Towards the Markets of Tomorrow

Capital Markets Vision 2025

accenture

Introduction

An industry facing a rare opportunity

The global capital markets industry saw mostly limited revenue growth in the years leading up to 2020.[1]

At the same time, firms' economic returns varied widely, with many industry players failing to beat a standardized cost of equity capital. Combined with persistent structural cost issues, these characteristics all suggested an industry in the latter phases of its economic cycle.

But then COVID-19 came along and defined the industry's landscape in 2020. And while the pandemic has had a terrible impact on humanity and many sectors of the economy, it has also brought the sell-side and the exchanges an unexpected respite with revenues at near-record levels. The buy-side saw strong growth in assets under management and high investor interest. Overall, capital markets industry revenues were stable in light of unprecedented economic times and short-term profitability was strong for many firms in 2020.

We believe that the industry's pandemic-driven rebound is a golden opportunity to accelerate investments in new technologies and new ways of working. From cloud to artificial intelligence, leaders should seize the chance to prepare their businesses for the next wave of disruption and strive for longer term success today.

A focus on realizing digital value

In our Capital Markets Vision 2022 report published three years ago, we identified the primary drivers of industry disruption in capital markets as being technology-led innovation and the creation of new digital value chains across the industry.[2] Today these trends remain fundamentally consistent. So, what *has* changed?

In the intervening three years, we saw even more advances in technology and profound shifts in mindsets than predicted—in part forced by the global pandemic. In our view, both the scope for change and the willingness to execute it have increased markedly in the industry, thereby redefining the art of the possible. We believe firms should continue their drive to unlock greater digital value and, as COVID-19's impact gradually recedes, capitalize on a unique opportunity for creating the capital markets of tomorrow.

From the heavily skewed capital markets industry of today...

In 2020, the capital markets industry as a whole generated some $1.12 trillion in revenues and around $119 billion of economic profit. However, a sector analysis reveals that the distribution of this value creation was heavily skewed.

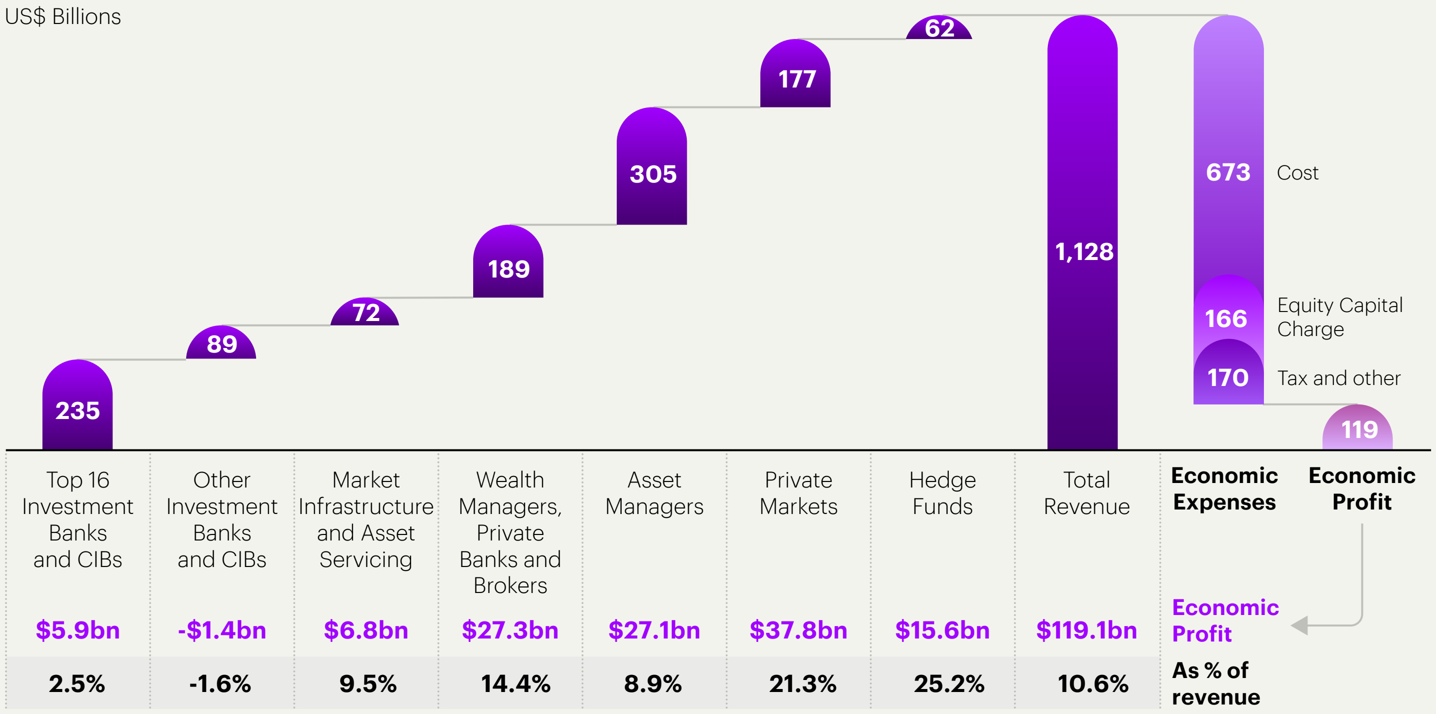
The buy-side generated 65% of industry revenues and a massive 90% of the economic profit (see figure 1). This dominance is partly due to the buy-side's "capital light" business model. The more "capital regulated" sell-side and market infrastructure businesses shared 35% of the total revenue pool in capital markets between them but generated just 10% of the economic profit.

This gap is somewhat due to the seismic shifts in the regulation of banks' capital bases since the financial crisis.

However, the disparity has continued to widen in the years since our last major report. Back then, figures for 2017 showed the sell-side and market infrastructure companies accounting for 13% of economic profit—a share that has now dropped to 10%.

Capital returns aside, the industry on an aggregated level hasn't improved overall efficiency. Our calculations put the average cost-income ratio of capital markets firms at 66.7% based on 2020 numbers, which is nearly unchanged from 2017 (65.3%). While investment banking and exchanges showed some improvement, there has been a rise of cost-income ratios in asset management and asset servicing. That is not a sustainable trend for delivering value in the future.

Figure 1: Breakdown of capital markets industry revenues by sector, 2020



… towards the markets of tomorrow

While transformation is a constant in every industry today, we see the rate of change in technology even further accelerating the flux in capital markets as we progress towards 2025. We believe that trading volumes will continue to rise under the impact of increasing global financial sophistication. The addition of tokenization could also open up new avenues to invest and lend while reducing the costs of doing so. This represents both an opportunity and a threat for the entire capital markets industry.

Also, the perceptions of buy-side firms will begin to shift from being alpha generators to being holistic stewards of capital, focusing on returns as just one of many metrics across the environmental, social and governance (ESG) spectrum. This same ethical compass shift will likely also become pervasive across the wider capital markets ecosystem.

As a result, in our view, the biggest changes to come to the capital markets sectors in the next phase of the industry will be as follows:

Sell-side firms will accelerate their strategic transformation programs, both in terms of changing business scopes and perimeters and also in reshaping the cost base to drive consistently higher profitability.

Buy-side firms are expected to increasingly become "digitally native"—meaning they would infuse technology across their operating models, including into their investment process, client interactions and organizational culture.

Financial market infrastructure players will find competition intensifying as exchanges and asset servicing firms' clients start to disintermediate and compete with them. The Members Exchange (MEMX) is a case in point, but competition in areas from market data to settlement and custody could also increase.[3]

Steering large, complex organizations through today's environment and setting them up for success is never going to be easy—and it's harder given a future in which disruption will likely accelerate. And while no single plan will be right for every firm, we believe that there is a common set of tools to begin the journey to being an industry leader in capital markets by 2025. Each sector in the industry has its own individual challenges and opportunities, and we will start by looking into the specifics of each sector in the next chapters.

About our methodology

In developing our vision for capital markets in 2025, we analyzed publicly available financial information from over 140 capital markets firms to define a clear view of profitability at the industry and sector-level.

We explored trends over time using 2020 business financial results as a baseline. We calculated economic profit as a yardstick, deducting from revenues: credit losses, full operating costs, taxes and the cost of equity capital. While the cost of equity capital will differ by company, sector and region, to facilitate comparisons we applied a standardized rate (10%) across our research, generating an absolute economic profit figure for the capital markets industry as a whole, each sector and the underlying companies involved.

In our analysis, we focused on exploring the underlying profit dynamics end-to-end across all capital markets sectors. The scope included the global, leading, publicly-traded companies from the sell-side (i.e., the markets and investment banking activities of a broad set of banking groups), buy-side (i.e., wealth managers, asset managers, private equity and hedge funds) and financial market infrastructure (i.e., exchanges and asset servicing firms).

We discussed our observations and insights with various industry leaders focusing on the likely development of value pools going forward. During these conversations, we also validated our thoughts on the key management challenges indicated by our findings for each sector of the industry.

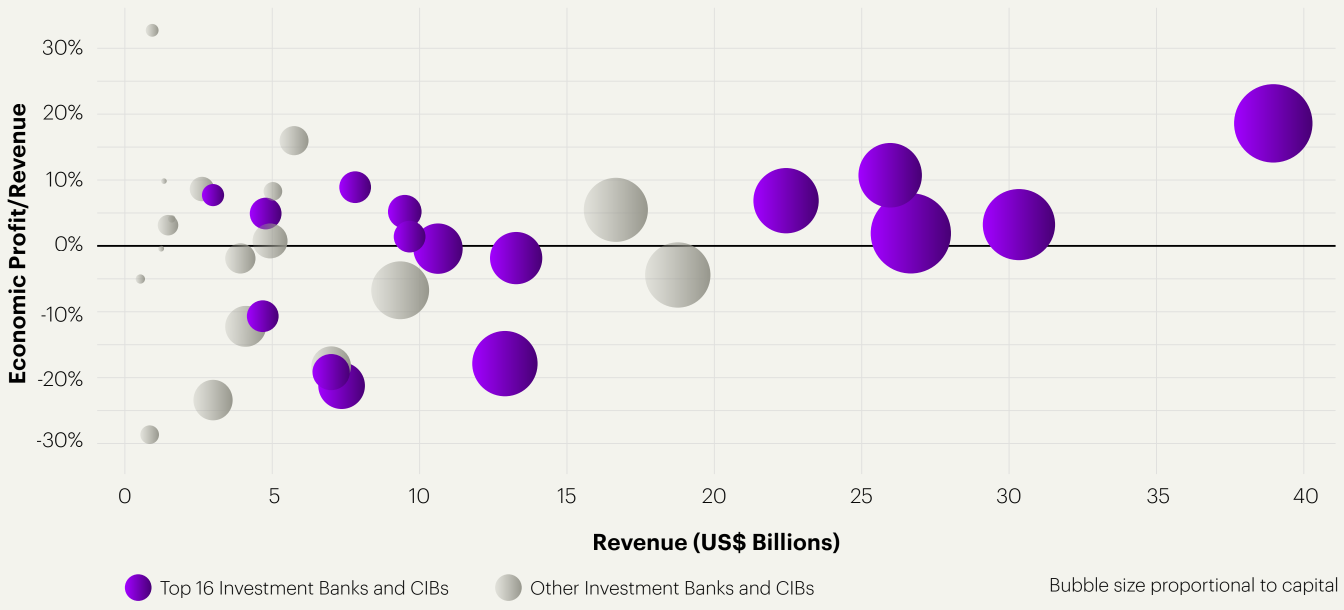
Sell-Side: Investment Banking

Executive summary

The core investment banking and global markets (IBGM) businesses have endured a tough decade of falling revenues and weak profitability.

In economic terms, the sector was largely characterized by shrinking core revenues over the past decade, high cost-income ratios and wide disparities in economic results (see figure 2). The unprecedented economic events of 2020 drove significant increases in volatility, risk management demands, sector rotation and trading volumes which all generated significant incremental revenue for IBGM businesses. We estimate core IBGM revenues were up around $45 billion in 2020 over the prior year.

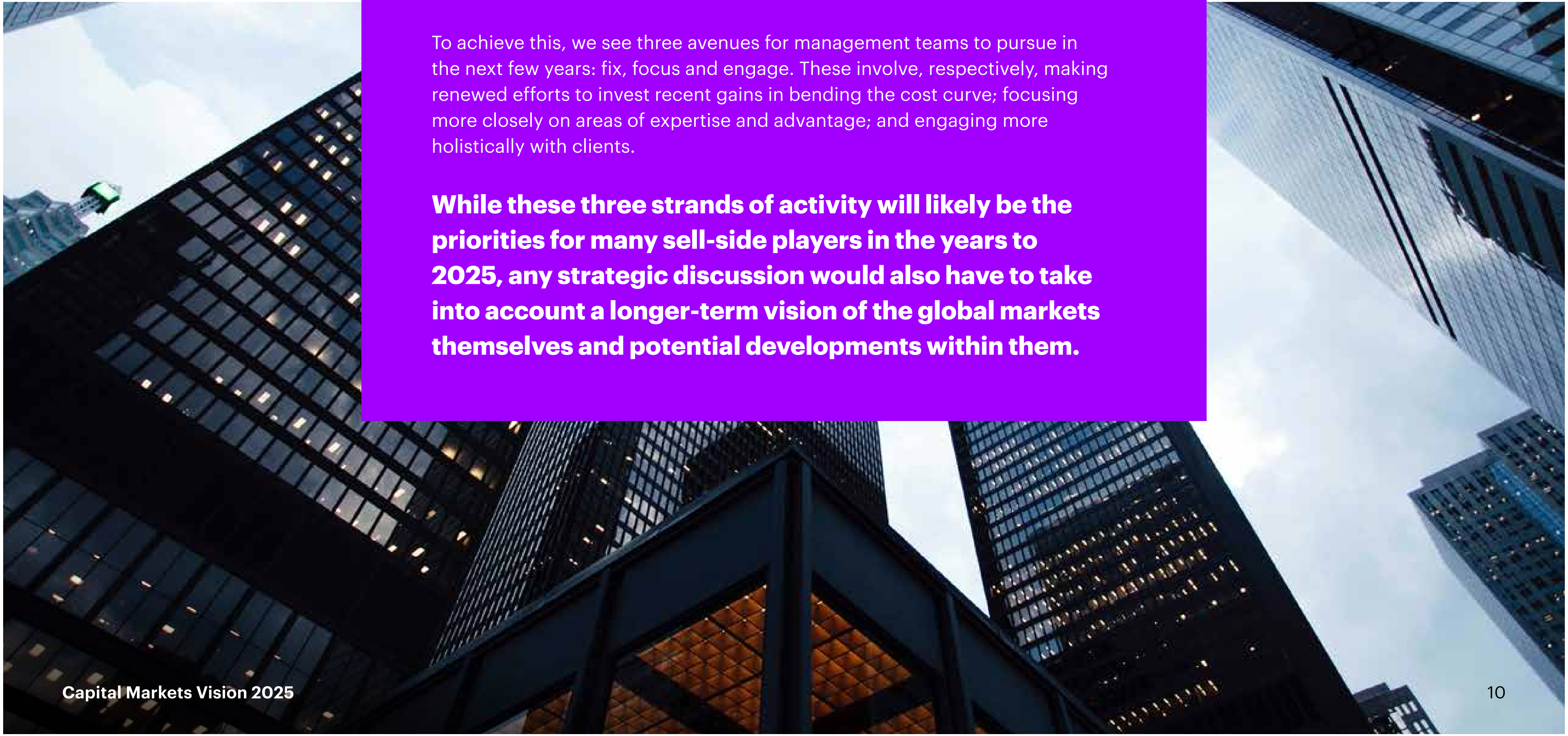
Figure 2: Economic performance of IBGM businesses globally, 2020



In assessing the future of investment banking, it's important to stress that there will always be a need for the fundamental role played by the sector: intermediating between corporates and investors.

However, it's equally clear that disintermediation in capital markets will not go away. So, the question for investment banks is not whether there will still be a role for them in 2025, but *what* that role will look like—and how it will differ from today? And, even more interestingly, what is on the horizon beyond 2025?

The remarkable strength of capital markets revenues in 2020 has brought the sector some respite. We believe the current situation—with 2020 results showing pre-tax profits being up by over $10 billion for the top businesses—offers the industry the opportunity to finally grasp the nettle in terms of restructuring. It is vital that the sector now avoids a return to the decade-long malaise that followed the financial crisis.



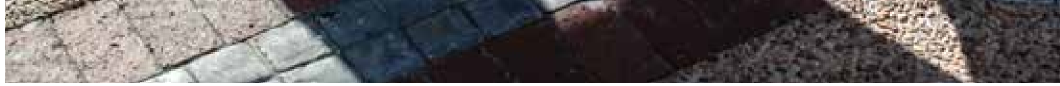
To achieve this, we see three avenues for management teams to pursue in the next few years: fix, focus and engage. These involve, respectively, making renewed efforts to invest recent gains in bending the cost curve; focusing more closely on areas of expertise and advantage; and engaging more holistically with clients.

While these three strands of activity will likely be the priorities for many sell-side players in the years to 2025, any strategic discussion would also have to take into account a longer-term vision of the global markets themselves and potential developments within them.

Investment banking today: Seeking to recover from a “lost decade”

Since the onset of the Global Financial Crisis, the investment banking industry in general has struggled to generate meaningful revenue growth.

Aggregate revenues for the top 16 investment banks have fallen from approximately $286 billion in 2010 to nearer $267 billion in 2019—an average year-on-year decline of 1% (see figure 3). In 2020, the industry saw revenues of over $285 billion—roughly back to the heyday of a decade ago. We do not believe this is some secular reversion. It is more a response to the pandemic and does not fundamentally alter the overall direction of travel for the industry.

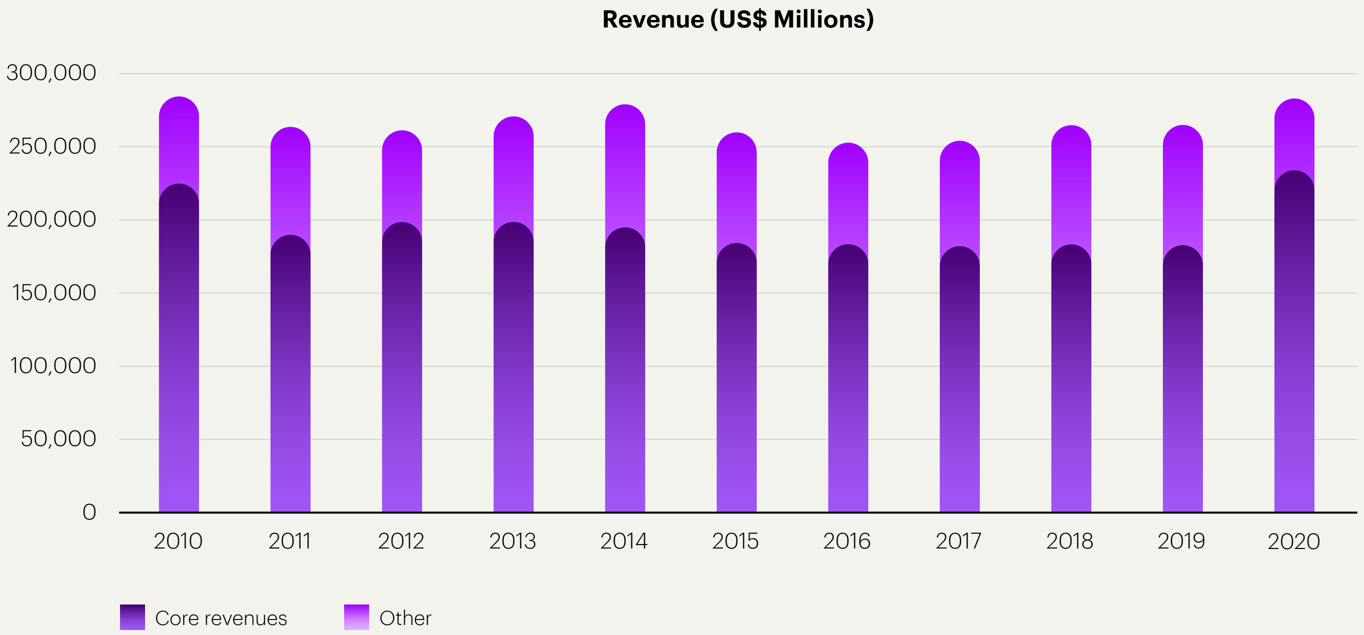


This steady slide in revenues until 2019 is rooted in several factors. These include a shifting regulatory landscape, fast-evolving customer behaviors and expectations, reduced volumes, increased competition, low interest rates and falling margins, along with liquidity stresses.

A more detailed breakdown shows that investment banks' core revenues (defined as FICC, equities, corporate advisory, and equity and debt capital markets businesses) suffered the most, dropping an average of 3% a year. In response, firms have grown revenues in other areas.

For some banks, these efforts have included seeking synergies by moving business lines from their corporate banking or private banking and wealth management businesses closer to the investment bank. Others have pursued new activities, expanding into areas like trade finance, securities services and transaction banking. Some have moved toward retail deposits and loans.

Figure 3: Investment banks' aggregate revenue performance, 2010-2020

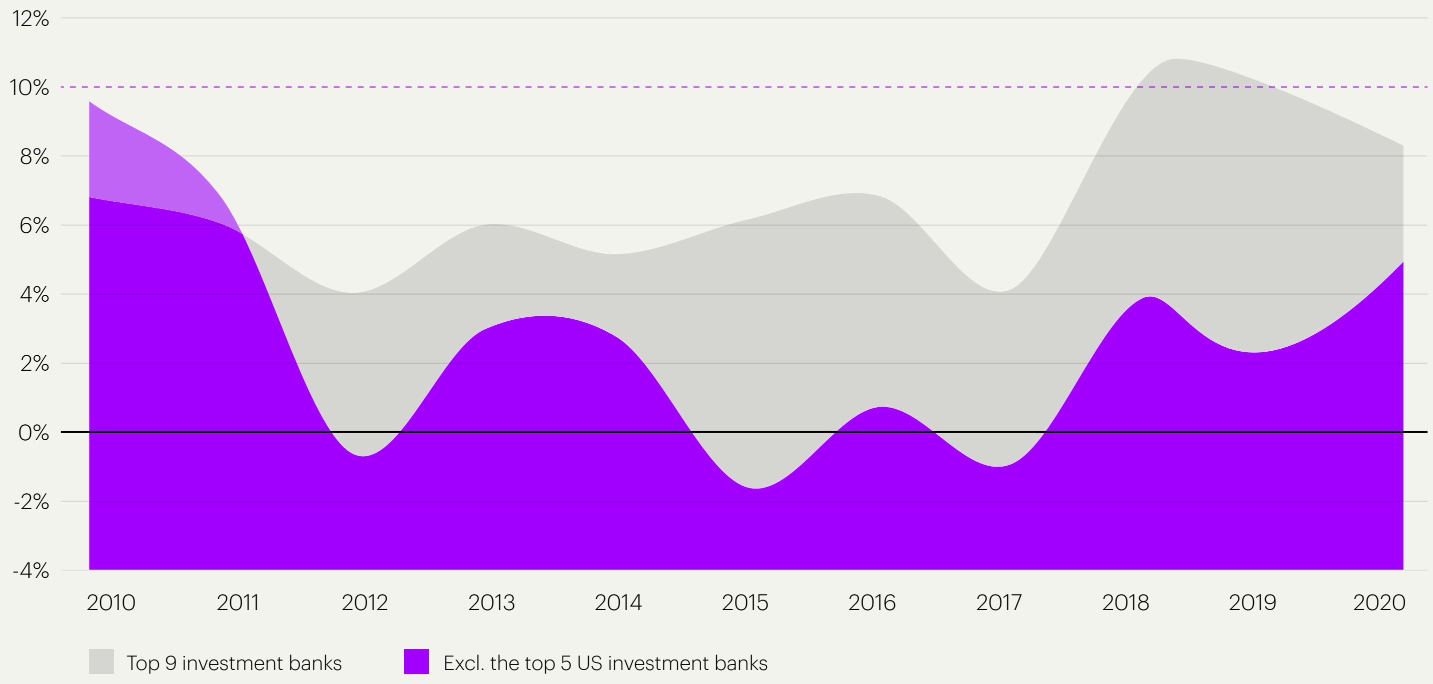


While such initiatives have yielded some success in terms of revenues, two things remain clear:

- First, the beating heart of the investment banking business has seen profound change over the past decade.
- Second, within that core, returns remain inadequate.

Even when we strip out the smaller players and look only at the top nine global investment banks, group returns on equity have almost consistently failed to beat firms' cost of equity capital, which—for this paper—we assume to be 10%. The picture becomes gloomier still if the five biggest US investment banks are excluded (see figure 4).

Figure 4: Global investment banks' RoE 2010-2020 – top nine, and excluding the top five US banks



Structural factors give US banks an edge

The glaring disparity between the (largely US-based) bulge bracket banks and their peer group reflects several factors.

First, the US sell-side is almost certainly more profitable from a structural perspective. Being located in the world's largest and deepest capital market has helped to bolster the US players' revenue flows—as has the speed of regulatory action, write-downs and recapitalizations in the US following the financial crisis.

Further factors favoring US investment banks include the easing of their regulatory burden in recent years together with more proactive central bank action, a stronger underlying economy and the absence of a sovereign debt crisis.

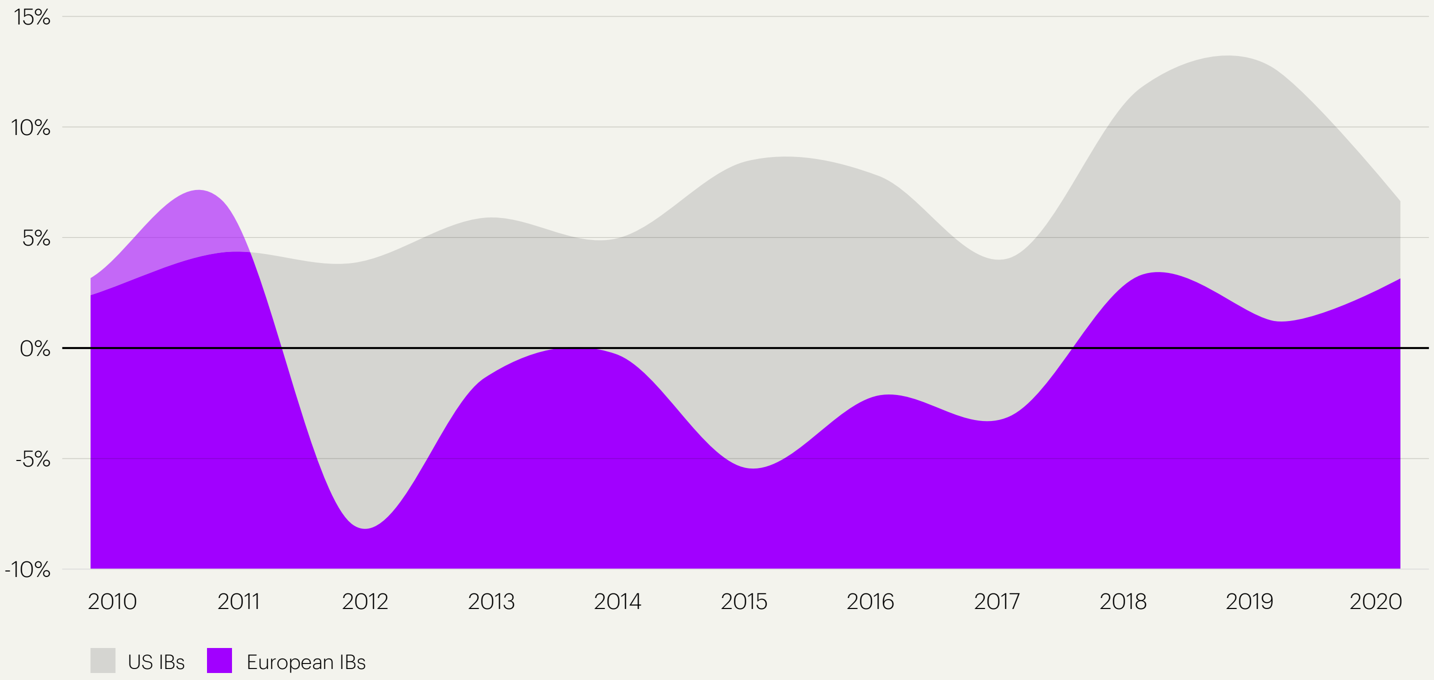
However, another factor that may be equally as important is the level of returns from the non-capital markets elements of the top nine global investment banks' business portfolios. Here the higher returns available in, for example, the US's vibrant retail and commercial banking segment give the US banks a significant advantage, as figure 5 shows—at least until 2020.

The rapid reversal in the prevailing level of US interest rates has meaningfully impacted these retail and commercial banking businesses. However, as the US yield shifted down aggressively as the pandemic set in, the long end has twisted more positively, implying an expectation of rising rates by 2025. This should re-establish that return premium of the large US groups from their mainstream banking businesses.

In addition to such structural factors, we believe that US investment banks' judicious investments in technology, especially in recent years, have also been instrumental in driving their stronger performance. That said, these investments would clearly have been enabled—at least in part—by better underlying economics of their existing businesses.

Overall, it's clear that the playing field is essentially skewed, and European banks would need to adopt more agile and flexible business models to generate US-style investment banking returns.

Figure 5: Returns on equity on US and European investment banks' non-capital markets activities, 2010-2020



The investment banking vision for 2025: People and technology as key assets

As mentioned earlier, there will always be a need for investment banks' fundamental role of intermediating between corporates and investors.

However capital markets has evolved rapidly into a very "tech-heavy" industry, with new methods of interacting, trading, advising and operating invariably being technology-led. This has created an entry barrier based on depth of financial and technical resources—which firms already suffering from inadequate returns have struggled to meet.

Outside of the bulge bracket firms leveraging huge scale, the reality is that too many investment banks may still be attempting to pursue global “across-the-waterfront” strategies aimed at playing in every market segment. In many cases the banks applying such strategies might be failing to deliver value or improve returns while also appearing to reinvent themselves continuously.

However, there are interesting niche examples of successful investment banks. Some of these outperformers focus on a particular geography, while others specialize in a specific suite of products. While some observers may feel this kind of niche focus limits a bank’s growth aspirations, we believe that it has helped those firms to enhance shareholder value over time.

Despite such success stories, the fact remains that significant cost challenges need to be addressed in investment banking. Many functions still require high-cost human interventions due to regulatory complexity, legacy technology, challenges around data and the persistence of excessively manual processes.

Examples include:

- Post-trade processes remain heavily intermediated, with poor-quality upstream data creating a need for constant human interventions downstream.
- Ongoing changes in regulation and the risk of fines and other regulatory sanctions mean front office staff are still having to focus too much time and effort on non-revenue generating tasks.
- Siloed functions continue to generate duplicated and even circular processes.
- Know your client (KYC) and anti-money laundering (AML) requirements have driven up the costs of onboarding new customers and maintaining the client base.

The disintermediation conundrum

As previously pointed out, investment banks act both as an intermediary and advisor. The latter role is almost entirely a human capital exercise—which makes it a double-edged sword.

On the one hand, the cost base can be flexed and capital consumption is minimal, meaning this business can be consistently profitable and closely controlled. On the other, it is difficult to maintain what Warren Buffet would call a "moat" as the key asset—people—could leave any day and even set up a new business independently. What keeps these human assets in-house is the theory that the balance sheet increases the overall size of the prize. And this is a problem.

Partly as a result, we see this role of intermediary undergoing fundamental change in the long run. Today, capital allocated to secondary trading businesses is already being disintermediated by technology among the most liquid instruments. At the same time, direct and SPAC (special purpose acquisition company) listings are lowering capital requirements within primary businesses. As more assets become tokenized—driving capital markets towards instant, global and reliable settlement—the requirement for intermediaries as capital providers is expected to decline.

There are precedents in other industries. Take Amazon, which began by selling its own products and is now reported to sell more of other people's merchandise than its own.[4] So the real value in the platform model lies in the tech platform itself and the fulfilment infrastructure it provides.

Similarly, tokenization in capital markets means the fulfilment infrastructure layer becomes vanishingly small and the technology platform becomes paramount, alongside the advisory capability. We see this shift improving efficiency across global markets and, for the (few) truly tech-led companies, creating meaningfully more profitable businesses.

Twenty-five years ago, being an intermediary meant having capital. Today it is about capital and capability, both in people and technology. In the future, it will be about the latter components far more than the first.

Becoming a globally connected business

Imagine a world where every capital provider (saver or investor) is linked to every capital user (government or corporate) via one platform (or perhaps more than one), and moving capital around is as easy as sending a message on WhatsApp. In such a world, regulators would have to work extremely hard to police compliance and maintain investor protection. But for capital providers, the effect of such an environment would be to create a critical mass or network effect business. And for investment banks to adapt to it, they would need the ability to move fast while dealing with regulatory arbitrage, changing regulations and shifting demands on both sides of the capital equation.

A further possibility is that one or more players might take over much of the capital markets "high street" as the client-facing front end, with other banks finding a role in shaping innovative products, bringing more reticent or harder-to-access clients to the market, or offering value-add services around this ecosystem.

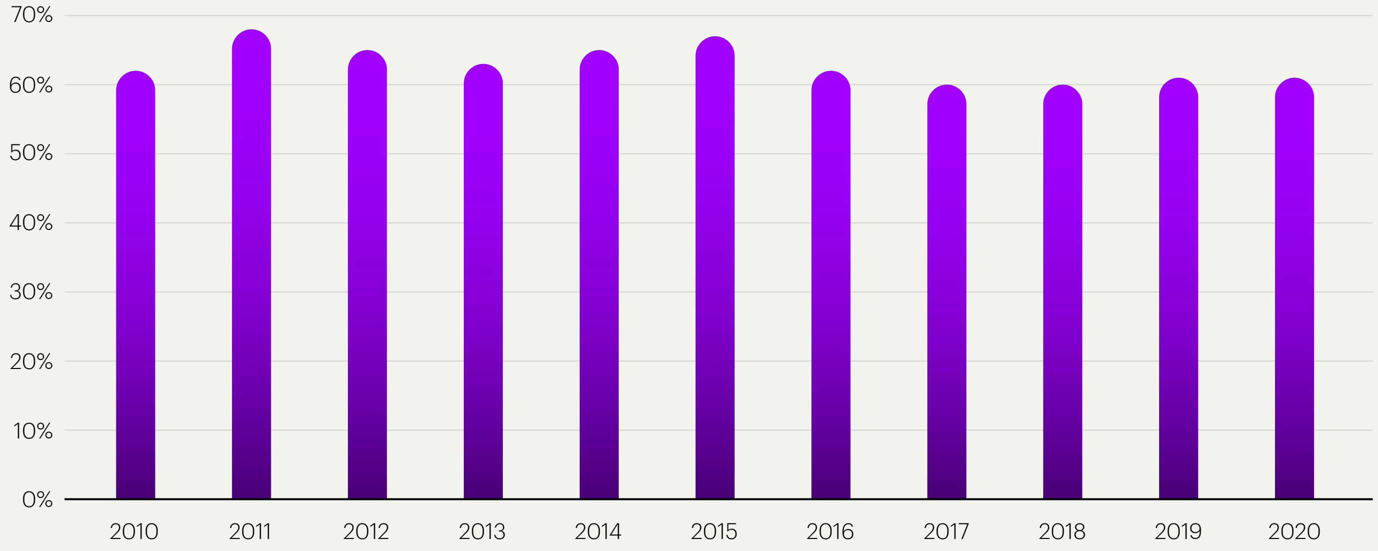
However, regardless of what the future holds, we believe that investment banks should embrace more radical action today. Action that is more strategic than tactical, more macro than specific, and which embeds technology deeply into the fabric of the business.

An action agenda for investment banking

COVID-19 has brought devastating impacts both for humanity and a range of industries. However, investment banking has benefited from the ongoing volatility, higher volumes and activity levels in the primary markets.

Revenues across many of the industry's major business lines are now meaningfully higher than a year ago and returns have improved significantly. Core sell-side revenues in 2020 have come out almost 25%, or nearly $45 billion, higher than in 2019. But we would add an important point here. We do not feel this is a new trajectory: rates are going to be low for a lot longer, activity levels are likely to slip back in line with (lower) global GDP, and much of the pull-forward of corporate refinancings appears unlikely to recur. In short, this is a welcome period of respite rather than a structural change of direction.

Figure 6: Investment banks' average cost-income ratio, 2010-2020



Many investment banks have been restructuring and cost cutting since the financial crisis. However, even a basic analysis of the interplay between costs and revenues shows that these actions have achieved only limited success. At 61%, aggregate efficiency (cost-income) ratios were roughly the same in 2020 as nearly a decade earlier (see figure 6). And, while 61% remains the average, the figures vary widely between individual institutions. While the five largest investment banks are achieving cost-income ratios below 65%, others are finding it harder to maintain efficiency at anywhere close to that level, reporting cost-income ratios of up to 100%.

With the incremental pre-tax profit gain of over $10 billion in 2020 compared to 2019, this presents a golden opportunity to invest, reshape and retool. But what should firms be doing?

The short term: Bending the cost curve

This opportunity should not be wasted—and to seize it, incremental change will likely not be enough. First, investment banks should aim to reduce costs in an intelligent way across the business. This is about bending the cost curve permanently by optimizing the cost base in three main dimensions:

Rebuilding around the core

Removing processing costs from the front office, and reshaping support functions using cognitive automation, compliance and anti-financial crime (AFC) innovation, liquid workforce models, end-to-end platform design, wider cost mutualization and asset tokenization.

A new technology landscape

Beginning with envisioning a new cloud architecture, and then moving beyond IaaS toward a more integral implementation of the promise of analytics, artificial intelligence (AI) and machine learning (ML), native security layers (SaaS) and a full DevOps environment, bringing the flexibility that these technologies can provide to help keep pace with client demands.

Future of work

2020 has shown us that the workforce can find new ways to work that can generate productivity gains. Technology investments (such as screens and connectivity) would be needed, along with new ways of supporting the mental health of the workforce. But we believe the savings to be made in real estate—not to mention from moving functions to lower-cost locations—could be significant.

The medium term: Setting the focus and enhancing the client experience

While cost-cutting is a more immediate priority, investment banks looking to position themselves for success in 2025 would need to combine a clear strategy with unwavering execution. There are few examples of successful sell-side strategies, and there are some decisions that need to be taken now, followed by refinements over the next few years.

Redesign the operating and technological model

This involves, in part, taking a fresh look at reducing the spread of products, businesses, geographies and customers to where there is a demonstrable, value-adding competitive advantage. Digitizing sell-side offerings brings additional opportunities to transcend the traditional counterparty relationship with the buy-side, crossing boundaries from electronic trading toward risk management, modularization, post-trade management and a deeper, more durable client relationship.

Cloud delivery could be key to developing a technological advantage, enabling the latest, differentiating services to be delivered at pace and at scale while remaining secure and cost effective. Also, new regulations such as the Fundamental Review of the Trading Book (FRTB)—which has become increasingly data-intensive—are more suited to the scalability and analytics that a cloud-native business can leverage.

Enhance the client experience

Ranging from trading to the entire client lifecycle, we see an array of new technologies enabling a more seamless journey for clients. In KYC and AML, automation is already performing large parts of manual efforts in periodic reviews, even aside from on- and off-boarding clients. A greater use of interconnected data and analytics could eliminate the requirement for high-touch efforts in the trade lifecycle, building towards truly digital gateways for clients to interact with the bank. These could bring together various touchpoints across risk, clearing, reconciliations, settlement and custody.

With digital accelerators and intelligent automation, powered by machine learning, banks can build straight through processing capabilities in all but the most complex interactions.

Finally, we see deep learning starting to augment sales and revenue. This technology can bring together a range of products, analytics and market data in tailored “next best action” cues for greater value-adding client conversations. This is where the future of these technologies lies—beyond the middle- and back-offices—as a vital adjunct to the front-office relationship and service.

The successful, value-creating investment bank of 2025 may be either a global scale player or a niche specialist. There would be room for both to create value in the marketplace.

We believe all winners would share a combination of greater agility and a clear focus on their chosen strategy. These attributes will require a digitally-enabled operating model that keeps costs low while offering enhanced experiences for employees and customers.

Talent: An increasingly critical success factor in investment banking

Alongside high agility and strong strategic focus, the right talent strategy is a further prerequisite for sell-side success in 2025.

As competition for the best talent intensifies, investment banks are up against the global tech giants both for new hires and employee retention. Winning this war for talent will not be easy, especially when leading sell-side firms are seeking to reduce staffing costs. To compete effectively for the right recruits, investment banks would need to prioritize the workforce with respect to the macro changes they make to operating models.

Data is a key challenge for many firms, none more so than investment banks which generate a wealth of information daily. Harnessing the power of that data, across both revenue and cost opportunities, is a challenge that only upskilling a large portion of the workforce can address—specifically in data fluency, handling and analysis. We see this as a major talent battleground and an opportunity to offer employees new skills while reaping the benefits in operational excellence.

What could this mean in practice? A recent Accenture study conducted both before and during the pandemic provides some pointers.[5] The top-line findings indicate that companies that succeed in making their employees "net better off" generate higher returns. This means unlocking the longer-term potential of people by addressing six fundamental human needs, only one of which is related to compensation.

Zeroing in on employees' non-compensation needs, two specific practices that investment banks can adopt to enhance their employees' contribution are using technology to enable flexible work arrangements, and empowering front-line employees with real-time data.

Our research shows that fewer than 20% of organizations claim to be leaders in these practices today. Yet 98% of workers would be more likely to feel fulfilled in their work if they were put in place—making them more likely to join a firm and stay with it, while also being more productive. We believe there are some valuable messages here for investment banks.

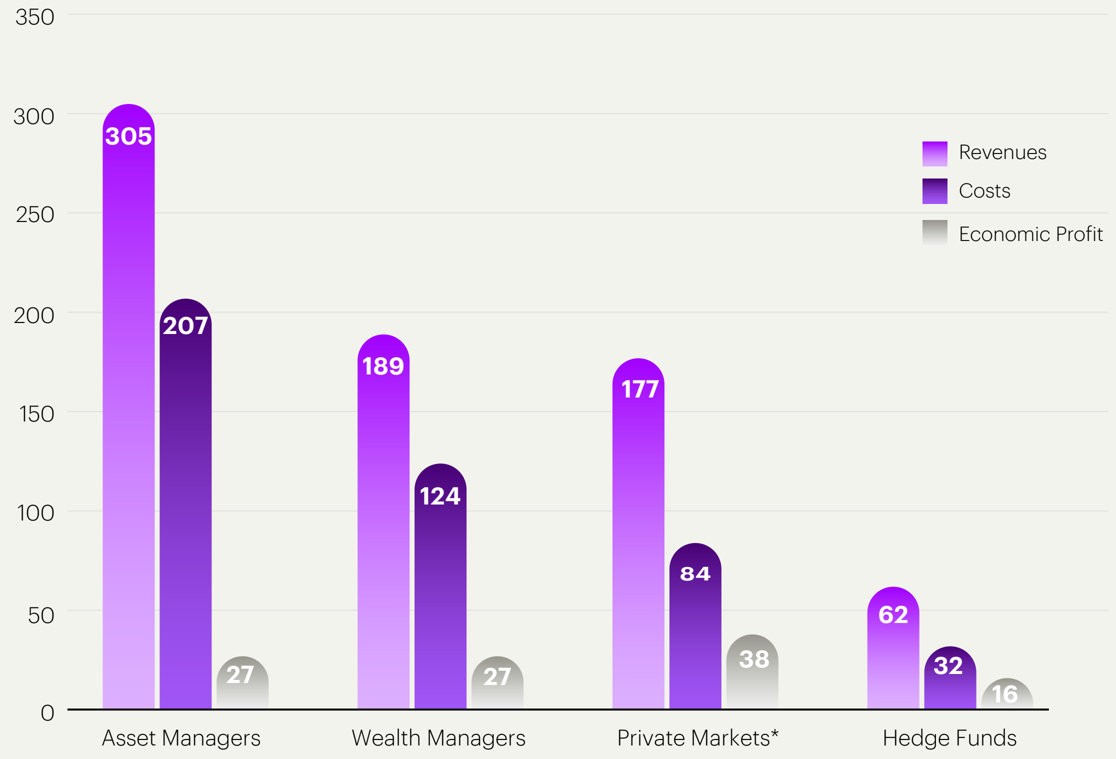
Buy-Side: Asset & Wealth Management and Private Markets

Executive summary

The capital markets' buy-side business is profitable, in demand and an integral part of the financial services industry.

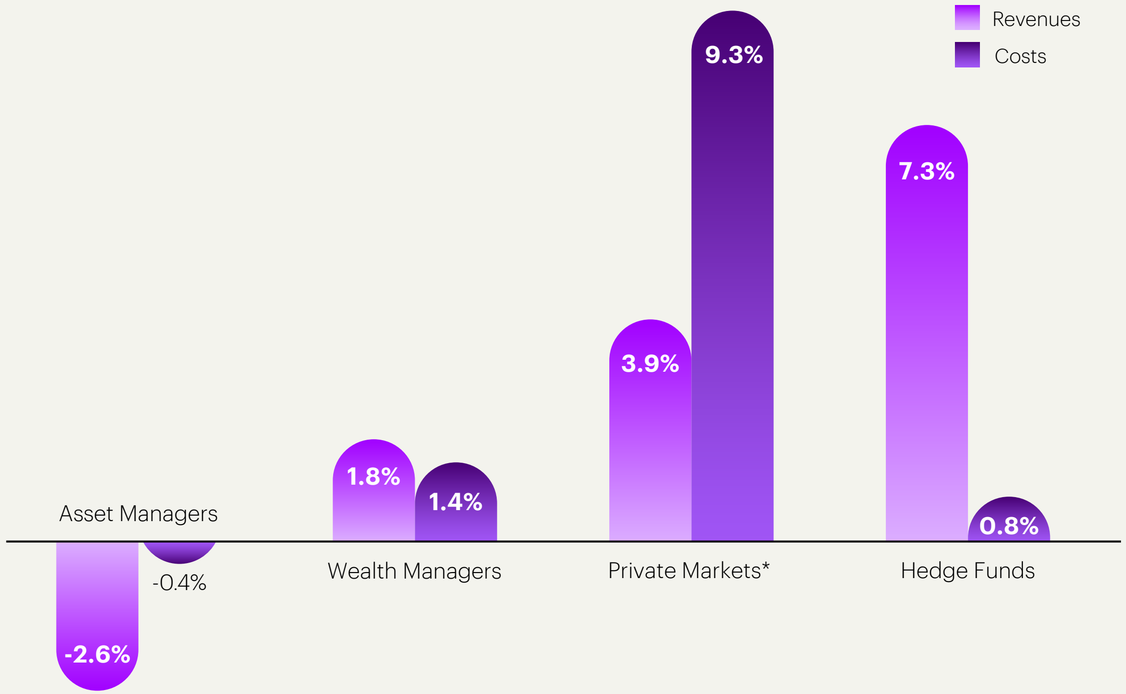
It generated 90% of the economic profit in capital markets on an aggregate level in 2020 (an increase from 87% per our Capital Markets Vision 2022 report). However, while the sectors of the buy-side are demonstrating mostly increasing profit and assets under management (AUM), many firms have not been able to achieve and sustain operating leverage in recent years in an era of rising markets and asset growth (see figures 7 and 8).

Figure 7: Breakdown of buy-side revenues by sector, costs and economic profit, 2020



*Includes PE firms and other Alternative Asset Managers

Figure 8: Year-on-year growth in revenues and costs for the buy-side, 2019-2020



*Includes PE firms and other Alternative Asset Managers

At the same time, the correlation between AUM and revenue is becoming less and less direct as markets are increasingly disconnected from underlying economic fundamentals—a development compounded by investor-driven euphoria, a new class of investors (15% of retail investors just began investing in 2020), strong demand for services and almost limitless access to information.[6]

Looking beyond these shifts in the industry's core economic fundamentals shows that the sector's DNA is currently evolving at an unprecedented rate across three key areas:

New formations

As a result of industry consolidation, we're witnessing the creation of newly formed, larger-scale asset managers, wealth entities and offerings built out of legacy incumbent pieces and parts. Those are set to become bigger players, with new capabilities and scale to match. And the pressure to consolidate isn't going away. In fact, it's likely to accelerate, given product and scale demands from clients, profits driven by wealth managers and returns delivered by the private markets—not to mention the attractiveness of sticky assets, recurring fees and in-demand services.[7]

New entrants

Fintech players are continuing to drive a gradual but steady transformation of the industry with new capabilities. We see this effect manifesting itself in areas such as accessibility and advice, where fintech players have the clients, clout, the engagement model and digital offerings to be a very real long-term threat to the industry incumbents.

New frontiers

ESG offerings, digitized/tokenized assets like non-fungible tokens (NFTs), client demands and the regulatory landscape are all evolving at a rapid pace—requiring firms to think and act differently in an effort to play catch-up, rather than lead.[8]

Against this backdrop, we also note the emergence of a new phase of development for the buy-side: one characterized by changing profitability dynamics and the need to address the fundamental disconnect between the top and bottom lines, between AUM and revenue, between product and demand, and between technology investments to manage the current state and the ones to drive innovation.

In this new operating environment, the "old" set of solutions—across-the-board expense reductions, rationalization of the product shelf and cost-driven M&A—are no longer enough. Instead, firms now need to take a holistic—and digital—approach to addressing strategic roadblocks across the economic, client and industry landscape (see figure 9).

Figure 9: Addressing strategic roadblocks for industry change

Economic barriers
As volatility is now part of the new normal, and with interest rates hovering around 0% globally for some of the world's leading economies, the gap between AUM and revenue growth will likely become more pronounced in the coming years.[9]

Perception barriers
Personal preferences, ESG demands and lifespan goals require firms to have a clear brand and coherence in differentiating themselves as stewards of capital—on top of their return profiles.

Consolidation barriers
An analysis of leading publicly traded asset managers shows the top 12 firms control some 60% of industry-wide AUM based on a sample population. This snapshot reinforces the concept of a top-heavy industry—one that needs a new path for innovation beyond M&A aimed at simply achieving scale.

A new playbook for the buy-side

The Silicon Valley giants succeeded in creating, mastering and capitalizing on a digital playbook that drives their businesses, creates practices that are industrialized across other industries, and ultimately integrates their business models into the very fabric of how we live and work today.

Digital at their core, client focused and data-driven, they blazed a new trail to go to market effectively and sustainably.

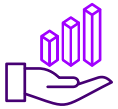
Buy-side firms should take a page from this playbook and write their own chapter (see figure 10), redefining the art of the possible by:

- Digitizing engagement and interactions all the way from distribution to client experience, e.g. developing client-facing capabilities that are digitally native as part of an engagement model.
- Rightsizing the business to drive efficiencies, using technology to bend the cost curve, e.g. automating to upskill and transforming the workforce and work experience.
- Customizing their business logic and capabilities to drive differentiation at the organizational level, e.g. becoming an employer of choice through technology and the workforce.
- Moving with a sense of speed to become the first mover and market maker, e.g. empowering the workforce to be agile, nimble, flexible and receptive to change.

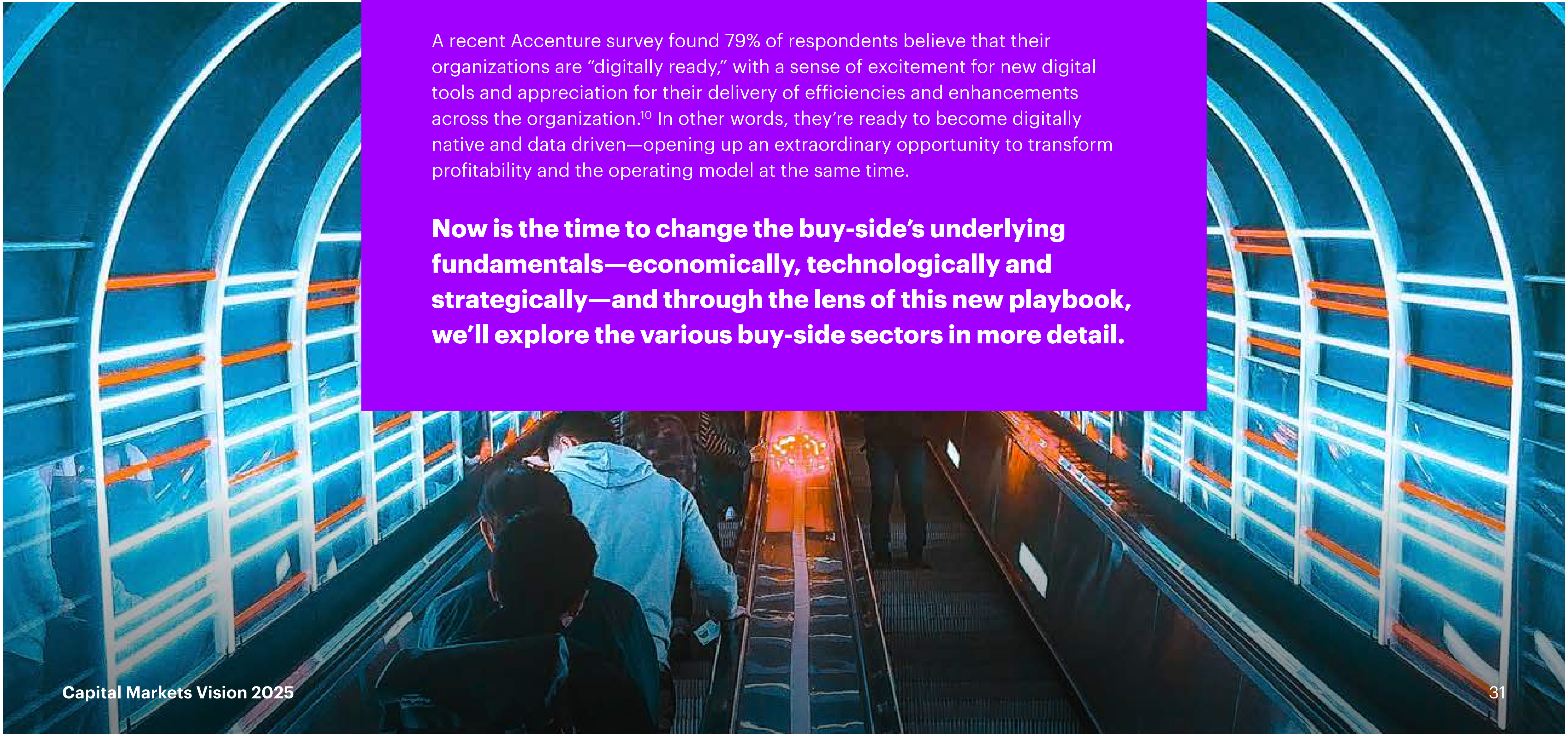
Figure 10: The new digital playbook for the buy-side

Asset managers
Leveraging cutting-edge data and analytics to gain an edge in the hunt for yield and alpha, while also bending the cost curve and realizing operational efficiencies.

Wealth managers
Creating a nimble and flexible, end-to-end digital model that delivers a simplified, more cost-effective core operating model and a better client experience.



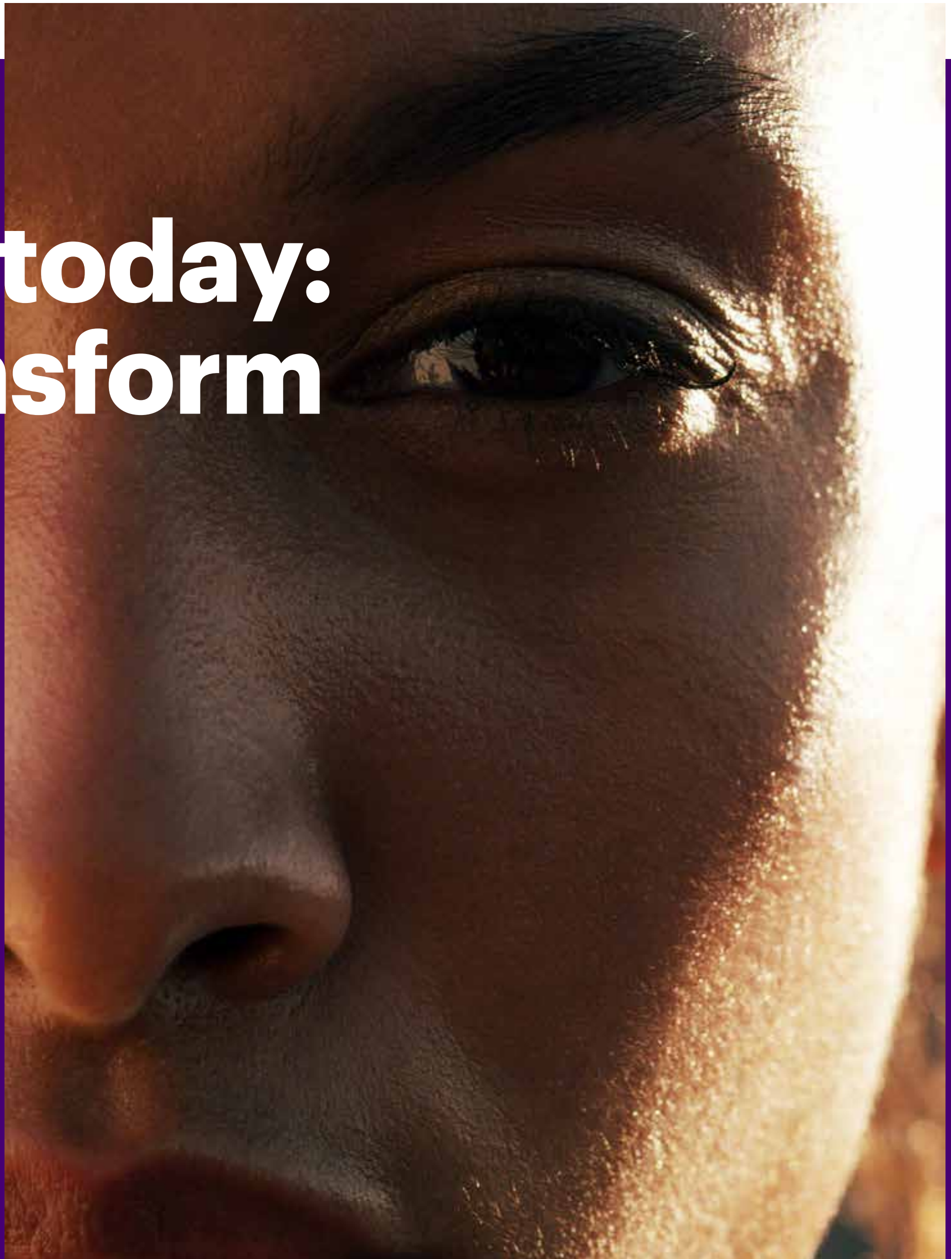
Private markets managers
Enhancing and expediting the investment process, enabling participants to move more quickly and decisively, while taking costs out of the firm, portfolio and holding companies.



A recent Accenture survey found 79% of respondents believe that their organizations are "digitally ready," with a sense of excitement for new digital tools and appreciation for their delivery of efficiencies and enhancements across the organization.[10] In other words, they're ready to become digitally native and data driven—opening up an extraordinary opportunity to transform profitability and the operating model at the same time.

Now is the time to change the buy-side's underlying fundamentals—economically, technologically and strategically—and through the lens of this new playbook, we'll explore the various buy-side sectors in more detail.

Asset management today: The pressure to transform



Asset managers sit at the nexus of the capital markets in their role as stewards of capital for clients and society alike, with scale, a clear purpose within the global financial systems and a strong client base.

However, there is a call to action for these firms to be as digital- and technology-driven at the core as possible to keep pace with changing economic, social and financial mandates.

This effort, in essence, will shape the evolution, growth and differentiation of asset managers.

A look into the sector's fundamental economics underscores this need to evolve. While asset managers drive most of the buy-side industry's revenues (42%), they are responsible for a smaller portion of overall net economic profit (25%). And as illustrated in figure 11, the gap between asset growth and profitable growth continues to increase. "Transforming" means more than taking costs out of the system; this is a story of future-proofing an industry.

In the three years since our last report, we note a gradual evolution in asset management across several drivers (see figure 12). In combination, these drivers are imposing a downward pressure on profitability, increasing the need to transform. Players have to manage increased public scrutiny, while mitigating product, profitability and fee pressures, and also addressing operational concerns.

Figure 11: Year-on-year growth in revenues, costs and AUM across asset managers, 2019-2020

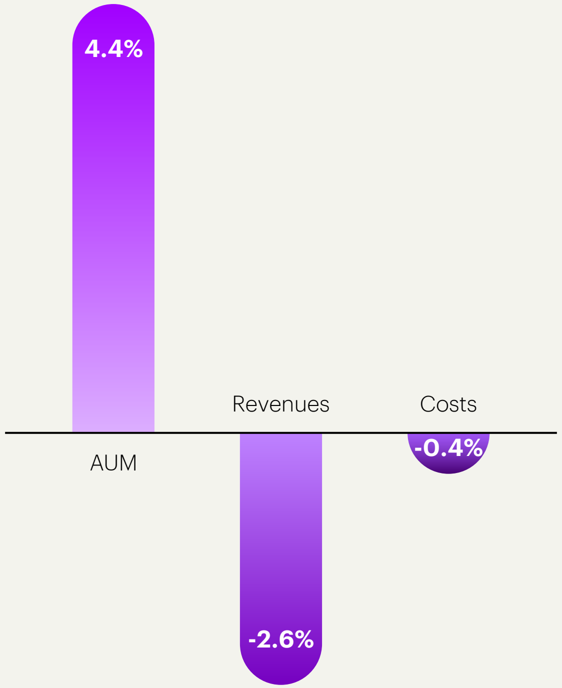
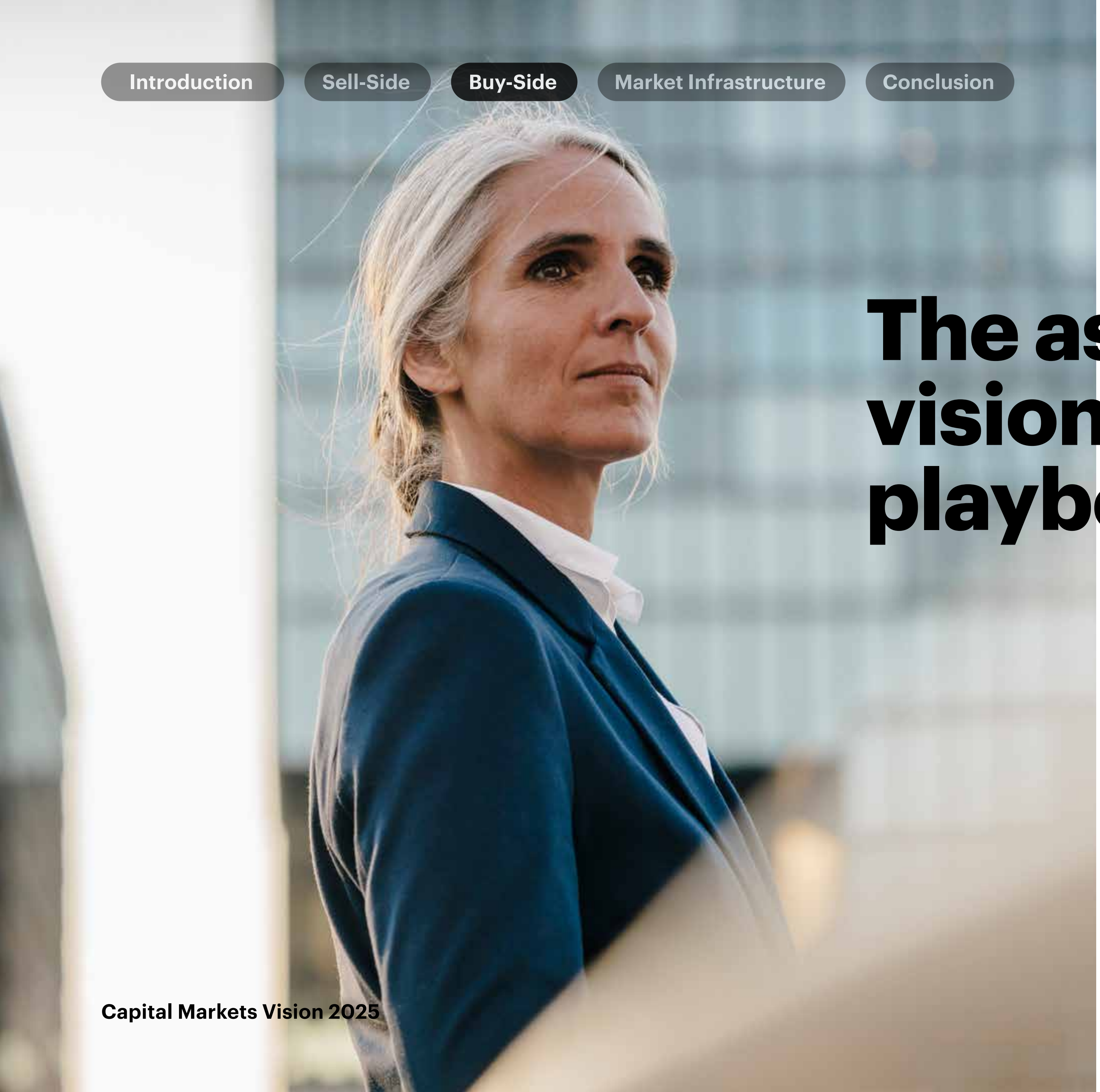


Figure 12: Asset managers' evolutionary drivers and levers, 2019-2020

	Driver	Lever
External	**Public scrutiny and perception:** Gradual shift from stewards of capital only to stewards of capital with a focus on purpose-driven investing.	Firms are facing demands from investors to expand their ESG offerings to deliver returns from the "right" types of products. They're also expected to yield their passive fund holdings to drive meaningful change at companies they invest in and expand into direct indexing.
	Product and fee pressure: The race to zero for ETFs continues; active managers continue to justify fees in light of performance; and demand for personalization is increasing.	Unrelenting demand for passive products is cannibalizing margins, forcing firms to ask if pursuing market share at the sake of profitability is a viable business strategy. Additionally, the return of active management remains to be determined.
	Distribution: Value is becoming increasingly difficult to measure.	The rise of ETFs coincided with a fundamental change in the culture and process of alpha generation (the goal of creating excess returns versus benchmarks) as distribution becomes more decentralized.
Internal	**Profitability:** Economic growth is further disintermediated from AUM and revenue.	Accenture research found a five-year revenue growth rate of 2.2% for publicly traded asset managers, suggesting size is no longer a competitive differentiator.
	Operations: Economies of scale and business structures are aligned to the booming equities markets of recent years.	As bull markets prevailed, significant cost reduction efforts and digital acceleration initiatives gave way to generating and delivering investment returns.

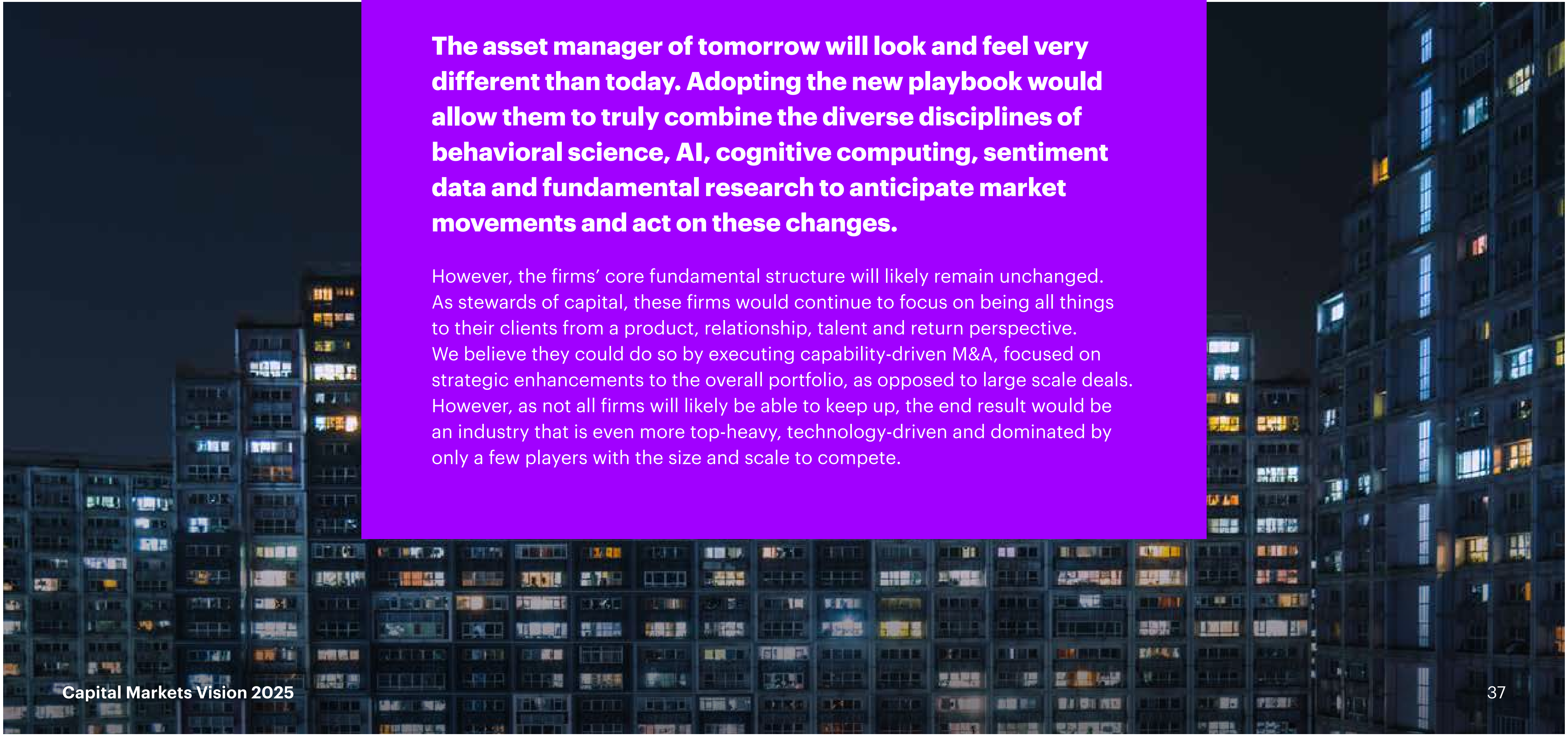


The asset management vision for 2025: A new playbook in action

To emerge as industry winners in 2025, asset managers need to transform their operating models by leveraging AI, data and analytics as part of a "new" industry playbook (see figure 13).[11] Whether used in part or whole, we are seeing this playbook gain ground, as firms look to harness the combination of alternative data and AI to drive profits or create new offerings.

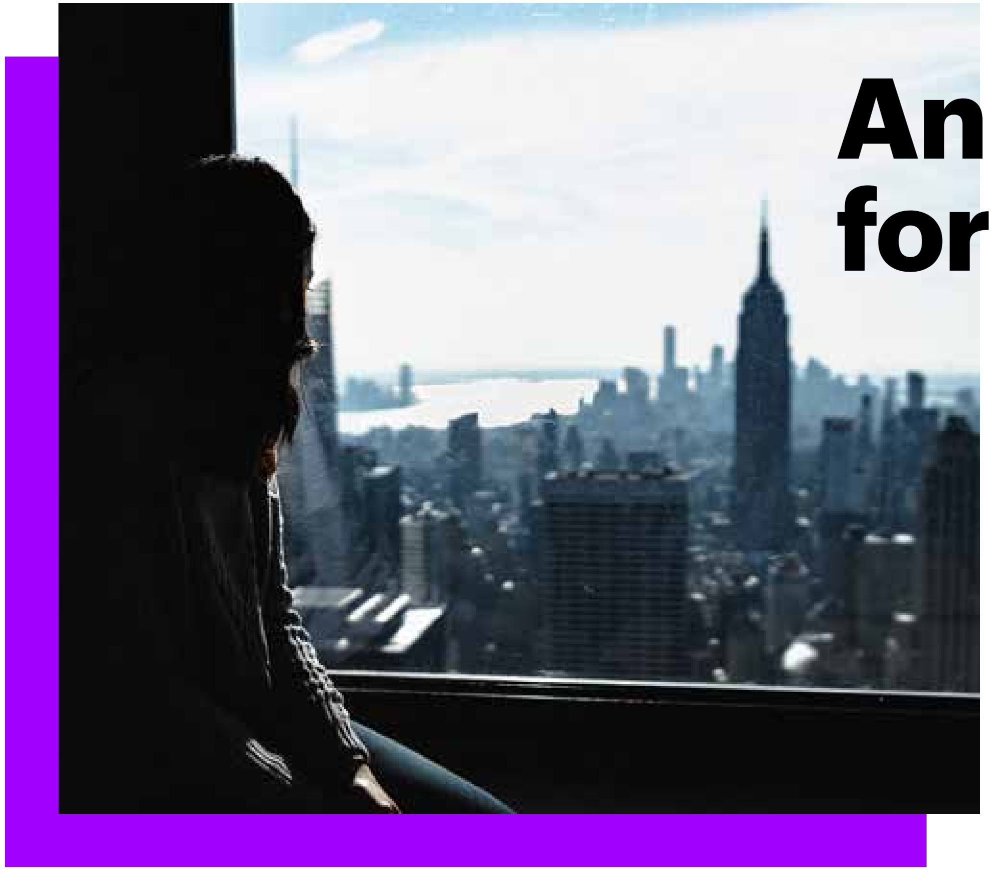
Figure 13: Asset management's playbook today—and the new playbook for 2025

Driver	Today	Tomorrow
Product	**Stress capabilities over products:** As investors continue to shift away from purely seeking alpha—first to passive investing and now to purpose-driven investing—asset managers should also look to emphasize capabilities over products.	AI is evolving, and asset managers—as with wealth managers—need to invest in more of these technologies to enable fast, data-driven decision making around returns, product suitability and new offerings.
	Turbo charge the investment process: The digital agenda requires consensus, testing and a clear demonstration of real, sustained and measurable results—especially when it comes to client returns.	Our research has found that firms who adopt a full range of AI and analytics solutions—data mining, signal generation, optimization and prediction—deliver real, sustained and measurable results.
Operating model	**Create a new path to profitability:** Product changes and client demand may force firms to restructure. Cost cutting is likely to remain a high priority but isn't enough on its own to drive sustainability.	Asset managers should create a seamless, end-to-end digital model that delivers a simplified and cost-effective core operating model and a greater client experience. By leveraging the new playbook, firms can embed new mindsets and ways of working to match the speed of innovation.
	From a static asset to a strategic asset: Firms should begin their "data reinvention" by leveraging their existing data in a new, exciting, client-focused and profitable way. Getting the data "right"—including cleaning, masking and validating it—is critical. It's also a key competency for firms to avoid entering an overcrowded space and suffering from product saturation.	Transforming data from a static asset to a strategic asset drives action across the firm. This requires a strong foundation, the new playbook and a cultural shift within the operating model.[12] When combined with cloud technology, this transformation effort becomes scalable, more efficient and more transparent.



The asset manager of tomorrow will look and feel very different than today. Adopting the new playbook would allow them to truly combine the diverse disciplines of behavioral science, AI, cognitive computing, sentiment data and fundamental research to anticipate market movements and act on these changes.

However, the firms' core fundamental structure will likely remain unchanged. As stewards of capital, these firms would continue to focus on being all things to their clients from a product, relationship, talent and return perspective. We believe they could do so by executing capability-driven M&A, focused on strategic enhancements to the overall portfolio, as opposed to large scale deals. However, as not all firms will likely be able to keep up, the end result would be an industry that is even more top-heavy, technology-driven and dominated by only a few players with the size and scale to compete.



An action agenda for asset managers

When firms embrace the new playbook, they could undergo a digital transformation, leveraging the powerful combination of cutting-edge technology and elevated talent to redefine their services.

Effectively using some of these new technologies—notably AI, automation and analytics—helps realize cost savings and drives operational flexibility and agility in tandem with a firm-wide cultural change.

The short term: Leveraging new solutions to drive profitability

As traditional strategies and assets become crowded, asset managers need to generate alpha in new ways. Firms can't shrink their way to greatness—and questions around fees for performance remain. With downsizing largely off the table in light of global economic fundamentals, asset managers need to look beyond the traditional cost levers to deliver incremental change. To manage further margin compression and revenue decreases, they need to think and act differently by being bold and resolute, starting today.

Embracing this new playbook will change how firms invest and, conversely, how they work. Consider the following data points: Accenture research found nearly nine out of every 10 investment managers are actively applying AI in their front office investment processes; four in 10 of the firms have successfully used AI to make predictions that ultimately affected their investment decisions; and 45% of respondents said it was possible to capture and attribute that performance to AI. The new ways of working, taken from the pages of a new playbook, are here and they're real.

The medium term: Reinventing the operating model for future success

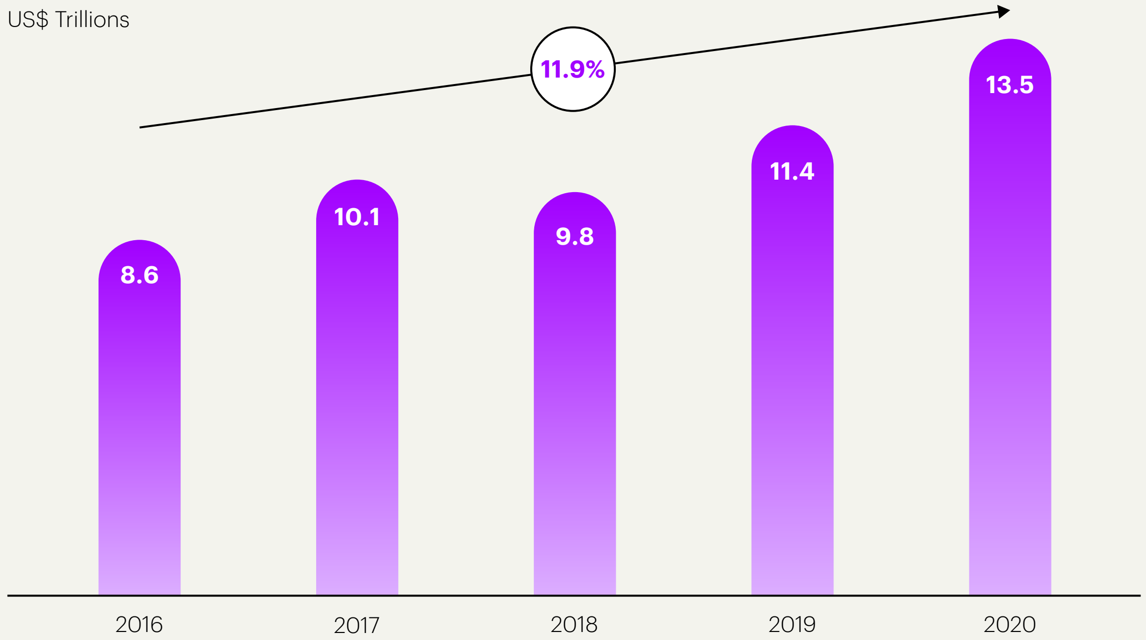
To succeed in the future, asset management firms would need to change their operating models to match the disruptive impact of constantly shifting customer demands and new offerings. Firms that do this would gain greater speed in how they go to market, make decisions and sell products, while also providing new ways of engaging with clients. They're data-driven at the core: from decision making to empowering employees to become citizen data analysts, those who act early across products, technology and client and employee demands are likely to secure a competitive edge.

Wealth management today: A story of client-driven transformation

Today's wealth management industry is framed by a large and rapidly growing market.

Core investment offerings are facing insatiable demand. Global diversification is resulting in increasingly technology- and market-savvy customer segments. Democratization and empowerment captured the public's eye. The growth in the segment over the last four years demonstrated an 11.9% compound annual growth rate (CAGR) from 2016-2020 (see figure 14).

Figure 14: Wealth management AUM growth, 2016-2020



Established players across banking, capital markets and insurance are pivoting parts of their business towards wealth management, with the aim of capturing stable, recurring and lucrative fees.

The industry isn't evolving from the outside-in only—some wealth mangers are driving change inside-out by launching new offerings such as multi-asset class portfolios. The industry is also becoming more decentralized, as personal trading platforms blur the lines between the customer, advice and the product.

Advice has also evolved as it's become democratized and partially automated, with the role of the financial advisor increasingly spanning business, family and life.[13] Clients are demanding more from their wealth providers—not only in terms of returns but expanding into financial education and access to information. They also want more relevant insights, a better understanding of their own needs and how these connect to wider networks and communities of interest. This is a call to action that wealth management firms need to respond to appropriately and decisively.

And this response is already underway. To win more business, more wealth management firms are deploying strategies for specific customer segments, including the emerging wealth and mass affluent categories. The timing is fortuitous: clients are demanding highly digitized experiences and are putting fee pressure on wealth managers. They also want investments that reflect their values more than return profiles, as ESG has moved to an essential product offering and demand for direct indexing is increasing. Also, traditional boundaries of segmentation are disappearing as wealth clients become a segment of one, and the commoditization of traditional asset classes is driving market growth in sophisticated private and non-bankable assets.

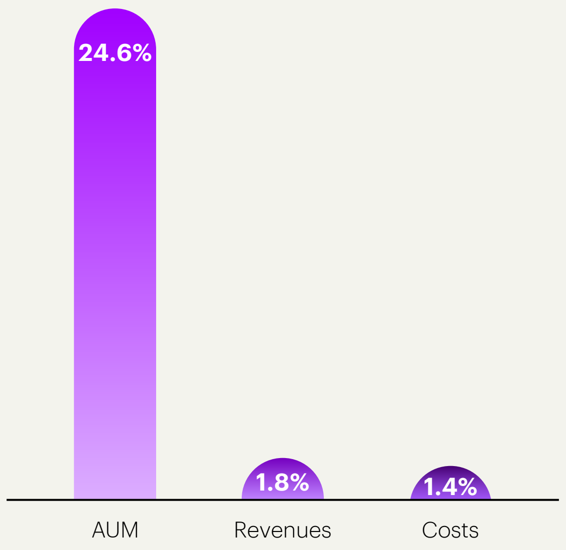
Harnessing data to drive competitive edge

Our industry analysis found a 0.4% difference between aggregate cost and revenues growth year-on-year, suggesting costs are potentially cannibalizing revenue at the expense of current and future client engagement, various IT programs and competitive advisor initiatives (see figure 15).

And while business, life and portfolio management are becoming increasingly digitized, it seems that many wealth managers are still continuing to focus on advances in the industry's core personal dynamic, as opposed to what they may regard as "ancillary" technological innovations. Bridging this gap between the personal and the digital may require some fresh thinking, which makes today a perfect time to leverage the new digital playbook.

We believe that now is the time to harness business transformation to drive digital transformation, including the creation of more flexible operational processes and the wider adoption of intelligent technology solutions. Creating a seamless, end-to-end digital model can deliver a simplified, more cost-effective core operating model and a better client experience. It's a strategic imperative: technology drives efficiency, which, in turn, can create a more focused and customized client experience.

Figure 15: Year-on-year growth in revenues, costs and AUM in wealth management, 2019-2020



The wealth management vision for 2025: Business models with the client at the center

The challenges we've outlined would require new business models in wealth management—business models that are technology-driven and data-enabled, with the client at the center of the value proposition.

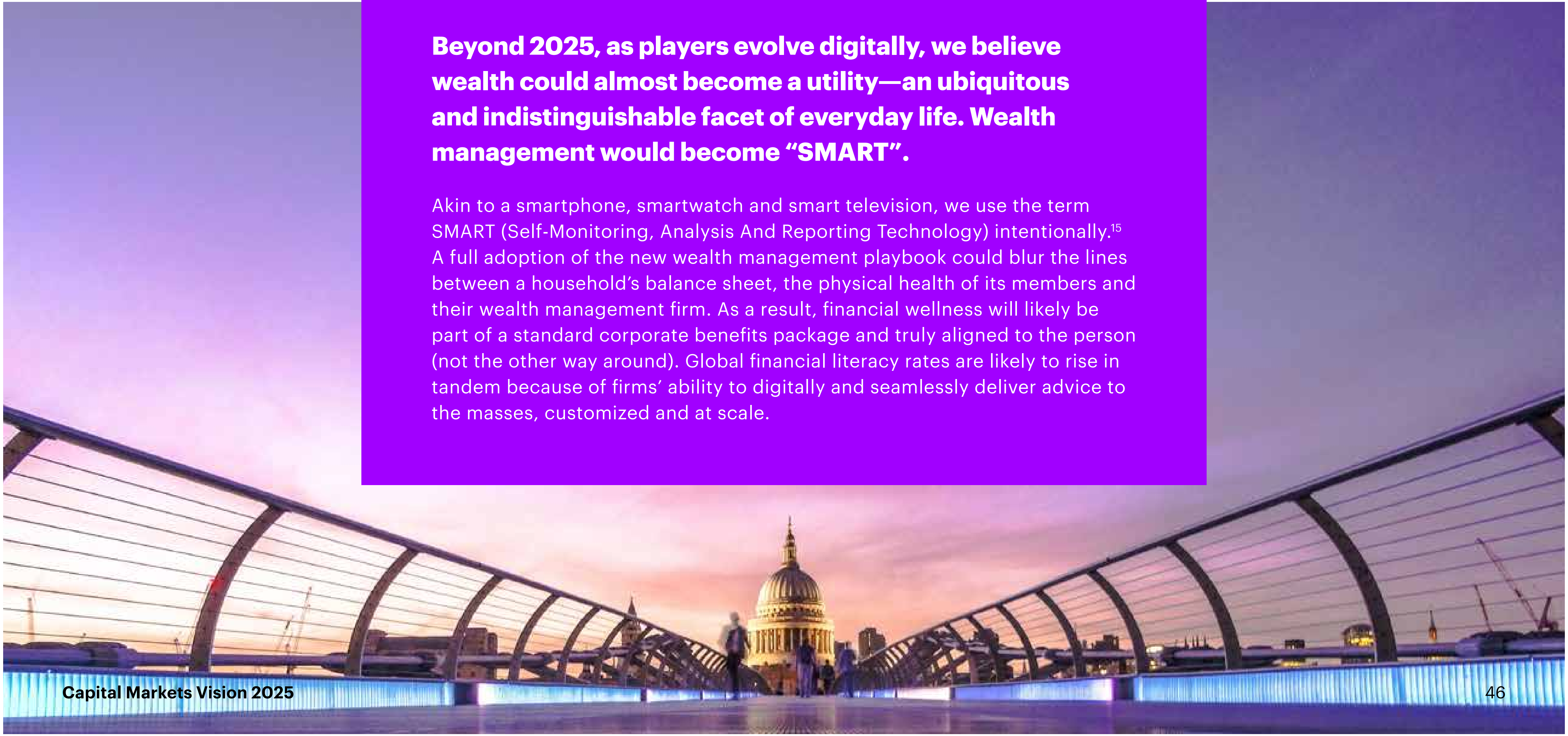
Firms need to find new ways to increase profitability and enhance the client and advisor experience, while also digitizing the overall operating model. This means embracing the new digital playbook for 2025, as outlined in figure 16.

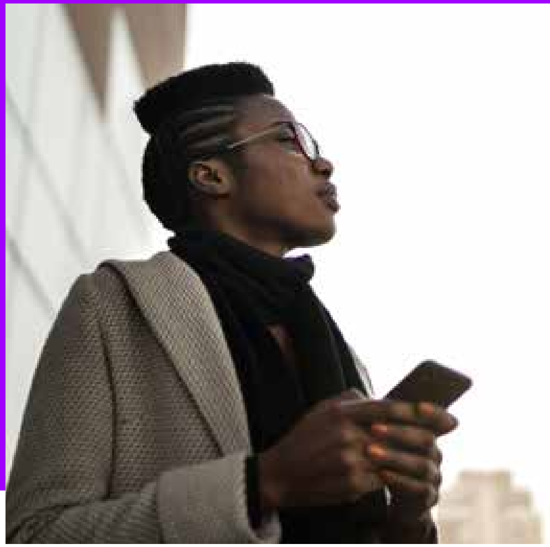
Figure 16: Wealth management's new digital playbook for 2025

Driver	Today	Tomorrow
Hyper-personalization	Future advice models need to be enabled by hyper-personalization, which would result in richer, more relevant client conversations and advice. Advisors' skill sets, conversely, also need to change.	Analytics can change the way a firm interacts with its clients in three ways: via products, by offering personalized client accounts without a fund wrapper; via algorithm-driven approaches to investment selection, while streamlining branding and marketing; and via digital, to drive the decomposition of risk and correlation in portfolio construction. It's the first step in delivering an experience that aligns the person to the product, not the other way around.
Diversified products and services	There's a need for new value creation and revenues generated from diversified offerings, beyond AUM-linked fee models, with boundaries between wealth and corporate advisory blurring. There will be a shift from a product centric view to one focused on how the advice is delivered.	From model portfolios (more than 400 have been launched since 2018 as of August 2020) to financial wellness, tomorrow's service offering should align to today's client demands.[14] To maintain client context and keep the person at the heart of the service, data and analytics are key.
Hybrid interactions	Digitizing client journeys will accelerate the use of touchless technologies such as remote, video-enabled advisory and digital onboarding, and the emergence of new pricing models. There's a need for flexibility around advisor-led versus self-serve digital channels.	From touchless technologies to an "anytime, anywhere" advice offering, firms should ensure they digitize the value chain to ensure the back-end data aligns to new, front-end, on-demand and real-time engagement, creating connected client journeys.
Distribution reimagined	Wealth managers need to reduce their reliance on physical distribution by restructuring the branch network and workforce on a large scale. Firms will need to utilize "Centers of Excellence", where advisors and middle-office experts collaborate closely to increase client trust and productivity.	Firms can use a "feeder" model to pass clients from other parts of the firm into wealth management. This requires client analytics and AI-powered recommendations, the removal of legacy silos and better cross-firm collaboration via agile coaching and effective cross-selling methods.
Digital E2E operations	Wealth managers need to digitize their operating models end-to-end, bringing together best-of-breed emerging technologies, modern engineering and strong wealth platforms. Their talent would have to transform as well.	A key to success in 2025 would be keeping advice, the client and the workforce at the core of every initiative. As talent is up-skilled to become data fluent and digitally enabled, the firmwide culture undergoes a rotation to an agile, action-oriented mindset.

Beyond 2025, as players evolve digitally, we believe wealth could almost become a utility—an ubiquitous and indistinguishable facet of everyday life. Wealth management would become "SMART".

Akin to a smartphone, smartwatch and smart television, we use the term SMART (Self-Monitoring, Analysis And Reporting Technology) intentionally.[15] A full adoption of the new wealth management playbook could blur the lines between a household's balance sheet, the physical health of its members and their wealth management firm. As a result, financial wellness will likely be part of a standard corporate benefits package and truly aligned to the person (not the other way around). Global financial literacy rates are likely to rise in tandem because of firms' ability to digitally and seamlessly deliver advice to the masses, customized and at scale.





An action agenda for wealth managers

There is both a need and opportunity to be future ready, requiring a new approach.

We see early movers adopting a more agile approach moving through awareness, discovery, design with testing and then rapid scaling in specific areas of their business model. By adopting such new ways of thinking and working, firms can gain momentum to achieve a continuous transformation to 2025.

The short term: Focus on advice

Firms need to continue to grow and evolve their core value proposition of advice. The events of 2020 caused many to look at their household balance sheet holistically. Managers should focus on providing the best insight and client experience possible. We believe advice is a function of perspective, insight and balance against a client's goals, context and construct. This remains true in a future-proof business model. In the near term, advice will focus on client-advisor engagement as the engagement method itself will be calibrated to become truly-client centric.

The medium term: Investing in client, technology and talent

Having embraced the new playbook, ensuring growth in the medium to long term would require firms to invest in additional capabilities. The client, technology and talent would need to be at the heart of this investment, with digitization opening access to a wider pool of clients while helping to retain existing ones. Winning firms in 2025 would combine the right mix of automation and talent (by automating lower-value tasks to free up advisors to be more effective in their engagement and prospecting, not to mention recruiting the next generation of talent) to deliver much more personalized client services across all customer segments. This opens opportunities for more efficient delivery of services at scale to clients with lower levels of wealth—a customer segment that has historically been underserved.

A good example of this can be seen in how ongoing enhancements in various trading apps, digital advice via financial planning, education and low- or no-fee offerings are further democratizing access to the industry. Investing in the right capabilities would enable a firm to become the wealth manager of tomorrow: digitized end-to-end, customized for the client and operationally right-sized to deliver sustained profitability and strong margins.

Private markets today: The industry's profit engine

While the buy-side overall has benefited from the impact of unintended *regulatory* consequences, the private markets (equity, credit and other alternative assets) have been the direct beneficiary of unintended *economic* consequences: lower-for-longer interest rates, changing central bank monetary policy and a flood of cheap debt and inflated equites.

In today's low-yield, lower for longer environment, private markets firms find themselves uniquely positioned as both stewards and deployers of capital. Investors seek long-term, consistent returns while some businesses prefer to stay private longer to avoid onerous regulatory burdens. Or, in other cases, they find themselves shut out of the public markets and look to new types of lenders.

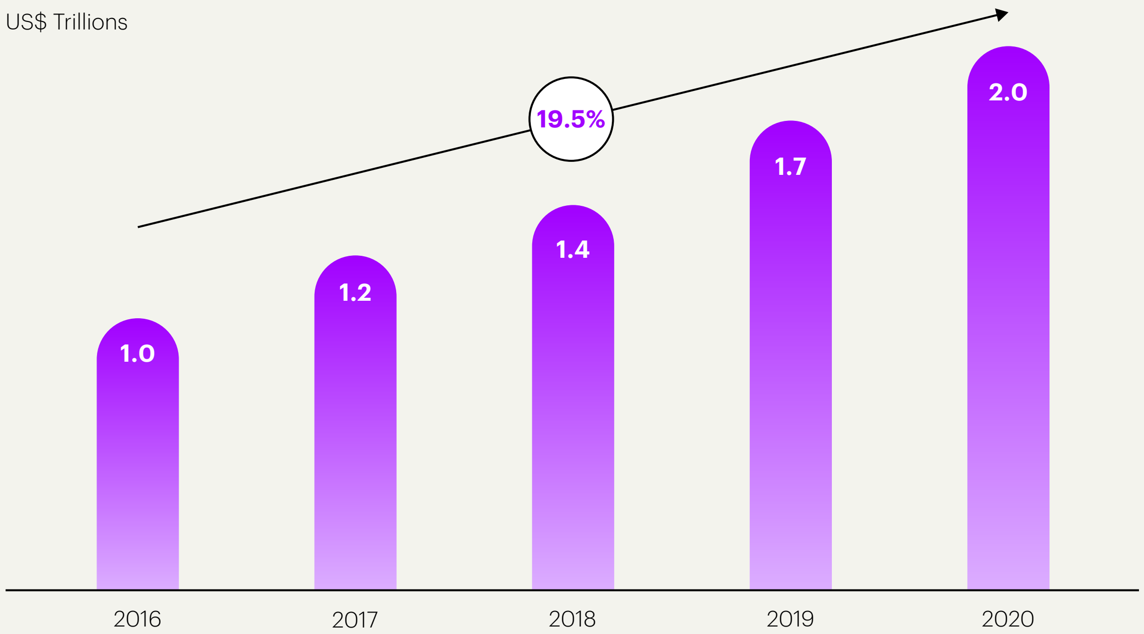
It's against this backdrop that the private markets have been delivering long-term and sustained returns for investors.

The MSCI World Index returned 15.9% in 2020 compared to a 19.3% for the Cambridge Associates Private Equity Index from 3Q 2019 to 3Q 2020.[16] And, over a 20-year timeframe, the former returned just 6.3% compared to the latter's 11.4%, according to data from Cambridge Associates.[17]

Rising AUM, rising revenue

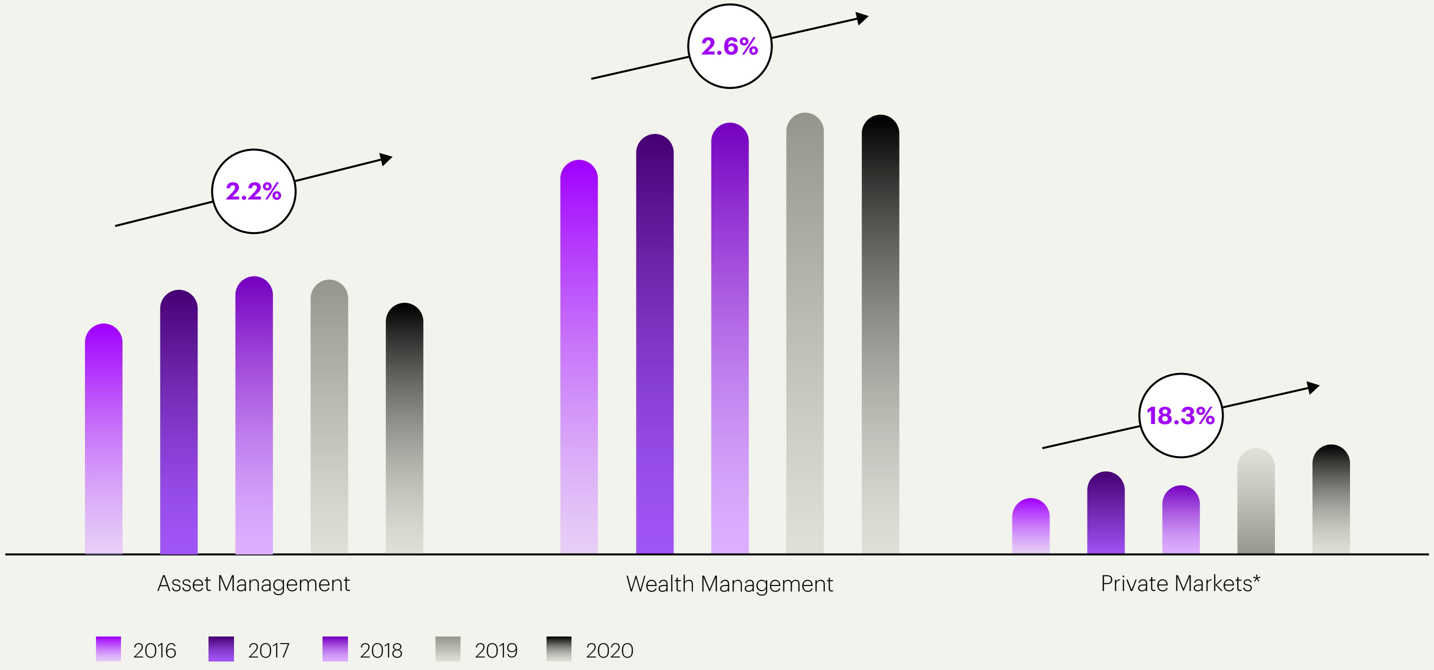
Such figures underline why the private markets players are attracting growing attention from retail, and assets from institutional investors alike. Over time, potential easing of the regulatory burden for investing in private markets would allow for full investor democratization. Until then, as the private markets gradually democratize, the figures are staggering: private market AUM (see figure 17) and dry powder (committed but unallocated capital) combined reached $7.4 trillion as of the end of 2020, and—showing inherent resilience in light of the pandemic—grew from $7.2 trillion as of the end of 2019.[18]

Figure 17: Rise of private markets AUM year-on-year, 2016-2020



Includes PE firms, Alternative Asset Managers and Hedge Funds

Figure 18: Relative revenues of private markets, asset managers and wealth managers, 2016-2020



*Includes PE firms, Alternative Asset Managers and Hedge Funds

Looking a little deeper into revenue structures, our analysis shows private markets players grew revenues almost nine times more when compared to other buy-side firms.

This growth neatly mirrors rising AUM, due to booming equity markets in light of increased investor and political scrutiny. Taking all these factors into account, private market firms have grown in profitability when compared to the rest of the buy-side, becoming the engine of the industry's structural rotation from the sell-side to the buy-side (see figure 18).

Realizing future opportunities through digital

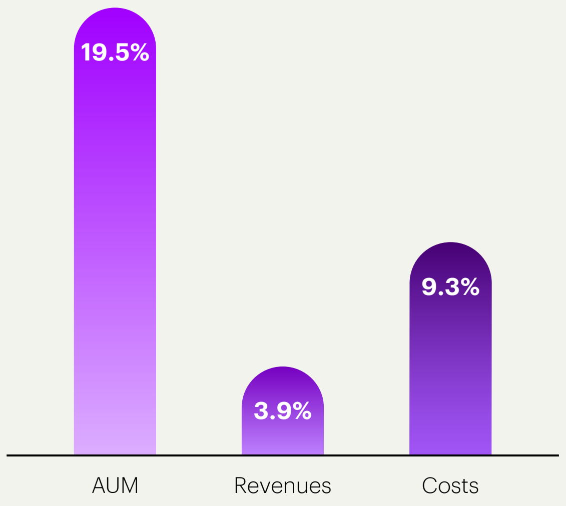
Emerging within this mosaic of capital stewardship and deployment is a lucrative business. It's one that demands the right talent, service, acumen and support to manage assets and provide valuation of opaque assets underpinned by sophisticated technology. With anywhere from $976 billion[19] in North America alone as of last September to $1.26 trillion[20] as of the end of 2020 and $1.9 trillion[21] in 1Q 2021, depending on whom you ask, private markets firms have significant money ready for deployment. They need to continue creating and realizing efficiencies to move faster than the competition—as economic volatility creates challenges and opportunities alike.

Private markets firms are experts at discovering opportunities—and their success depends on acting decisively to put together the right deal and executing with speed. However, they are comparatively lean when it comes to headcount and back-office staff. As a result, handoffs, transformation initiatives and change management programs may fall behind with a new deal materializing or a holding company re-entering the public markets.

Against this background, digitization creates an opportunity for the industry to drive costs out of the business model while also streamlining and organizing data more effectively (see figure 19). We see cutting-edge data and analytics as a natural fit to help enhance and expedite the investment process in the private markets, enabling participants to move even more quickly and decisively.

The benefits could be maximized by bringing technology seamlessly across the value chain from front-office data-driven assessments to back-office automation.

Figure 19: Year-on-year growth in revenues, costs and AUM in private markets, 2019-2020



Includes PE firms, Alternative Asset Managers and Hedge Funds

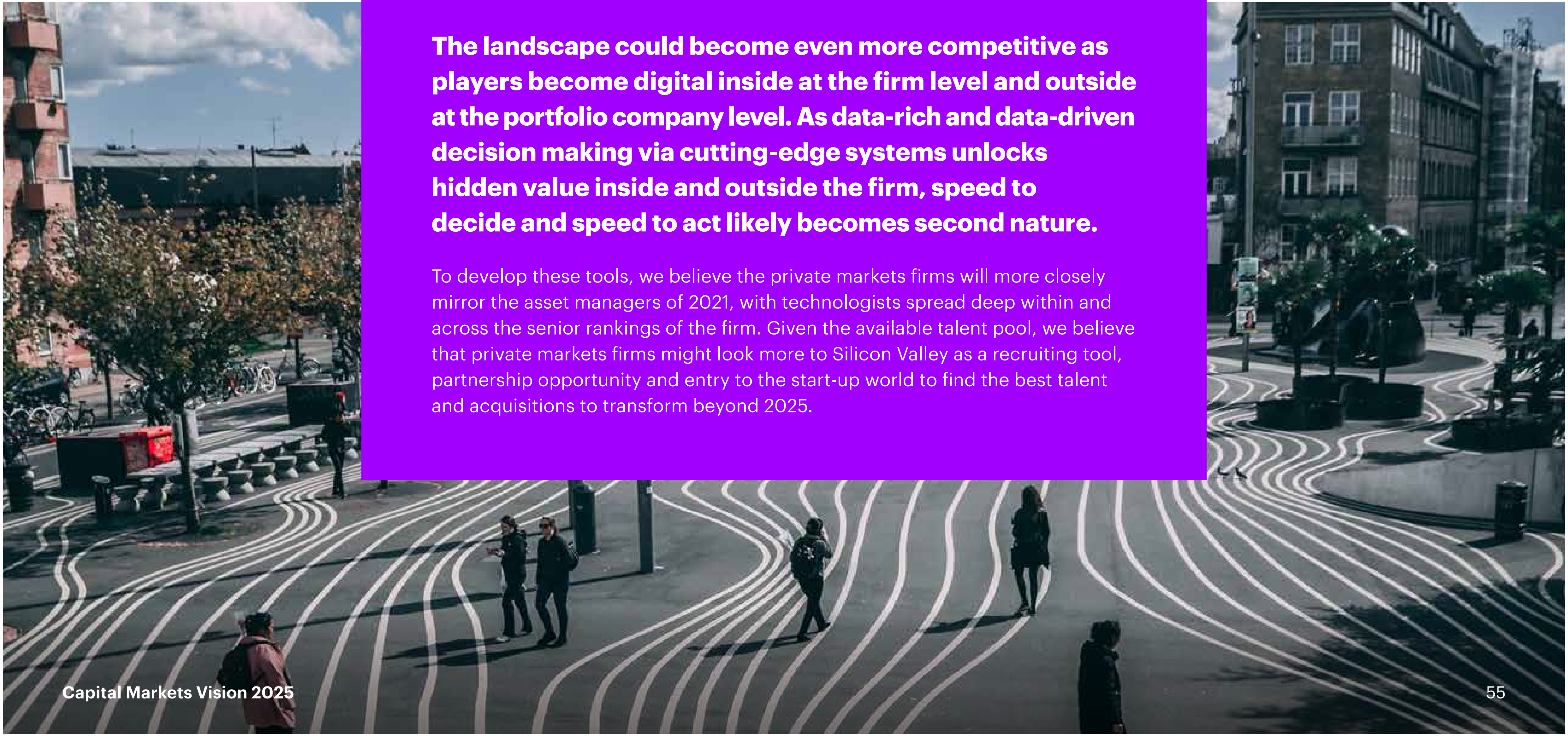
The private markets vision for 2025: Creating the digitally enabled firm

Today, the hallmark of the leading private markets firms is operational excellence, delivered at scale and protected by high barriers to entry.

However, the industry is facing growing competition from upstarts looking to disintermediate or disrupt parts of the investment process by leveraging the new playbook across all parts of the lifecycle: fundraising, deployment and engagement, and the operating model itself. The cost curve needs minding too, as costs are outpacing revenues. However, as figure 20 shows, the new playbook also offers incumbent private markets firms options to transform in pieces or holistically, while addressing both operating model and business considerations.

Figure 20: Private markets new playbook for 2025

Driver	Today	Tomorrow
Operating model considerations		
People	Continue waterfall and consensus-driven ways of working.	Embrace additional agile and forward-looking ways of working.
Process	Manage a collection of processes and technology.	Transform the collection of processes into an operating model.
Technology	Push forward with a monolithic and siloed technology stack.	Shift to a modern, modular technology platform.
Business considerations		
Portfolio company engagement	Implement and leverage customer relationship management (CRM) tools to collect necessary information and share limited information on a need-to-know basis.	Enhance CRM with data-rich analytics and visualization tools to provide in-time snapshots of key operational and financial metrics, enabling faster action and resolution.
Portfolio company due diligence	Execute spreadsheet-based due diligence, with visualizations to better understand past and present performance and predict future cash flow and valuation.	Leverage data and analytics to arrive at relevant valuation metrics more accurately, allowing firms to move from decision to action more quickly and decisively.
Portfolio company pre-deal	Manage a limited view of the available data and test current assumptions based on current accessibility.	Develop models and leverage predictive analytics to determine where and how to deploy initial investments post-deal close.
Portfolio company post-deal	View each company as a single entity with its own unique set of challenges and opportunities.	Leverage a common taxonomy via analytics to identify common synergies and leverage best practices to further transform operations.
Firm-wide communications	Capture information via organization silos, analyze the data, and align on key messages and data points for regulatory filings.	Deploy cognitive capabilities like robotic process automation (RPA) and ML to streamline the data collection and sharing process, making it more accurate and efficient.
Data-as-a-service	Evaluating an opportunity should expand beyond the target portfolio company’s products and services to market and include data as a key variable.	View the target’s data holdings as an asset in its own right to ultimately provide another revenue stream for the firm.
Asset / holding valuation	Support the quarterly close by using existing tools and data to value current holdings (and their complexity at both the holding level and the individualized returns to a number of limited partners) instead of driving the close with technology.	Developing robust valuation models fed with a diverse mass of alternative, unstructured and economic data sources and using AI to develop point-in-time valuations and scenario-based hypotheses for the purpose of calculating returns and carry.



The landscape could become even more competitive as players become digital inside at the firm level and outside at the portfolio company level. As data-rich and data-driven decision making via cutting-edge systems unlocks hidden value inside and outside the firm, speed to decide and speed to act likely becomes second nature.

To develop these tools, we believe the private markets firms will more closely mirror the asset managers of 2021, with technologists spread deep within and across the senior rankings of the firm. Given the available talent pool, we believe that private markets firms might look more to Silicon Valley as a recruiting tool, partnership opportunity and entry to the start-up world to find the best talent and acquisitions to transform beyond 2025.

An action agenda for private markets firms

The short term: A focus on platforms

Firms will continue to leverage specialized platforms and offline tools to support unique asset classes such as privates and infrastructure, and then focus on aggregating data, portfolio views and client reporting. As more and more private markets firms leverage a platform-based perspective, they will be able to create—and ultimately deliver to market—a true end-to-end view of the investment lifecycle. Getting there, however, requires the right operating model to have command of real-time data, the in-house expertise to drive continued operational efficiencies and the strategy to look both internally at processes and externally for investment opportunities.

The medium term: Balancing the platforms

The balancing act dictates whether one single platform can address the requirements for all asset classes or if there is a need to build on the emerging trend towards greater interoperability. This concept emerges at the intersection of the platform and service providers moving and aggregating data between separate platforms as efficiently and seamlessly as possible. Regardless, the art will be finding a way to balance the product's unique nature and the common platforms and operations that increasingly cut across asset classes and products.

Financial Market Infrastructure: Exchanges and Asset Servicing

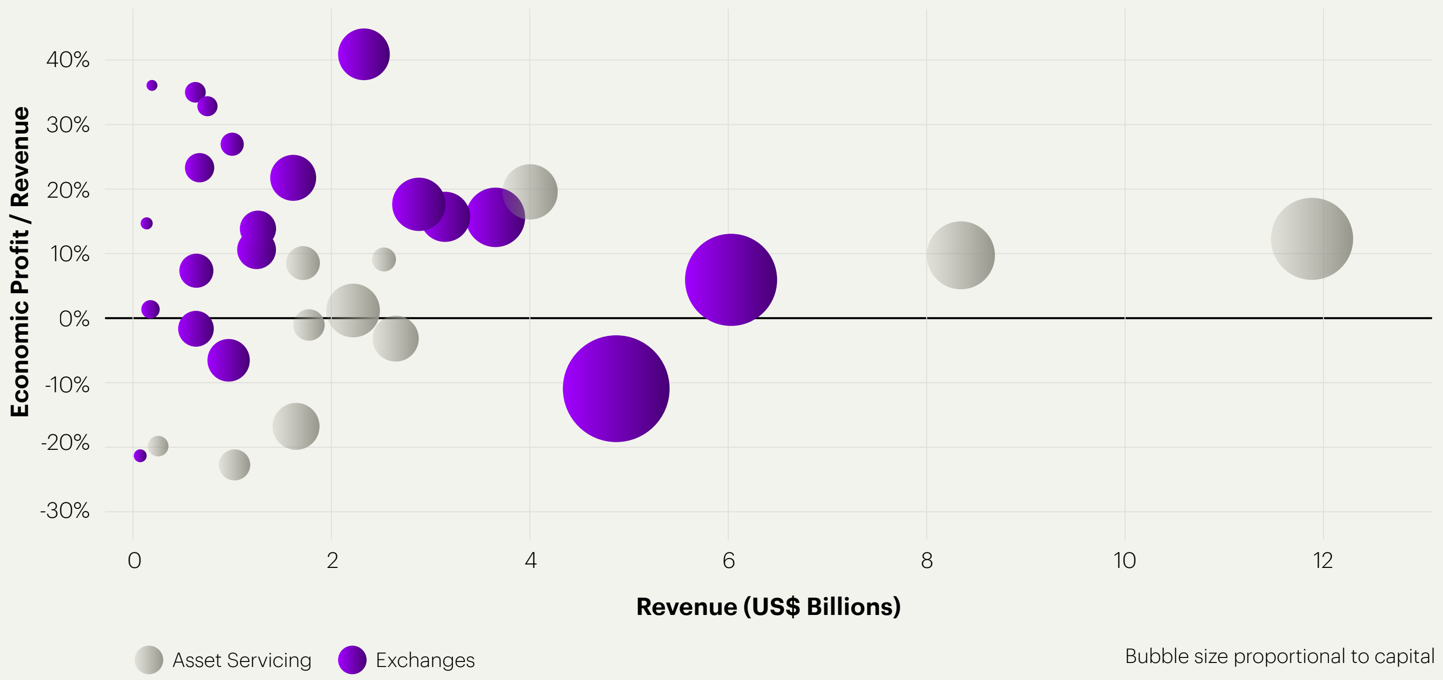
Executive summary

Financial market infrastructure players—including exchanges, clearing houses, central securities depositories, trade repositories and over-the-counter alternative trading venues—support activities on both the buy-side and sell-side, therefore a large part of this segment's revenue is linked to market volatility and transaction volumes.

Firms have benefited from the steady increase in trading activity seen over the past few years, in particular during 2020 with high market volatility linked to COVID-19.

In the research for our Capital Markets Vision 2022 report, we concluded that size—defined in terms of revenues—does not necessarily drive economic profit in this sector. This largely remains the case today (see figure 21) even as many financial market infrastructure players have been actively revisiting their business models alongside transformational cost reduction and digitization programs in recent years.

Figure 21: Economic profit against net revenue for selected financial market infrastructure companies, 2020



We believe that the traditional financial market infrastructure business is under threat as new digital solutions represent both challenges and opportunities.

For example, tokenization using blockchain technology may ultimately reduce risk (counterparty, liquidity), remove redundancies in roles and inefficiencies in processing and ultimately lower costs (mainly at the clearing, central securities depository and custodian level as well as their participants). This is an interesting proposition for the buy- and sell-side—the members and participants using market infrastructure—but presents a fundamental revision of roles of financial markets if there is a collective shift to DLT-based platforms or tokenized market venues.

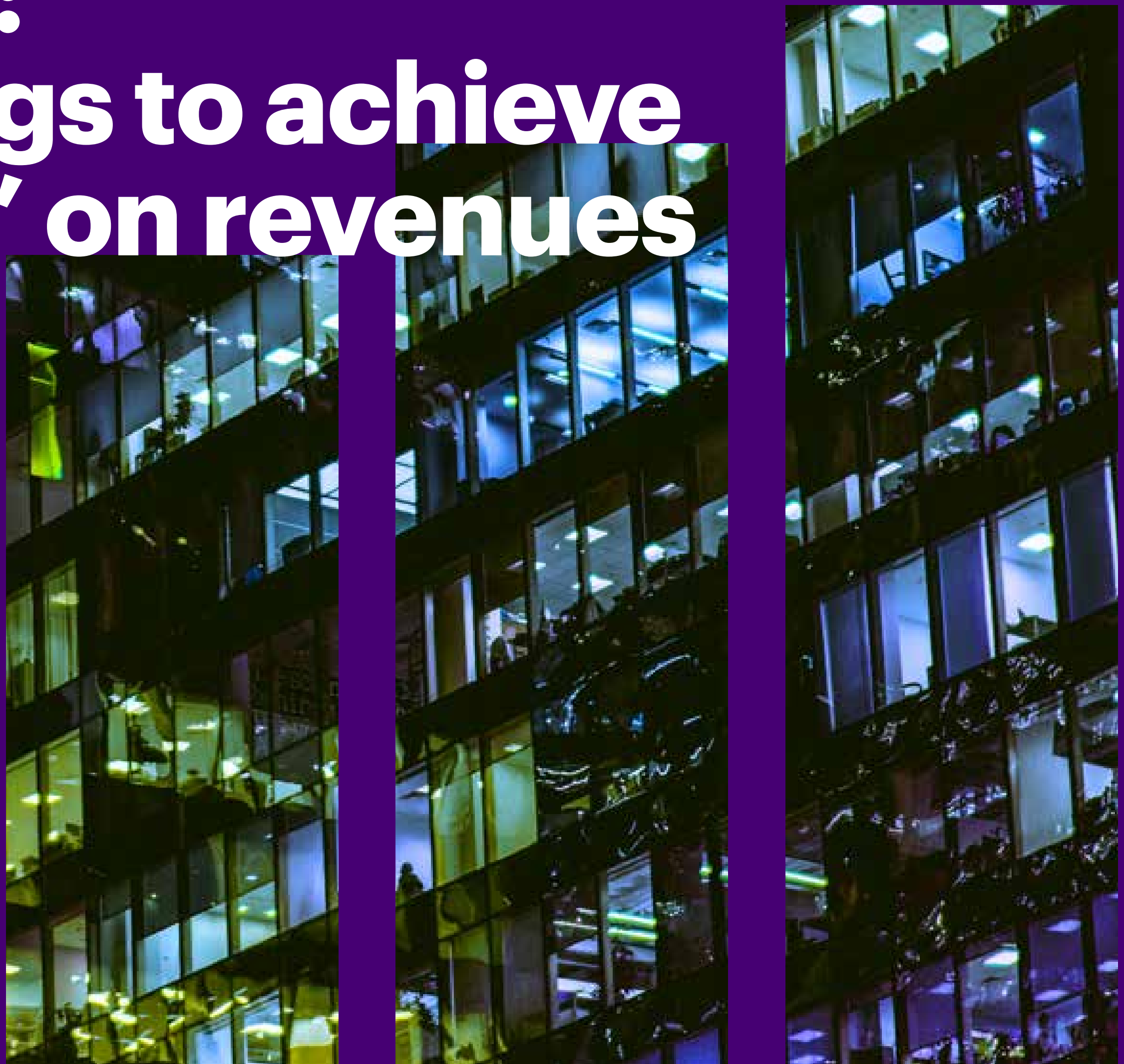
Also, blockchain-based Central Bank Digital Currencies (CBDCs) are rapidly emerging today. And in the future, tokenization via blockchain could enable an exchange to support any asset or market, creating new disruptions and vistas of opportunity for all market participants. We believe this will be a key element for the adoption of tokenized settlement not only for cash but also securities.

In the next chapter, we take a more detailed look at two types of financial market infrastructure players: exchanges and asset servicing companies. As very different types of businesses, they will each have to find their unique path to success in 2025.

Exchanges today: Fighting for listings to achieve a “domino effect” on revenues

The exchange marketplace remains highly competitive, with many firms looking for ways to expand beyond their domestic markets.

The exchanges in our benchmark include a broad set of participants (using data on the group level where applicable), with North American firms generating 22% of total global market infrastructure revenues in our research while firms in Europe and Growth Markets (exchanges located in other parts of the world) accounting for 14% and 11% respectively (see figure 22).



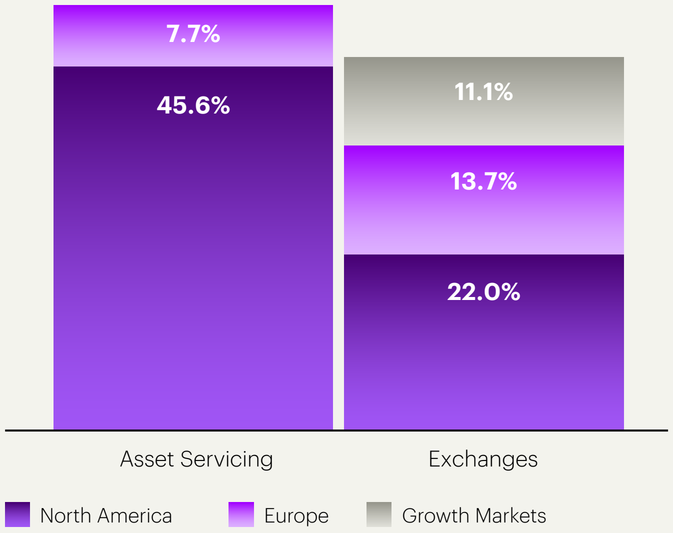
For exchanges, higher overall transaction volumes drive increased fees, higher levels of data and additional revenue from services such as clearing and settlement.

In turn, successful listings and strong transaction volumes attract greater interest from companies seeking a broader market for funding. These underlying economics mean exchanges that boost their listings could also increase market share and generate additional revenues.

The exchanges sector is currently dominated by a small group of firms. This makes it harder to compete and raises the possibility of regulatory intervention. Mergers and acquisitions are also changing the landscape as individual exchanges seek greater volumes. Yet, the number of company listings has remained relatively flat since 2015. We saw a small overall 1.1% increase in the number of global listings in 2020 versus the previous year, though listings across Europe fell for the third consecutive year. The limited number of new listings are mostly offset by de-listings and we see new off-market venues continue to strengthen.

A further challenge for exchanges is that potential issuing companies are seeking alternative funding sources, with private financiers taking a higher share of the financing market every year. Exchanges can no longer rely on their reputation alone to attract companies to list with them. They need to have an offering that attracts listings and thereby increases revenue across the business. Some exchanges are also revisiting their listing venues and models to expand their footprint (e.g. to serve more corporates and small and medium-size enterprises) and creating more non-regulated market offerings.

Figure 22: Net revenue split between financial market infrastructure companies in our analysis, 2020



Commercialization of data and technology remain growth opportunities

Exchanges' net revenues have grown at a CAGR of 8.7% since 2016, reaching $33.5 billion in 2020 (see figure 23). The exchanges in our benchmark have widely differing product mixes—and while trade services may be considered the staple (accounting for 60% of total net revenues), most exchanges are also looking to provide additional services. As such, data and technology and post trade services accounted for 20.3% and 19.7% of net revenues respectively in 2020. While several exchanges have expressed their goal of offering more data services in the past, the contribution of data and technology to aggregate net revenues has edged up only slightly over the past three years. Nevertheless, the biggest growth opportunities may lie in data and technology.

Figure 23: Breakdown of exchanges' net revenues, 2016-2020

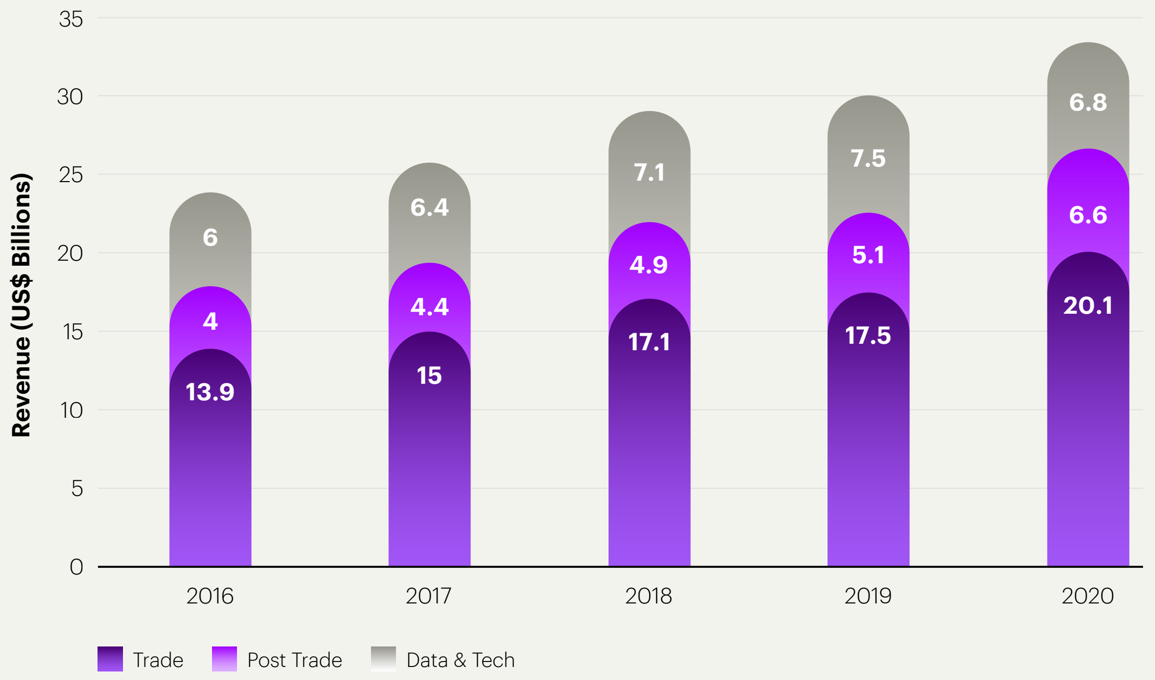
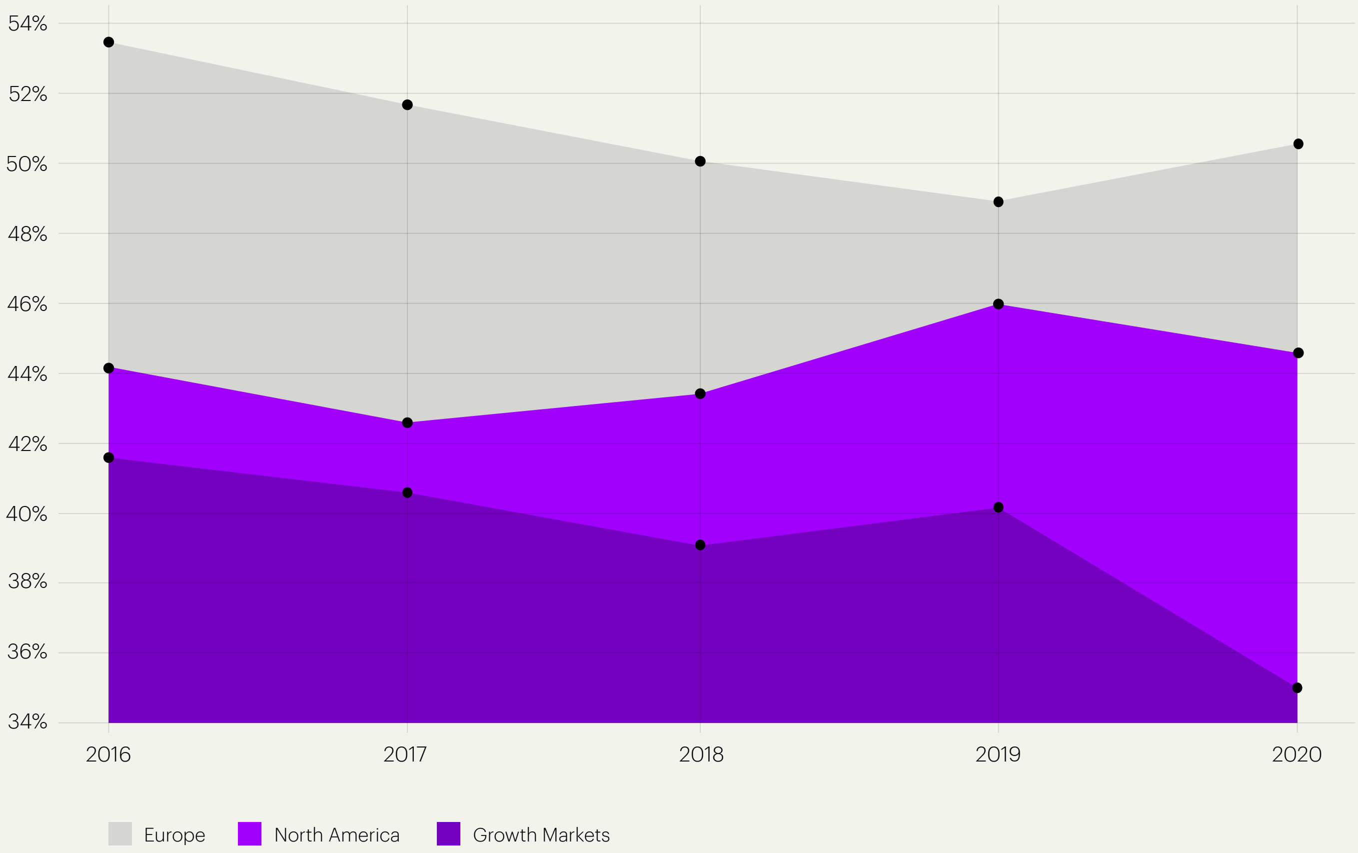


Figure 24: Cost-income ratio for peer group exchanges, 2016-2020



The average cost-income ratio for exchanges remained at 45% from 2016 to 2020 after a slight increase in 2019, albeit with wide variations between markets in different regions (see figure 24).

Looking globally, accelerated cost increases over revenues were generally due to two main reasons—higher technology and integration costs, and increased compensation expenses. The latter was attributable in some cases to rises in headcount following the incorporation of newly acquired businesses, and in others to higher performance-based payments. Given the relative "guaranteed" revenues and limited structural change we have seen at these organizations in recent years, we also observe a very limited workforce turnover—resulting in an ageing workforce with continually growing direct costs.

Exchanges are already facing an array of challenges

As revenue growth has exceeded the growth in underlying capital, with cost-income ratios remaining constant, the average economic profit margin for exchanges in our benchmark has risen to 14% in 2020, up from 12% in 2016.

For exchanges, the type of trading activity being undertaken would influence potential revenues. Looking across the peer group of exchanges, we see a broad range of equity order book trade sizes and number of trades, which play a role in determining profitability.

For most exchanges, a significant proportion of their turnover value and the combined market capitalizations of their listed companies may be attributed to the top 5% of domestic companies. This may range from 65% to 75% for those exchanges that report it.

This means that most of the value generated from trading is from a small group of companies at each exchange. This is all the more reason to further invest in digital to enable better management of costs.

The exchanges vision for 2025: The fully automated digital exchange of the future

In the exchange space, somewhat trailing behind their members, there is growing momentum toward becoming more "digital". The holy grail would be to achieve full automation throughout the stack with tokenization using blockchain technology, thereby removing the high cost messaging and reconciliation dynamics of the industry. This could also enhance the potential for accelerated and integrated settlement and be the primer for a new wave of product and services innovation.

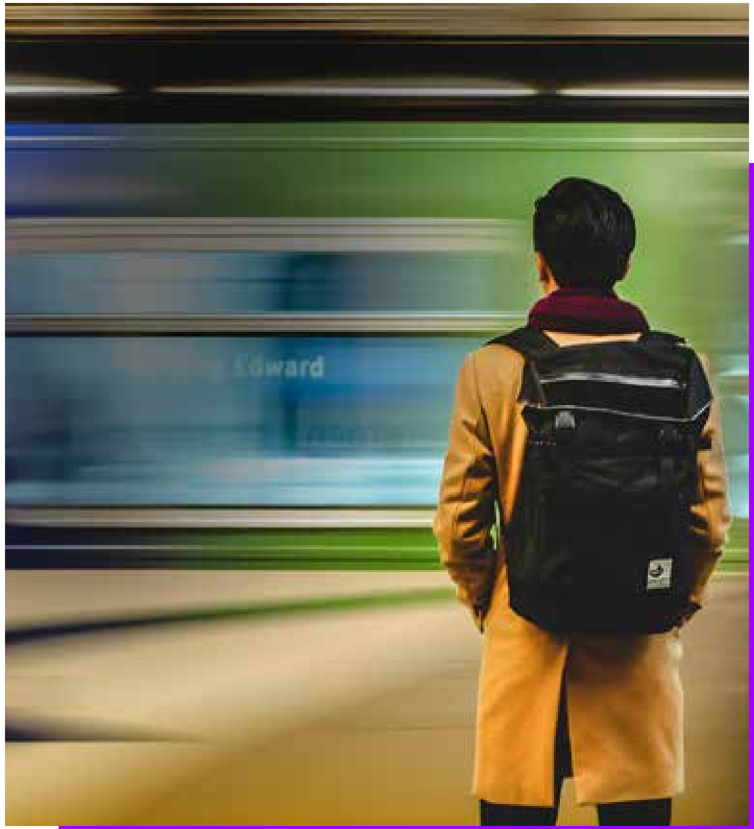
Several players are close to launching digital exchange offerings, and those have the potential to revolutionize the exchange market as we know it. Today it is mainly the exchanges that are investing in tokenization, with clearing houses and central securities depositories (CSDs) following at a slower pace.

A successful digital exchange could take market share from incumbents, as listings and the follow-through revenue would likely move towards the disruptor.

This could disrupt markets in which one exchange has a monopoly. Also, securitization structures enabled by tokenization could bring emerging and illiquid assets—such as environmental-benefit linked securities—within the capital markets ecosystem. It could potentially unlock billions of dollars in new economic activity. New business models could emerge as commercial viability comes within reach for new markets. New exchange models could also reduce the overall number of market infrastructure providers and possibly drive a rethinking of the role of clearing houses and CSDs.

Another key development in the space is the emergence of CBDCs, which represent a third form of central bank money alongside physical currency and bank reserves. They are expected to have the same legal status in the future as the other two forms of money. Their arrival will accelerate the development of fully digital asset markets.

Crucially, CBDCs can enable atomic payment-versus-payment (PvP) and delivery-versus-payment (DvP). These capabilities could address many industry pain points such as failed payments, an inability to meet future payment requirements and businesses' need for new opportunities for revenue growth. They could also mitigate counterparty risk in clearing and settlement, improve liquidity and provide settlement finality.



An action agenda for exchanges

Recent high trading volumes due to portfolio rebalancing during the pandemic have led to strong performances among financial market infrastructure players, but we believe those results are an exception.

To sustain momentum and maintain margins in the future, exchanges would need to take a number of important steps—including generating more value from data and reviewing all of their offerings for relevance and attractiveness in the digital world. They would need to invest in technology as well as strategic workforce transformation to prepare for competition in the digital era. Indeed, in both the short and medium term, they have many questions to answer about the digital solutions set to emerge in their ecosystem.

The short term: Review the offering structure

To position themselves for success in the near future, exchanges should look at the offerings they provide with a view to broadening their revenue generation potential.

For exchanges, data is at the crux of everything they do and, like most legacy platforms, many incumbent exchange and other market infrastructure players may not be yet ready to mine or get value from their data. Nevertheless, they should find opportunities to commercialize their data assets more effectively and review their investments in this space. But data can only become a valuable offering once firms have solved data quality and cleansing hurdles.

Many exchanges are already exploring the use of cloud, AI and advanced analytics to get their data foundations right to better manage, organize and embed clean data practices, content and outputs. The next step is building differentiated data assets—such as insight-led or new indices—to serve new customers. This investment in data is happening at some venues at a rapid pace and, alongside cloud and cybersecurity, data is consuming the majority of group investments.

This journey will take time, so it is imperative the foundational infrastructure and business models are in place as soon as possible to ensure exchanges can evolve quickly enough to capture the changing market dynamics. Those that can adapt and evolve at pace will likely maintain their competitive edge. Conversely, those that cannot run the risk of losing market share and relevance, as their client base might shift to other service providers who can satisfy their changing demands better, faster and cheaper.

As well as having to manage their cost structures, exchanges will also need to manage their risks. The move to variable settlement windows will impact the way collateral is deployed and change how risk models are managed. Again, this is a change that firms need to manage and navigate carefully.

The medium term: Embrace new product opportunities

Alternative or emergent asset classes are mostly traded in private markets and have suffered from a lack of liquidity combined with low trading volumes due to non-standardized, manual and paper-based processes. Through tokenization via blockchain or distributed ledger technology (DLT), an exchange could support any asset or market and allow for new products and new avenues for yield and alpha for investors. While this is a target for the future, a possible step now would be to develop a strategic transformation agenda that can be executed with initiatives geared towards upgrading legacy infrastructure, introducing agility or "decoupling for digital". This could be combined with a move to reimagine the current message-based business model by leveraging the benefits of new technology, ultimately bringing down the barriers to entry for existing as well as new asset classes.

An example of such a new asset class could be environmental-benefit linked securities. Investor demand for these products is increasing, driven by new sustainability goals for portfolio managers and by major corporations pledging to become carbon-neutral or carbon-negative by the end of this decade. Examples of environmental-benefit linked securities include:

Green bonds

These are typically use-of-proceeds or asset-linked bonds used to fund projects with a positive environmental impact and provide sustainability-focused investors with a vehicle to meet portfolio targets. With tokenization, there is clear visibility into the underlying collateral of the bonds, removing the ambiguity that exists today.

Renewable energy certificates (RECs)

These represent the energy generated by renewable sources such as solar or wind power facilities. They are typically offered to producers as an incentive and can be traded on the secondary market. Blockchain technology and tokenization can speed time to market for RECs, providing liquidity to the producers.

Carbon offsets and credits

These are permits that allow the companies holding them to emit a certain amount of carbon dioxide or other greenhouse gases. There are two main types of carbon credits: emission allowances and carbon offsets. Currently there is no single standard to verify claims to carbon offsets—rather, the industry relies on multiple entities, leading to a fragmented ecosystem and non-fungible assets across projects. A universal token standard could create a more streamlined marketplace and help meet increasing investor demand.

Also, exchanges need to find their reply to CBDCs. Overall, CBDCs could increase the resilience, choice and autonomy of the current payments landscape, and—more importantly—accelerate offshore settlement and enable money to be programmable. Digitized exchanges underpinned by blockchain technologies would be ideally placed to get involved in CBDCs. Such actions could improve the reliability, resilience and flexibility of future payment offerings while increasing liquidity and reducing risk.

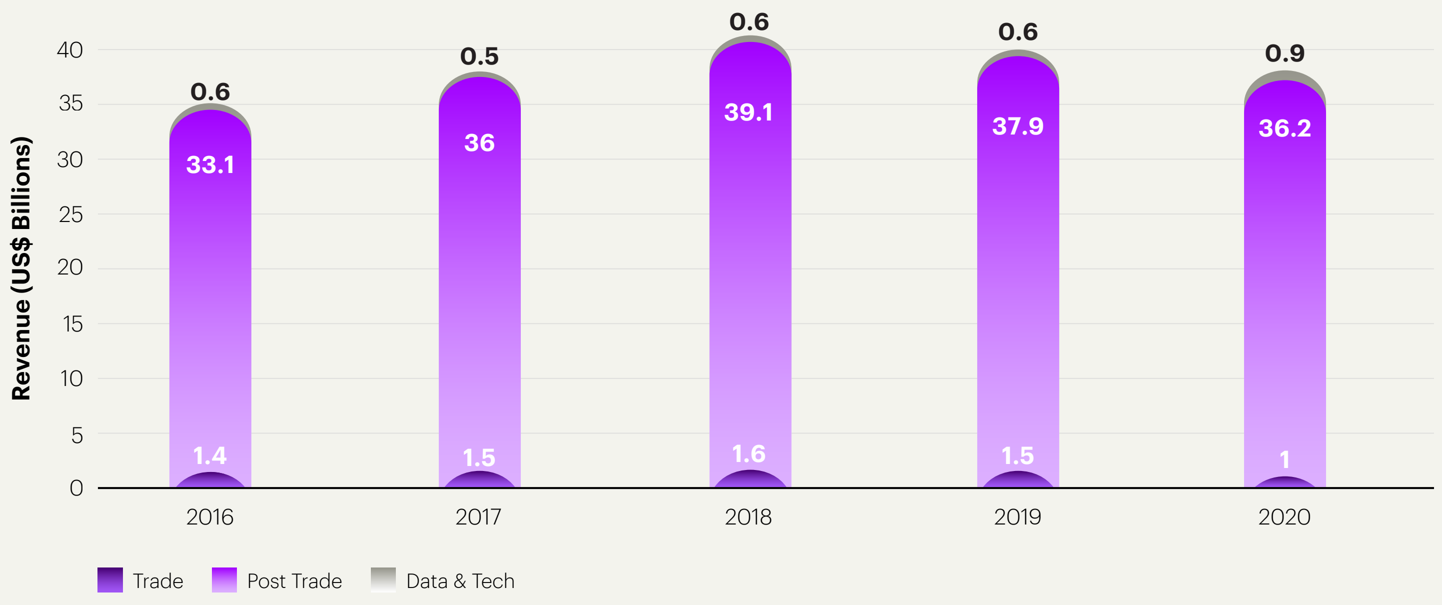
Asset servicing today: A strong focus on post-trade services

Asset servicing firms are heavily focused on post-trade services such as clearing and settlement and depository services (see figure 25). Approximately 95% of their net revenues are generated from those offerings.

In return, on average only 3% of asset servicing net revenues in 2020 came from trade services and just 2% from data and tech services. These figures have remained remarkably steady since 2016, while overall net revenues in asset servicing have grown at a compound annual rate of 2.03% to reach $38 billion in 2020.

That said, asset servicing revenues peaked in 2018, experiencing small drops in 2019 and 2020 due to the impact of low interest rates and a reduction in investment servicing and administration fees as a proportion of assets under custody.

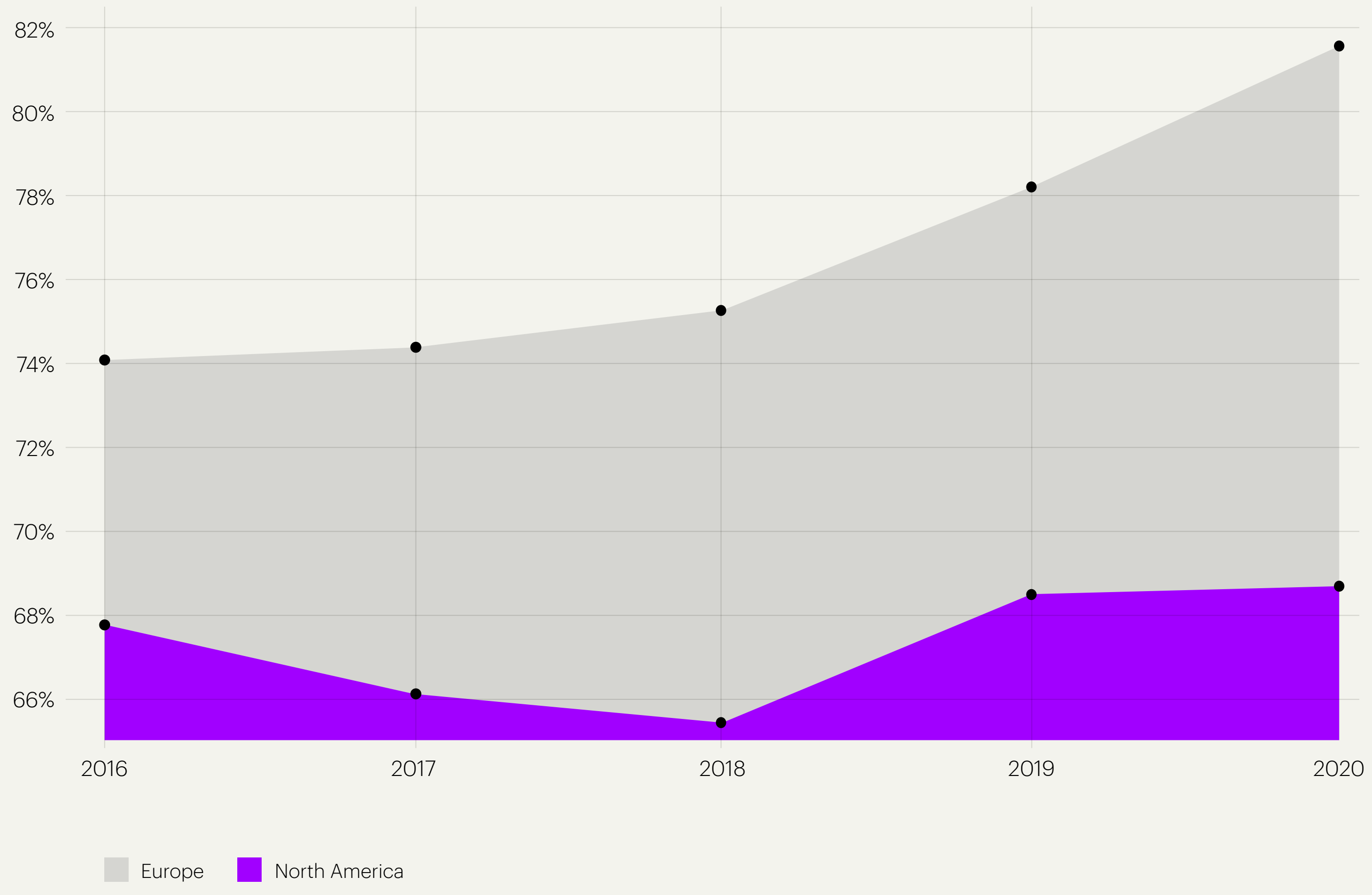
Figure 25: Breakdown of asset servicing net revenues, 2016-2020



The asset servicing sector is dominated by North American firms, which generated 86% of the total revenues of our global peer group in 2020. It's also a highly concentrated sector, with two U.S. banks accounting for over half (53%) of total asset servicing net revenues in 2020, down marginally from 54% in 2016.

As revenues have grown, so have costs. The average cost-income ratio in asset servicing has increased slightly over the last four years, rising from 71.2% in 2016 to 73.6% in 2020 (see figure 26).

Figure 26: Cost-income ratio for peer group asset servicing firms, 2016-2020



The asset servicing vision for 2025: A digital industry

While economic data suggests asset servicing firms are currently holding onto their market share, the reality is that a host of factors are making sector-wide change inevitable.

The change drivers at play include:

- Traditional operating models with limited revenue sources or new revenue streams
- Long-term depressed interest rates
- A need for agility, reflected by a slow response to clients' demand for new platforms
- Increased market appetite for digital assets and custody
- Competition from new "all-digital" market entrants

The key question facing the asset servicing industry is this: In a future where assets are transferred through DLT, settlement occurs nearly in real-time and transaction costs are nil, how can asset servicing firms position themselves to create revenue—especially given the fact that 95% of sector revenues come from post-trade clearing and settlement activities?

As digital assets are already growing in popularity, there is increasing demand from institutional investors for digital asset custody services. Digital asset custody will involve the safekeeping of "private keys"—a unique and inconvertible cryptographic pointer to the asset—and a verifiable authorization framework around the movement, transfer and modification of the asset.

The control and ownership of the asset that this framework provides will affect the regulatory scheme and risk profile of the asset. Also, the increased transparency into the movement of the digital asset would lead to an improvement in audit and regulatory compliance capabilities and a reduction in the associated costs.

An action agenda for asset servicing firms

While a complete migration to digital assets and custody is probably still years away, the period leading up to it is likely to involve a hybrid environment consisting of both digital and traditional assets and custody.

To be ready for the fully digital future when it comes, we believe asset servicing firms should start taking steps now to claim a position in the emerging hybrid ecosystem.

The short term: New services in the data and trading space

How firms will capitalize on the looming transition to digital is still open to question. Additional revenue streams would be needed to supplement traditional post-trade services, with the most likely candidates being data and trade services. However, if new market entrants can leverage better technology, the sector may be ripe for acquisitions and consolidation.

The likelihood of asset servicing firms being leapfrogged by digital entrants is increased by that fact that technology investment in the sector is increasing relatively slowly and adoption is difficult. Asset servicing is lagging behind other areas of financial services, especially in the adoption of cloud, digital platforms and real-time data and analytics. Principally this is because custodians sit on large legacy platforms that host a community of clients. Moving the ecosystem to newer technology is expensive, and adoption across all parties can be time-consuming. This means the implementation of new technology would only happen if the benefits for all parties in the community are compelling and the migration is economically worthwhile.

All of this means asset servicing firms should prepare to open their core architecture to clients and offer plug-and-play connectivity, thus strengthening those critical partnerships.

The medium term: Harnessing the rise of digital assets and custody

As digital assets become ever more prominent, asset servicing firms can provide the digital custody solutions needed to enable this new market to thrive. Digital assets require enterprise-grade infrastructure that can be integrated with existing technology and processes to run properly in regulated environments. This integration enables digital assets to be aligned with the existing business, creating a hybrid of digital and traditional assets. It also ensures the rise in digital custody can be properly regulated—a prerequisite for market acceptance, trust and long-term success.

Conclusion

The capital markets industry is truly at an inflection point. Even before the global pandemic accelerated existing trends such as digitalization, the need for change was already apparent.

As outlined at the beginning of this paper, the 2020 financial results of capital markets firms have provided the industry with a respite from ongoing pressures, as well as a golden opportunity to implement long-overdue change. In this context, one of the clearest lessons from the past year is that—given a strong impetus and unwavering focus—capital markets firms can embrace technology-enabled change much quicker than many thought possible.

Across the industry today, there is a clear convergence of business strategy and technology strategy. How these two elements combine is increasingly critical to firms' future success.

While each segment of the industry has its own unique dynamics, there is a common set of tools that firms should apply today to position themselves for success in capital markets by 2025. These include:

- Conducting a forensic review of the current restructuring agenda, including evolving priorities and competitive landscapes. Firms should refine their strategies based on low risk and rapid cost optimization, thereby releasing investment funding for other projects, such as the journey to cloud.
- Becoming a "cloud first" business.[22] Some firms may need to accelerate their journey to this position and mindset while others have yet to start. Adopting "cloud first" is not just about improving efficiency; it's about enhancing flexibility, capability and agility, and it's key to future proofing businesses.
- Embracing other emerging technologies, both for their potential cost benefits and revenue opportunities. Many of these technologies will likely only reach their full potential when applied to cloud-based infrastructures.
- Taking active steps to position the firm to secure the right people and skills in an increasingly competitive market for talent. The past year has underlined the value of human capital in terms of its inherent flexibility and perseverance. Firms should continue to nurture and capitalize on this value.

In addition to these steps, keep an eye on the longer-term developments that are shaping the capital markets of the future that we outlined earlier. These are worth watching and incorporating into your strategy as you prepare your organization for 2025.

Please reach out to us to discuss your ideas around capital markets in 2025 and beyond. In the meantime, we will be releasing a series of papers over the next few months with deep dives into the various industry segments as they progress toward 2025. So, stay tuned!

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