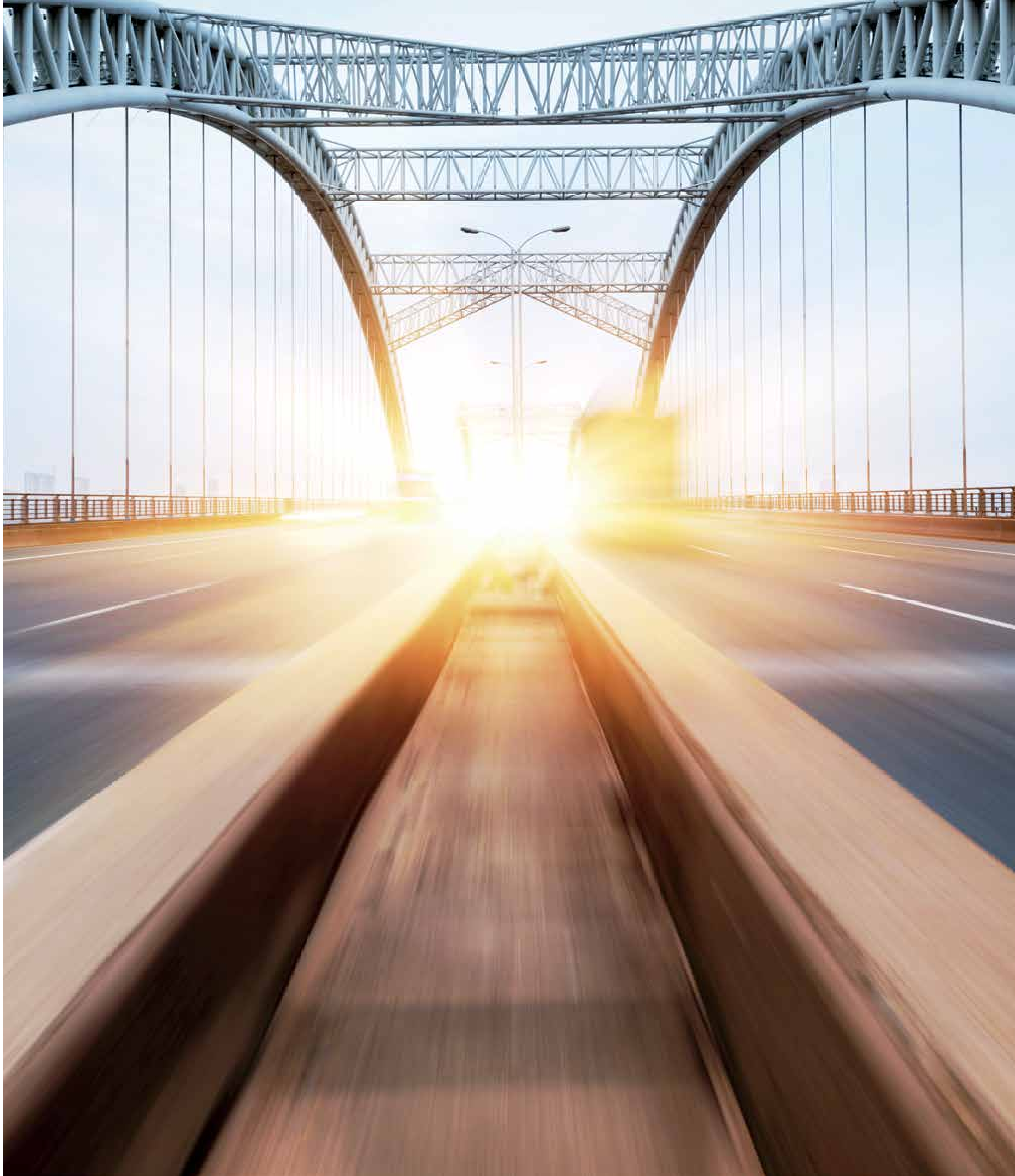
Banks will also have to invest significantly in combatting cyber threats and financial crime — now a key agenda item for investment bank management teams, with one major universal bank spending US$250 million enhancing cybersecurity capabilities in 2014 alone. We also believe there will be opportunities for banks to use social media and mobile technology to enhance organizational performance — for example, by supporting greater connectivity with clients or enabling staff to access information they need for their jobs more quickly and easily.

... but the most critical area for investment is dealing with legacy IT

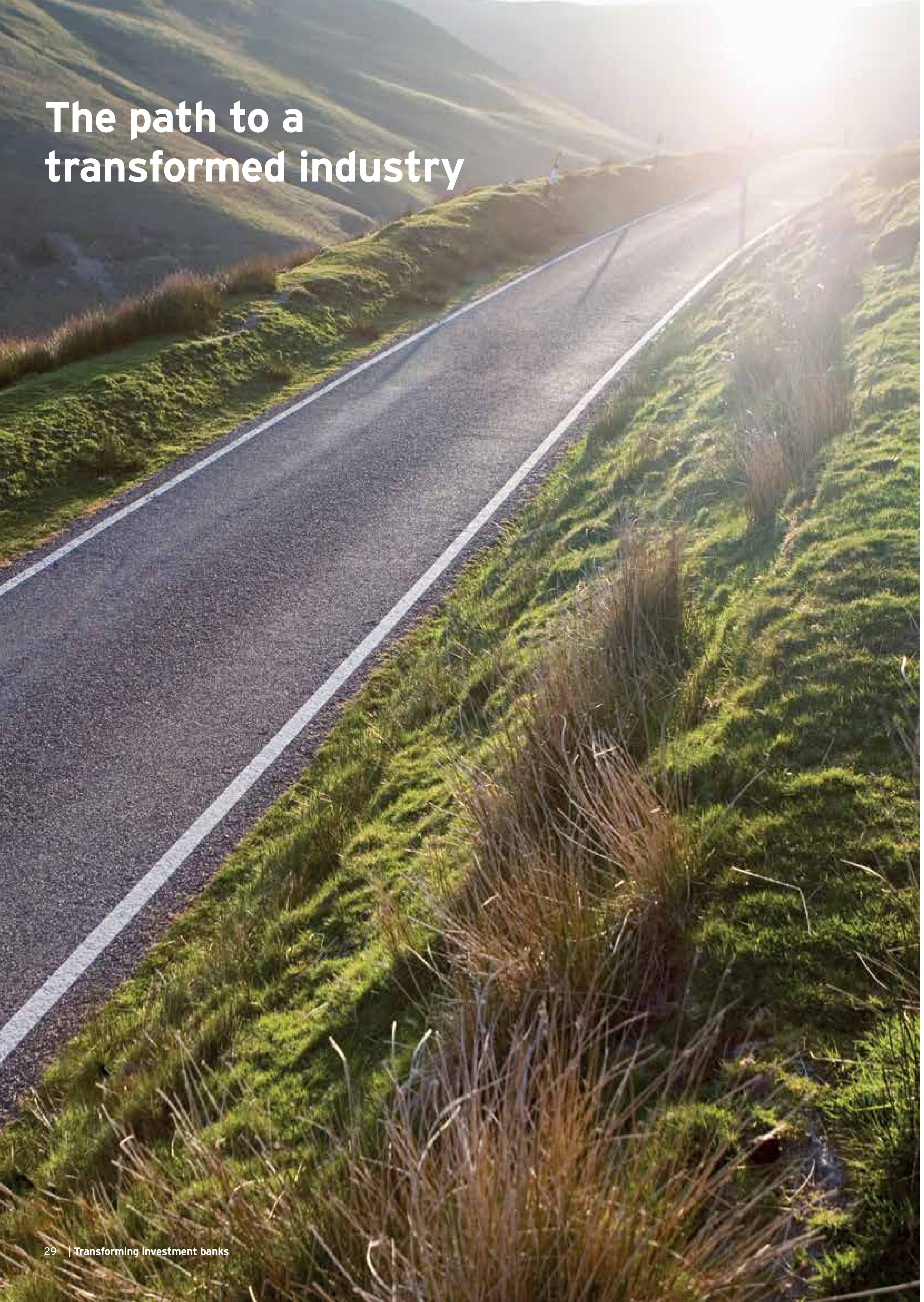
Investment banks are hampered by disparate systems, legacy landscapes and manual processes. This is a growing problem at a time when investment budgets are generally directed to short-term regulatory programs, with a small share allocated to mid- to long-term program and structural changes, including the evolution of legacy IT.

Looking over the next 36 months, investment banks will need to rationalize their technology architecture, integrating trading platforms and centralizing existing systems. In doing so, organizations must assess whether technology functions, processes and underlying services are best provided internally or externally. And if a particular technology is not a differentiator, then it should no longer be serviced in-house.

As banks come to grips with legacy technology, they will be able to reinvest cost savings in new technology to support wider organizational change. This is critical because being technology-led is not an end in itself: it is about technology enabling the bank to transform — to take control, to rebuild trust, to drive efficiency and to become digital.



The path to a transformed industry



We believe that investment banks can deliver sustainable, double-digit returns.

To deliver sustainable, double-digit returns, regardless of their business model, institutions will need to be in control, efficient, digital and trusted. Achieving this will require considerable investment and an unrelenting focus on four pillars of change [see Figure 16].

First, banks must optimize assets and operations. They must look for opportunities to make more efficient use of their balance sheet and optimize capital and liquidity, as well as take cost out of the business through simplification and innovative sourcing options.

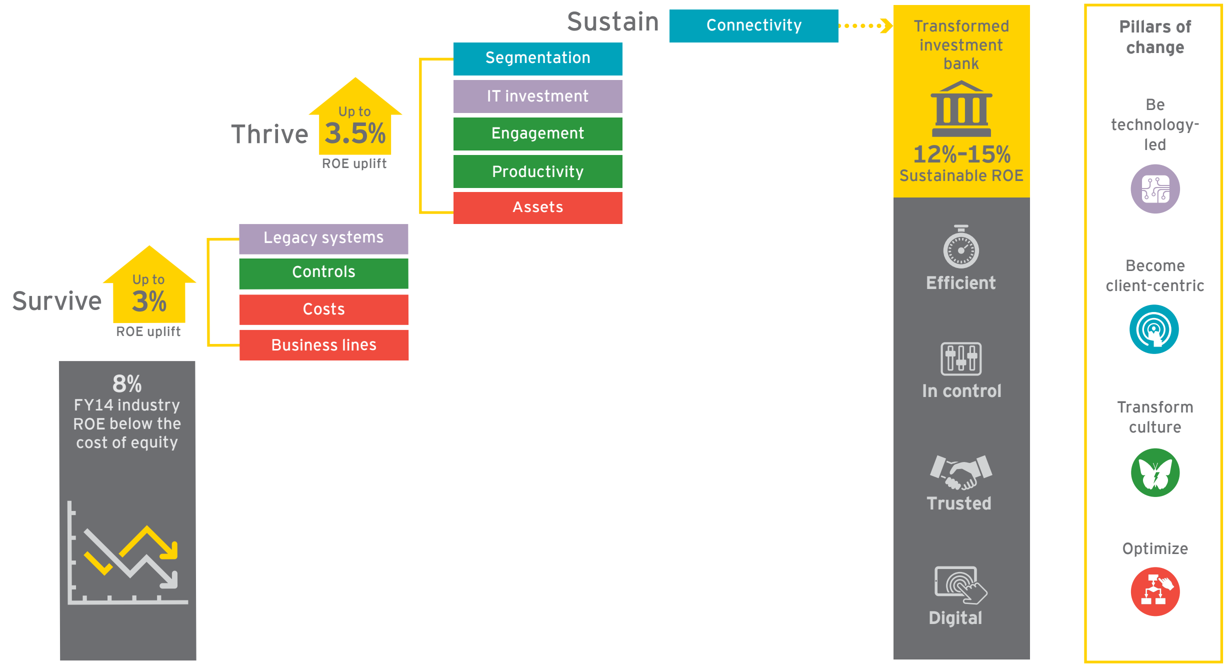
Second, they must transform the culture of their organization to rebuild stakeholder trust. This is critical to reducing future fines and losses from control failures. Banks must go further than setting the tone from the top and enhancing communications and training. They must fundamentally transform their employee propositions to recruit and retain the top talent while driving behavioral change.

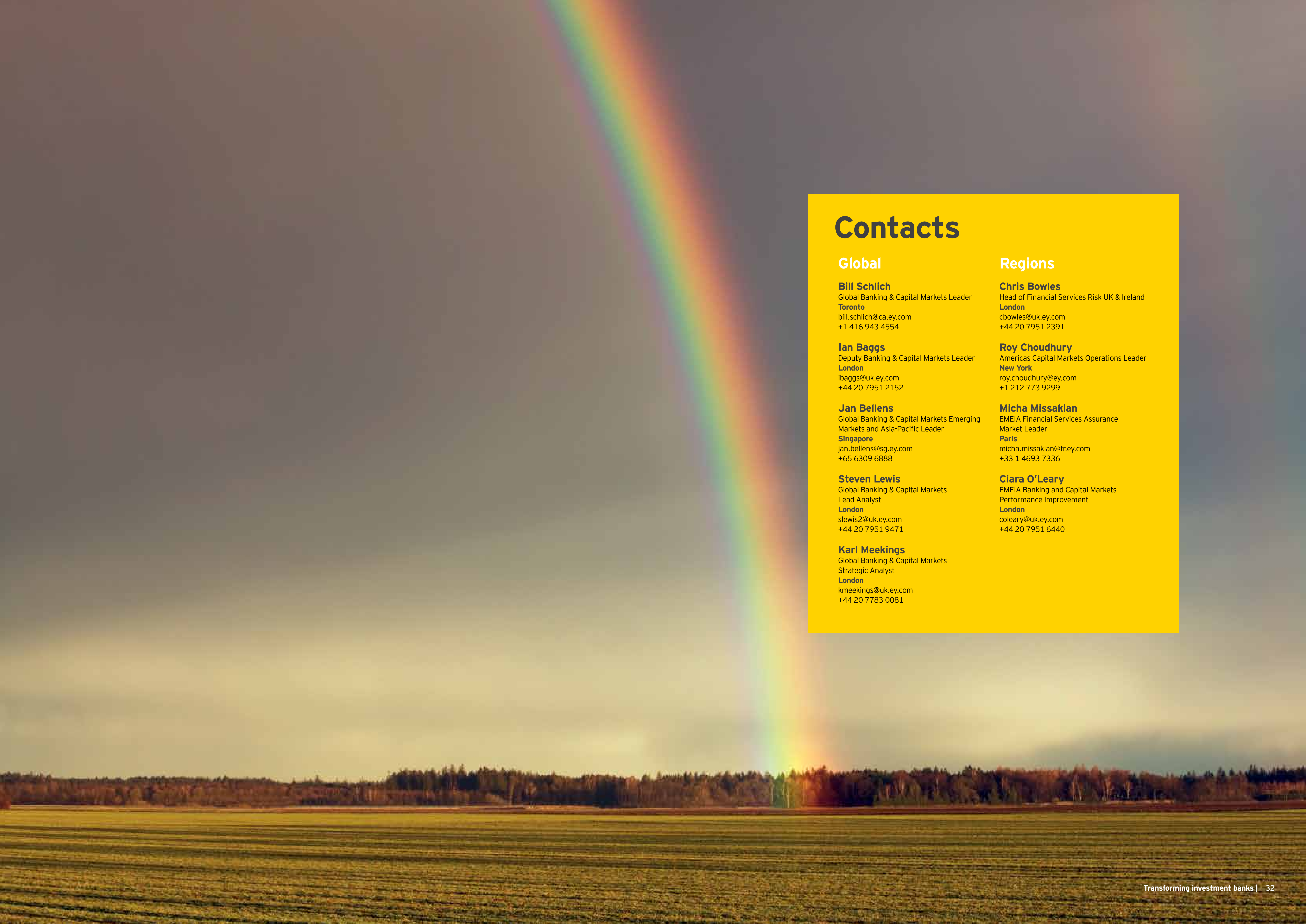
In addition to changing behaviors, banks must put their clients at the heart of everything they do. By being client-centric – understanding their clients better and tracking their satisfaction – they will be better placed to deliver value and enhance their own profitability.

Finally, they must invest in technology as a key enabler of business transformation. This will support optimization, cultural transformation and client-centricity as investment banks embrace digital transformation. Being technology-led means banks should not only look to rationalize systems and invest in technology to defend against emerging threats and drive efficiency; they should also look to adopt new technologies – such as mobile and social media – across the enterprise. Although the initial costs of a technology transformation may be high, it should enable banks to drive efficiency and reduce staff costs, allowing them to reinvest these savings in IT that supports transformation organization-wide.

The banks that do not just react to the pressures of the markets today, but adapt to them with an eye to the future, will be those that thrive in the long run.

Figure 16: Applying the four pillars of change to deliver sustainable returns





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