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Investment banks need to partner if they want to survive and grow

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As returns fall and costs stay high, the challenge for investment banks is not IF they need to partner with others, but HOW.

EY Head of Capital Markets UK, Pierre Pourquery and Emanuel Vila the UK Capital Markets Consultant, explain the different partnership models available and the substantive benefits they can bring to investment banks.

1. Once too big to fail are now becoming too small to survive

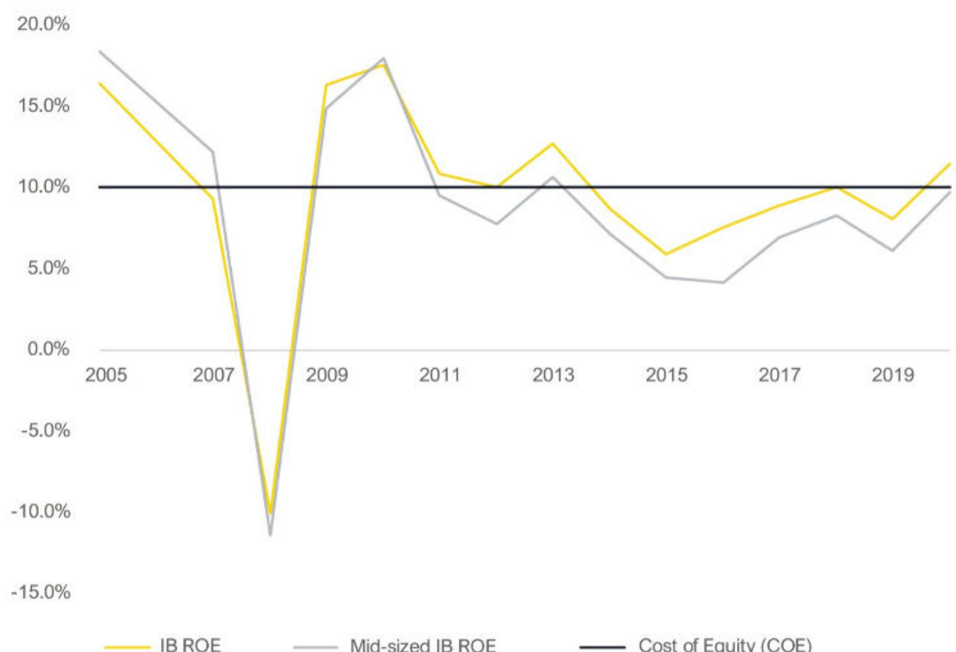
At the heart of the debate about the future of investment banking is the inescapable fact that investment banks continue to fail to cover the cost of their capital — with an average return on equity of 6-8%, against the cost of capital of around 10%.

As a result, since the crisis of 2008, we have seen some investment banks exit certain products or locations. We have also seen ambitious strategic cost-reduction programs, although these have largely failed to bring down costs significantly.

Something fundamental needs to be done and quickly by the banks as the status quo is not sustainable.

Front, back, middle office costs and technology investments remain too high for most banks. Critically, margins have fallen significantly as automation and e-trading have increased in use. We are now seeing this in Fixed Income, Currencies and Commodities (FICC) and Foreign Exchange (FX), while it has been the reality for some time in equity markets.

Investment banks with limited scale and high-cost income ratios, especially those part of a universal bank, are the most likely affected by this decline in profitability and must act now. Only those able to operate at a large scale — i.e. at lower cost



[1] EY Analysis - Average investment banking ROE (%) from 2005 to 2020, based on 16 banks across multiple sizes and regions. Mid-sized investment bank ROE is based on the average ROE from a sample of mid-sized investment banks.

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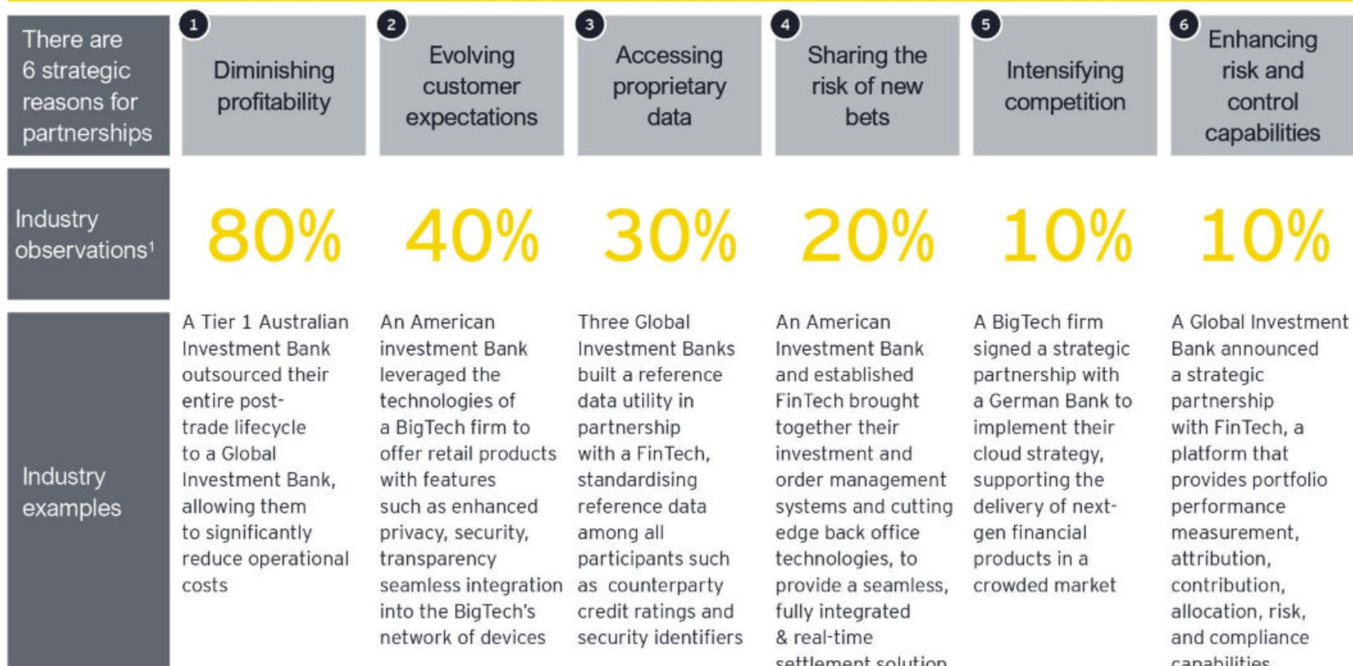
and for large volumes — will be able to survive unchanged. These large banks are benefitting from their significant market share, continuous investment in technology, underscored by large balance sheets, entrepreneurial culture, and the benefits of economies of scale.

For the majority of other investment banks, developing industrial partnerships, in the form of outsourcing, is probably the only way to continue their activities and to provide clients with the right breadth and quality of products. Without scale or outsourcing, they genuinely face being too small to survive.

We have seen strong financial performances in 2020, driven by market volatility. This has led to some temporary improvements in ROE, tempting some banks to shift their focus away from cost-reduction in the very short term. However, banks shouldn't be deceived by these short-term gains. The reality is they still face fundamental challenges (regulatory driven costs, intensifying competition, need for size and scale to price effectively, etc.) and partnerships will remain key to long-term success.



What are the main reasons that Investment Banks choose to partner?

There are 6 strategic reasons for partnerships	1 Diminishing profitability	2 Evolving customer expectations	3 Accessing proprietary data	4 Sharing the risk of new bets	5 Intensifying competition	6 Enhancing risk and control capabilities
Industry observations[1]	80%	40%	30%	20%	10%	10%
Industry examples	A Tier 1 Australian Investment Bank outsourced their entire post-trade lifecycle to a Global Investment Bank, allowing them to significantly reduce operational costs	An American investment Bank leveraged the technologies of a BigTech firm to offer retail products with features such as enhanced privacy, security, transparency seamless integration into the BigTech's network of devices	Three Global Investment Banks built a reference data utility in partnership with a FinTech, standardising reference data among all participants such as counterparty credit ratings and security identifiers	An American Investment Bank and established FinTech brought together their investment and order management systems and cutting edge back office technologies, to provide a seamless, fully integrated & real-time settlement solution	A BigTech firm signed a strategic partnership with a German Bank to implement their cloud strategy, supporting the delivery of next-gen financial products in a crowded market	A Global Investment Bank announced a strategic partnership with FinTech, a platform that provides portfolio performance measurement, attribution, contribution, allocation, risk, and compliance capabilities

[1] The conclusions made are based on 35 observed examples seen in the Banking Ecosystem between 2010-2020. Percentage represents the number partnerships that occur for that given reason (e.g., diminishing profitability). The strategic reasons behind partnerships can overlap (i.e., two banks can partner to reduce costs as well as deliver an enhanced service to their end-clients)

2. Cooperation not competition - Table 1 – A win-win for all parties

	The outsourcer can improve its margin by up to **2.5%** per client		**The outsourcee** can improve its margin by up to **100%**	
Revenue	+4%	**4%** increase as a result of access to partner banks flow	+5.5%	**5.5%** increase in business driven by more demand for improved services, more breadth of products, more competitive pricing etc.
Cost	+5%	**5%** increase in people, tech, ops and investment costs (see below)	-45%	**45%** decrease in people, tech, ops and funding costs (see below)
People	+2%	Setting up new client servicing teams, additional FO FTEs, trade support etc.	-50%	FO & eSales automation, reduced need for in-house trading and structuring etc.
Tech	+4%	Processing additional flows, operating across more regions, maintaining new systems etc.	-50%	Less spending on maintenance of platforms, market data access etc.
Ops (MO/BO)	+2%	Increased functional support to onboard clients, manage more risk etc.	-30%	Most ops outsourced to partner, reduced market risk spending, less complex financial reporting etc.
Funding (One-off)	+20%	Additional funding required to implement tech, ops, legal and compliance changes required for connectivity, scale, extra capacity etc.	-25%	Most projects completed by the outsourcer, integration & implementation costs shared etc.
Margin	+2.5%	**2.5% increase in margin**	+100%	**100% increase in margin**

A partnership around outsourcing can benefit both sides (see Table 1). For the smaller bank, it means outsourcing a function or the entire value chain of their activities in which it is not competitive – this could include execution and front-office activities, to a third-party market player who is able to perform the same function at a lower cost and more effectively.

The impact could be genuinely transformative. By outsourcing instead of having their own infrastructure, banks could see costs reduce significantly as illustrated in Table 1. This could fundamentally change the viability and underlying economics of their services. It also means the banks can focus their limited resources on areas in which they already excel or wish to gain scale.

For the large bank, it provides extra revenue with low additional costs and capital requirements. It also helps them as part of a wider move away from relying on transaction fees, which are on a downwards trend, to more resilient service fees.

It is this win-win aspect that makes the rise of partnerships so compelling and inevitable. The question is when not if this occurs. To date, capital markets have lagged behind other sectors when looking at partnerships as they strived for innovation in products rather than service models. Retail banks, for example, already often outsource back-office loan processing, to save costs and speed up the process. Partnerships are not only limited to the finance industry and are also evident across other sectors like Pharma, where established players outsource the manufacturing of treatments when they lack their own tech capabilities to manufacture in a cost-effective way, increasing their production capacities without any investment. We expect the next few years to see an exponential rise in the rate of partnerships within investment banking.

Of course, it is not just large banks that can step in. We have seen the rise of FinTechs, who have the technology to take advantage, as smaller banks look to outsource core activities, such as execution, post-trading processing, and back or middle office operations.

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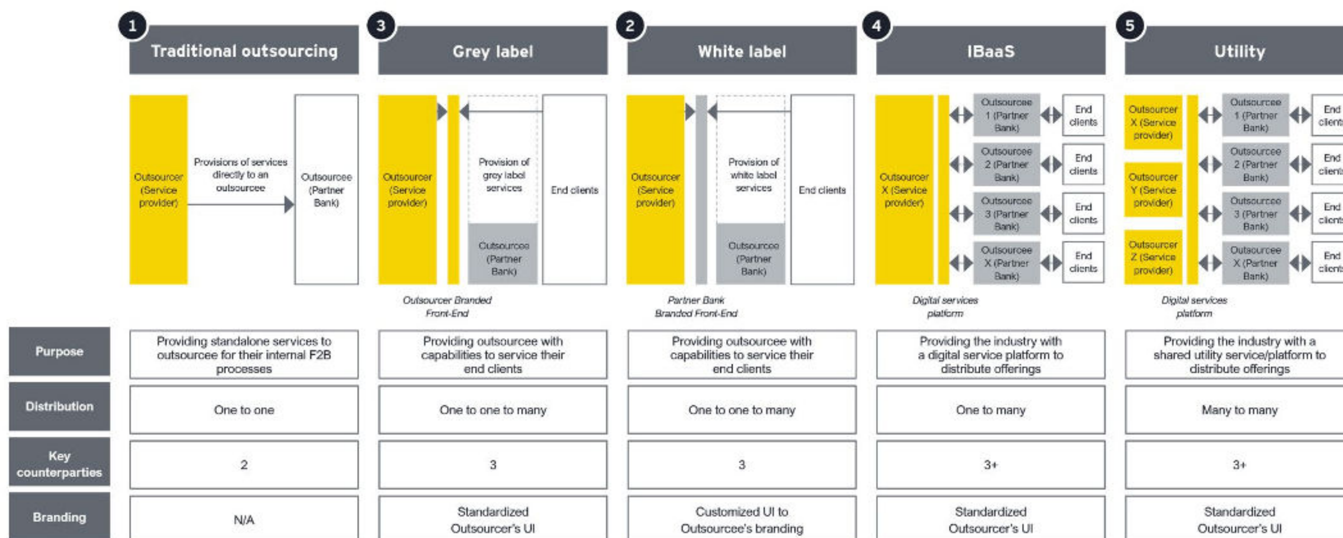
3. Five different outsourcing options



	Traditional outsourcing	Grey label	White label	IBaaS	Utility
Purpose	Providing standalone services to outsourcee for their internal F2B processes	Providing outsourcee with capabilities to service their end clients	Providing outsourcee with capabilities to service their end clients	Providing the industry with a digital service platform to distribute offerings	Providing the industry with a shared utility service/platform to distribute offerings
Distribution	One to one	One to one to many	One to one to many	One to many	Many to many
Key counterparties	2	3	3	3+	3+
Branding	N/A	Standardized Outsourcer's UI	Customized UI to Outsourcee's branding	Standardized Outsourcer's UI	Standardized Outsourcer's UI

1) Traditional outsourcing

Using another firm's existing technology, people, and processes to manage trade lifecycle processes for internal purposes (e.g. order book management). This is a one-to-one relationship between two partners, with no end-client directly involved.

2) Grey label services

Using another firm's existing technology capabilities, people, and processes to execute trade lifecycle processes (e.g. settlements) for their own end clients. Typically, the end client of the partner (outsourcee) is aware that a third party has delivered the service.

3) White label services

While the bank still uses another firm's technology, people, and processes for their own end clients, the end client will not be aware of the use of a third party. This allows it to cut costs without losing its own unique branding and image. Given investment banks are keen to sustain their brand consistency we are seeing a high appetite for this model.

4) Investment banking as a service (IBaaS)

Sometimes known as the "Amazon model", this is a digital services marketplace where market participants can plug in and make their products available to the wider ecosystem in a one-to-many relationship. Other banks can then pick and choose the relevant services available and then automate them internally into their own systems.

5) Utility model

Similar to the IBaaS model, market participants make their products available to the wider ecosystem via a digital services platform. However distinctively from IBaaS, in utility models, we observe a many-to-many relationship, whereby multiple service providers come together in a consortium to offer their modular services.

Unlike the first three options, the IBaaS and Utility models results in a distribution model where many banks can be customers of the service, while traditional outsourcing, grey label, and white label services are one to one bespoke models.

Whatever model they use banks need to be cautious. Poor outsourcing can harm a bank's reputation or delivery of service. It can also expose misunderstanding of the true financial benefits or lack of an agreed pricing and tracking mechanism. Critically, banks also need to be ready to manage the transition and new arrangements in-house. They are importing a cheaper, more efficient system but also potentially importing risks – such as control of customers' data.

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4. Execution will not be easy

For bank executives, the strategy around the future of investment banking has been a difficult equation to resolve. It involves numerous factors such as legal, IT, operations, culture, regulation, profitability, and strategic plan. Trying to determine where and how to offer investment banking services, to find a sweet spot in terms of what's easiest and most profitable has been very difficult. Partnerships could be a decisive factor in this consideration. From our experience and recent interaction with clients, there are some key decisions executives need to take:

1) Decide what products, markets, geographies and services the banks want to outsource: As well as products and geographical scope banks will need to be clear on what branding model they wish to pursue

2) Leveraging strengths as compared to Fintechs: Some Fintechs are eager to grab market share in the overall investment banking value chain. Although they may have superior technology and innovation capabilities, they cannot really cover the entire value chain – from front to back services. Large banks should therefore focus on providing integrated outsourcing solutions under the same umbrella. Their global reach and superior risk and control management are capabilities that are very difficult to match.

3) Be pragmatic and practical: Don't invest huge amounts until you understand what the client wants. Perhaps choose two or three clients and test and learn before developing the next possible offering

4) Market more and earlier: Ensure marketing works in parallel to developing and building a solution. It cannot be left until the end as it takes time to establish a go-to-market framework, educate and train teams, establish funding, set sales targets, and develop marketing messages.

5) Always have a strategic blueprint in mind: While staying pragmatic is key, leaders also need to keep in mind the big strategic end picture, to ensure they have a clear roadmap for progress.

6) Understand the regulatory, risk, legal and compliance considerations: Understanding the detailed impacts and effects of the regulatory and legal environment is critical to ensure that both parties are clear about their legal liabilities and who is accountable for what along the outsourcing construct.

5. Partnerships will be a gamechanger

To ensure sustainability in the long run, it's clear some investment banks will be better off focusing on certain areas, rather than competing across the full value chain and asset classes. Outsourcing may be the most visible sign of a new wave of partnership use in capital markets. Investment banks are now looking at partnership models to develop new ways of working. We expect to see a shift away from M&A and joint ventures to more digitally enabled, customer-centric, platform-based models that allow white label solutions.

Those who get it right will benefit from substantial cost savings, freeing up much-needed capital. They will also be able to provide a better level of service than competitors, using the latest technology, priced competitively. It may not return investment banks to the return on equity of the 2000s, but it will be a vital step in ensuring they are focusing on the most profitable parts of their business.

Partnerships could be critical in competing with Fintechs, which are increasing their role and market share in the banking industry; their presence in Capital Markets has been growing steadily in the last years. They leverage their tech platforms and talents to deliver services at a lower cost with service excellence in mind.

After years of fierce competition, some may observe the irony in partnerships being the platform for investment banks to thrive. But in times of declining profitability, increased competition with Fintech firms, and increased regulation, partnerships can free up capital and management time to ensure smaller investment banks can thrive, and not just survive.

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How wealth and asset managers can leverage ecosystems to catalyze growth

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Learn how investment firms can use partnership-based strategies to deliver better financial and operational results.

In brief

- While Ecosystem strategies have become commonplace in other industries, they are still developing in the investment management space.
- At a time when traditional M&A has struggled to deliver on return expectations, accelerating digital transformation will give investment firms the opportunity to meet customer needs and drive growth and efficiency.
- Leveraging diverse ecosystems of third parties can allow investment management firms to redesign product mixes, strengthen distribution capabilities and enhance operating platforms without the need to build or buy.

Today's investment management industry is under pressure in ways that go beyond responding to the COVID-19 pandemic. Assets under management (AUM) have been growing at a healthy rate, but much of the industry struggles to generate adequate risk-adjusted returns.

Competition from emerging FinTech and established big technology firms is increasing. Intensifying shareholder scrutiny has resulted in many firms to look to the M&A market in search of efficiencies of scale, differentiated products, new distribution channels or deeper customer relationships, but relying solely on such traditional strategies has not been enough.

To remain competitive and satisfy activist shareholders, wealth and asset management firms may want to think boldly about using ecosystem business models, similar to those employed by Amazon or Uber, to unlock value. The accelerating digital transformation has caused growth-minded firms to look beyond traditional industry boundaries and leverage the capabilities of partners to meet customer needs, drive growth and lower operating costs.

Leveraging diverse ecosystems of third parties can allow investment management firms to redesign product mixes, strengthen distribution capabilities and enhance operating platforms without the need to build or buy. This approach can free up energy and capital to develop, implement and market their own differentiated products and services.

Partnership models require wealth and asset management firms to expand their strategic playbooks and acknowledge that M&A may not be the only way to achieve efficient and resilient outcomes in a rapidly changing digital environment. To prepare for the journey requires an honest assessment of the firm's strategy, strengths and weaknesses. It also demands a structure for prioritizing partnership opportunities, thoughtful planning and sharp execution.

These are still early days for ecosystems in the wealth and

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asset management space. At the pace the digital world is evolving, it may only be a matter of time before they become a core part of every investment firm's strategic arsenal.

Asset management: partnering for growth and efficiency

The urgency to embrace ecosystems may be the greatest for institutional asset managers, that can risk losing increasingly sophisticated investors if they cannot find ways to offer differentiated products, expand digital distribution and build resiliency on a budget. Growth and efficiency are the name of the game, and ecosystems are a potentially more effective way to achieve those goals than acquisitions.

Today, asset managers are using M&A to chase growth in one of two ways. The biggest firms are seeking scale to support strategic objectives. For example, Invesco's acquisition of Oppenheimer is focused on achieving scale to drive down costs. Franklin Templeton's deal for Legg Mason creates needed scale in fixed-income trading and other key product sets.

On the other end of the spectrum, smaller, more-nimble asset managers are looking to reach, attract and retain customers by acquiring boutique firms with differentiated products or distribution capabilities. The effectiveness of these M&A-driven growth strategies has been mixed.

Ecosystems provide a potentially less-costly and less-complicated alternative to achieving many of those same objectives. Partnering generally does not require the same investments of time, capital and labor as an acquisition, yet it can afford many of the same benefits in an expedited fashion.

For example, BlackRock is hosting its Aladdin infrastructure on Microsoft's Azure platform to enhance client experiences with greater computing scale. Partnering with cloud platforms or FinTech firms can enable asset managers to pursue continuous innovation and develop scalable operating solutions in resilient, cost-effective ways.

Ecosystem partnerships can be an effective way for asset managers to achieve growth and efficiency goals without massive capital outlays, while also avoiding some of the more complicated cultural and integration challenges commonly associated with M&A.

Wealth management: partnering to expand reach and capabilities

For wealth management firms, it's crucial to attract and retain clients through different stages of financial maturity to meet growth objectives. Recent M&A deals, including Morgan Stanley's acquisition of E*Trade, Charles Schwab's acquisition of TD Ameritrade and Goldman Sachs' acquisition of United Capital Financial Partners, have been driven in large part by this strategic imperative to broaden customer bases.

Ecosystems provide a more cost-effective way to achieve similar objectives. Leveraging the capabilities of partners to serve the digital needs of clients — something they have come to expect in other parts of their daily lives — can make those relationships more meaningful and longer lasting.

The following are some top considerations clients are seeking from wealth managers, and some perspectives about how ecosystems can help meet those expectations.

- **Digital access.** Retail clients are accustomed to accessing and buying products and services online and expect wealth managers to provide the same convenience. Partnering with FinTech and nonfinancial technology firms to enable seamless digital interactions not only can enhance the user experience, but also may enable stickier relationships.
- **More diverse investment choices.** By partnering with specialists to provide leading-class environmental, social and governance (ESG) and thematic fund options, wealth managers can solidify relationships with mass-affluent customers as their needs evolve. We expect global financial services firms will continue to partner with more technology-focused asset managers that have expertise in ESG investing to allow advisors to create personalized values-based portfolios for clients who increasingly care about the social impact of their investments.
- **Account assessment and monitoring.** Retail investors are more hands-on today and want transparency around the social impact of funds.

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Providing third-party tools that filter, screen and monitor investments can empower customers, making the relationship more relevant.

Lower costs. Leveraging lower-cost back-office functionality from partners to enhance efficiency, resiliency and risk management can enable firms to provide greater value to clients.

Partnering with nimble FinTechs and other specialists via ecosystem strategies is becoming a preferred way for wealth managers to provide customers with high-quality digital experiences and leverage emerging technologies in pursuit of efficiency and resiliency.

Four actions firms can consider now to leverage ecosystems

Align vision with strategy

Investment firms can identify clear strategic objectives for an ecosystem operating model and resist the temptation to simply react to what is happening in the marketplace. Firms can establish frameworks based on those objectives to assess existing capabilities and value chains.

1. Which customer needs, product deficiencies and operational challenges need to be addressed, and is that best accomplished through building, buying or partnering with a third party?

2. Where does the firm stand relative to competitors — in terms of AUM levels, product specialization, distribution channels and customer experiences? And how can partnerships help make up the most glaring gaps?

3. Which core products and capabilities are very unique to the firm's offerings to be part of an ecosystem? Which customer and back-office needs can be best addressed by partners?

4. Which customer segments may be targeted through the ecosystem and what value propositions will drive ecosystem participation for each of those segments?

Evaluate and prioritize focus areas

Leverage industry and proprietary data sets to scan the market for partnerships that can provide the greatest benefit. Analyze potential partners' track records, investment histories and capabilities to prioritize opportunities relative to the firm's short-, medium- and long-term strategic objectives.

Develop an engagement plan

Prepare to work with partners by developing a baseline version of the firm's current operating model, including people, processes, existing third-party relationships, regions and platforms. Develop the integration strategies, talent, tools and IT capabilities needed to execute a platform-based business model.

Execute the transition

Identify and conduct due diligence on potential partners and business models that extend beyond basic financial metrics to integration strategies, operations, technology compatibility and cultural fit. Finalize the details of partnership agreements, including ownership, management, branding and communications rights, and exit provisions.

Form teams to integrate partner capabilities based on well-defined execution plans and establish that partner incentives are aligned with those of the firm. As ecosystem capabilities mature, the firm may consider developing a center of excellence to manage its ongoing ecosystem relationships.

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Summary

An effective ecosystem strategy can require an investment firm to assess its existing strengths and weaknesses, prioritize solutions, develop engagement plans and execute sharply with others. It may require a different skill set and thought process, but in an increasingly interconnected platform world, customers and investors alike will demand it.