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Corporate and investment banking in Mexico: Delivering value through new models

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Introduction

Mexico is the fourth-largest economy in the Americas and has experienced yearly average real GDP growth of 1.9 percent in the last ten years. The Mexican economy has benefited from increasingly stronger macroeconomic fundamentals after the 1994 crisis, and has leveraged the creation of free-trade agreements to become an export-oriented economy.

Economic growth in Mexico, along with a stronger private sector, and an increasingly relevant position in the international trade scene, have had a significant impact on the corporate and investment banking (CIB) industry: CIB revenues have grown at 6 percent per year over the last ten years, mainly driven by transaction banking, which grew at 9 percent per year. Lending revenues, meanwhile, grew by 3 percent (pushed by an 11 percent growth in lending volumes). Despite this robust growth, the penetration level of CIB in Mexico, measured as total volume/GDP, is still low (39 percent) compared to similar economies (e.g., 50 percent for Latin America overall).

The profitability of the CIB sector in Mexico is healthy. However, profit margins have declined in recent years due to pressure on interests and fees. In fact, return on equity (ROE) for CIB firms in Mexico decreased from 27.6 percent in 2009 to 14.8 percent in 2017. Improvements in operational efficiency and a decrease in risk costs have helped to offset interest and fee pressure, but not enough to compensate for the decline.

Mexico's CIB industry focuses on specific sectors and client sizes. Services, retail and wholesale trade, construction, and manufacturing—pillars of the Mexican economy—account for 70 percent of commercial banking lending volume. Meanwhile, large corporations account for 80 percent of commercial lending, with small and medium-size enterprises (SMEs) accounting for the remainder.

Mexico's real GDP growth is expected to average approximately 2.5 percent, and yearly average inflation of about 4 percent, for the near term. Nominal CIB revenues are expected to grow four times faster (10 percent p.a.), with commercial lending (13 percent) and transaction banking (9 percent) contributing most of the growth. To tap into this growth, successful banks will adapt to the evolving competitive environment by better serving SMEs and capturing growth that follows from the formalization of the economy.

Three factors could further propel growth in Mexico's CIB industry:

- further integration of international supply chains (Mexico is a global leader in number of international trade agreements)
- an increase of investment and infrastructure development
- the strengthening of guarantee funds programs

These factors—together with the emergence of partnerships between banks and fintechs, the adoption of new technologies to serve currently underserved segments, and incentives for the formalization of family businesses—could lead to revenue growth of between 12 and 13 percent per year for the industry.

Conversely, heightened regulation—for example, increasing capital requirements and tighter anti-money laundering regulation—and the advent of cheaper funding from foreign banks, could hinder the growth of the Mexican CIB sector. Under this adverse and more uncertain scenario, CIBs could adopt a more restrictive credit policy and decrease investments in innovation, which would reduce revenue growth expectations to 7 to 8 percent per year.

Regardless of which scenario takes shape, five trends will shape the Mexico CIB industry:

- Continued pressure on profits
- Competition from new entrants and client in-house solutions
- Demand will polarize between commoditized digital products and tailored value-added services
- Digitization as a driver of value creation
- The battle for talent will grow even more competitive.

McKinsey's view is that these trends will require Mexico's CIB firms to reshape their strategy around four coordinated actions:

- Achieve commercial excellence
- Digitize processes end-to-end
- Redesign products and pricing strategies
- Develop advanced analytics capabilities

The prospects for Mexico's CIB sector are strong. Depending on a number of broader factors, profitability should continue along a sound and sustainable path. But individual banks will not succeed by standing still. A number of trends are changing the terms of success in the CIB sector—tomorrow's leaders will prepare now to compete in a new landscape.

Report at a glance

This report aims to identify trends that will shape the Mexican CIB industry in the near future, and actions that banks can take to be successful in the current and future marketplace

- The Mexico CIB industry has grown significantly in the last decade (6 percent per year, versus 1.9 percent annual GDP growth) but has also been challenged by a decrease in overall profitability—ROE has decreased from 27.6 percent to 14.8 percent over the past eight years.
- The CIB industry is expected to grow revenues at 10 percent per year for the next eight years. To capture this growth, banks will need to explore new commercial models to better serve small and medium enterprises, which will increasingly need CIB services as they join the formal economy.
- The industry is being shaped by five trends: profitability will continue to be challenged; competition will increase and the industry will face disruption from new entrants; consumer preferences will continue to evolve; banks will increasingly adopt digital solutions; and the need for more diverse roles will make talent attraction a continuing challenge.
- Banks can succeed in the coming years by taking four main actions: reach for commercial excellence; digitize processes end to end; upgrade product offerings and pricing strategies; and build an advanced analytics DNA.

CIB in Mexico: Growth and challenges

Mexico is the fourth-largest economy in the Americas, behind the United States, Brazil, and Canada, and the 15th-largest in the world, with a GDP of $1.14 trillion in 2017. The country has experienced yearly average real GDP growth of 1.9 percent in the last ten years.

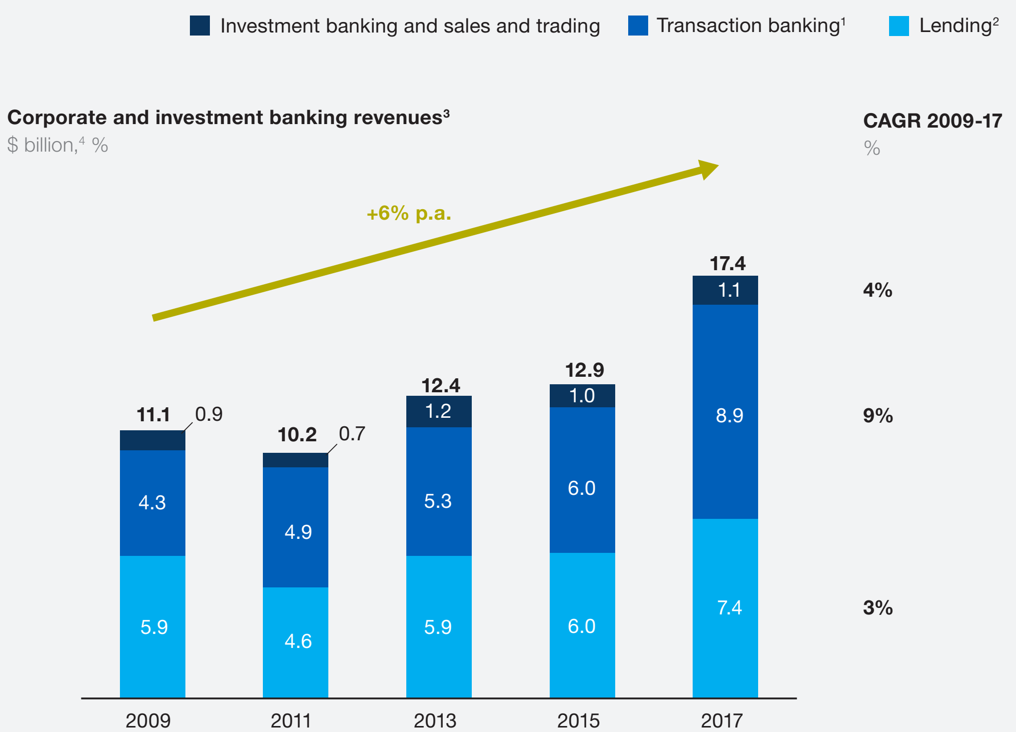
The Mexican economy has benefited from increasingly stronger macroeconomic fundamentals after the 1994 crisis, and has leveraged the creation of free-trade agreements (mainly NAFTA) to become an export-oriented economy.

Economic growth has been led by three sectors: manufacturing (20 percent), services (19 percent), and wholesale and retail trade (19 percent).

This economic growth, along with a strong private sector and an increasingly relevant position in international trade, has been accompanied by growth in the CIB industry, where volumes and revenues increased 12 percent and 6 percent, respectively, between 2009 and 2017, mainly driven by transaction banking (Exhibit 1).

Exhibit 1

CIB revenues and volumes in Mexico have grown steadily since 2009.



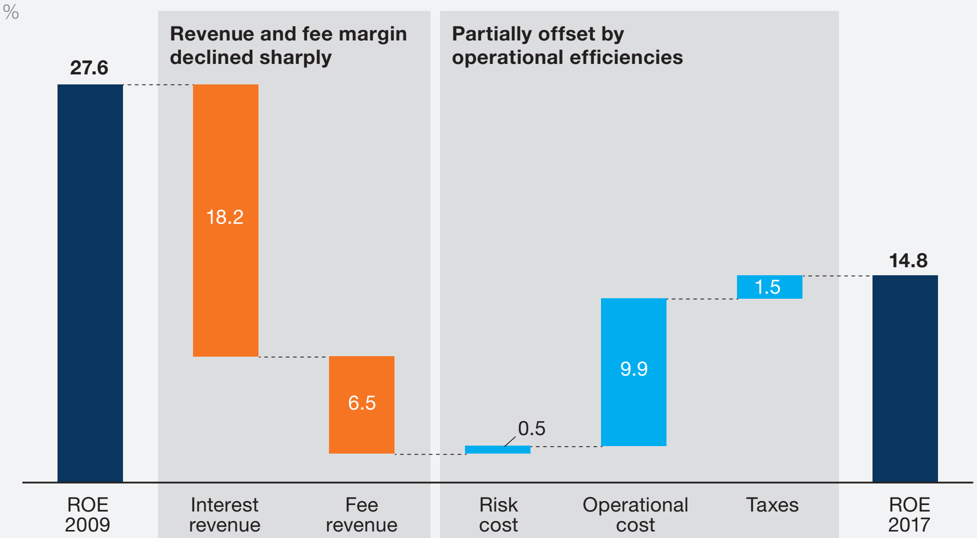
[1] Includes deposits, payments, and overdrafts of corporates, public sector, and nonbanking financial institutions.
[2] Straight and structured domestic and cross-border loans from financial institutions to corporates, public sector and nonbank financial institutions. Excludes leasing and factoring, but includes nonstructured syndicated loans.
[3] Revenue before risk cost.
[4] MXN/USD exchange rate = $18.9039.
Source: McKinsey Global Banking Pools

Exhibit 2

CIB continues to be profitable, although ROEs have sharply declined in recent years.

Corporate and investment banking ROE, 2009-17

%



Source: McKinsey Global Banking Pools

Despite this growth, CIB penetration in Mexico is still low: volume/GDP is at 39 percent compared to the Latin American average of 50 percent. This holds true for all products, including transaction banking, lending, investment banking, and sales and trading. Two factors weigh heavily on the shallow penetration of CIB in Mexico. The first is the size of the "informal sector" in the Mexican economy; the second is the fact that banks have not yet found a model for serving SMEs.

In Mexico, investment banking and sales and trading contribute only 6 percent to CIB revenues; the average for all other developed economies where is 22 percent. Investment banking and sales and trading also lag compared with other LatAm countries. The Mexican Stock Exchange lists 144 companies, while smaller economies such as Chile and Peru list 298 and 264, respectively. M&A transactions in Mexico represent 1.8 percent of GDP while the average for Latin America is almost 3 percent.[1]

Two factors explain the minor role investment banking plays in Mexico's CIB sector: First, the preponderance of family-owned companies, which typically are more reluctant to disclose financials/private company information; second; an overall lack of fiscal incentives for private equity firms to invest and generate IPOs.

The profitability of Mexico's CIB banks is still strong, but it has sharply declined in recent years. ROE fell from approximately 28 percent in 2009 to roughly 15 percent in 2017 (Exhibit 2), due to an increase in price competition and

[1] Considers the average M&A transaction volumes per year over GDP between 2009 and 2017.

commoditization of the most basic CIB offerings (such as cash management products); these revenue pressures were offset by lower operational costs.

The competitive landscape

The competitive landscape for CIB in Mexico is characterized by the following three traits:

- A wide variety of firms, operating under different models and legal structures, can be grouped in four archetypes according to their client and product coverage (see sidebar, next page). Among these archetypes, the winners (measured by onshore credit portfolio growth) have been the universal local banks, which gained a roughly 2 percent market share from universal global banks (mainly regional and niche banks) between 2009 and 2017. In addition, competitors such as ICBC, Sabadell, and Mizuho have recently received authorization from regulators to operate with formal banking licenses.
- Sharp focus on a few sectors that predominate in Mexico: services, retail and wholesale trade, construction and manufacturing. These sectors account for 70 percent of commercial banking lending volume in the country.
- Large corporates account for the majority of the CIB business in Mexico, with about 81 percent of corporate lending volumes. Around 70 percent of SMEs in Mexico are informal,[2] with no access to bank lending, which indicates that there is still significant room for growth in the segment.

[2] National Economic Census 2014.

Mexico's CIB archetypes by coverage level

- **Universal global banks:** These banks have entered the market through acquisition of local banks in the last 20 years or so. Their main focus is on clients seeking integrated services and capabilities and platforms with local and offshore balance sheets that offer a wide array of products (including specialized and globally integrated services).

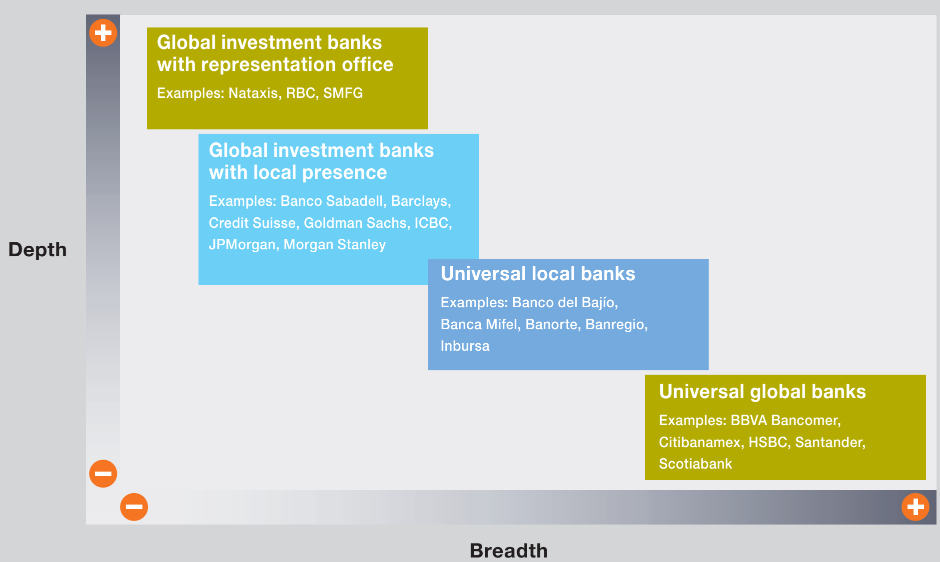
- **Universal local banks:** These banks emerged from regional or niche banks to build a national presence. Typically focused on specific regions or industries, local knowledge and networks have made them the preferred choice for Mexican companies with less sophisticated needs. These banks offer a wide array of products, including specialized services for CIB at a country scale, using their local currency balance sheet.

- **Global investment banks with local presence:** These banks have evolved from representation offices to entities with bank or brokerage house licenses, which enable them to offer a wider variety of products. Local teams are usually supported by specialized product experts from global offices. These banks have local balance sheets, but are usually more competitive in foreign currencies. Their offer is focused on wholesale clients and, in some cases, private banking services.

- **Global investment banks with representation office:** These offices offer mainly IB and structured lending services through their offshore entities or local partnerships. They have small local teams focused on client service, and can call on global experts to structure tailored products.

Exhibit 3

Four bank archetypes characterize Mexico's CIB sector.



Source: McKinsey analysis

Performance expectations

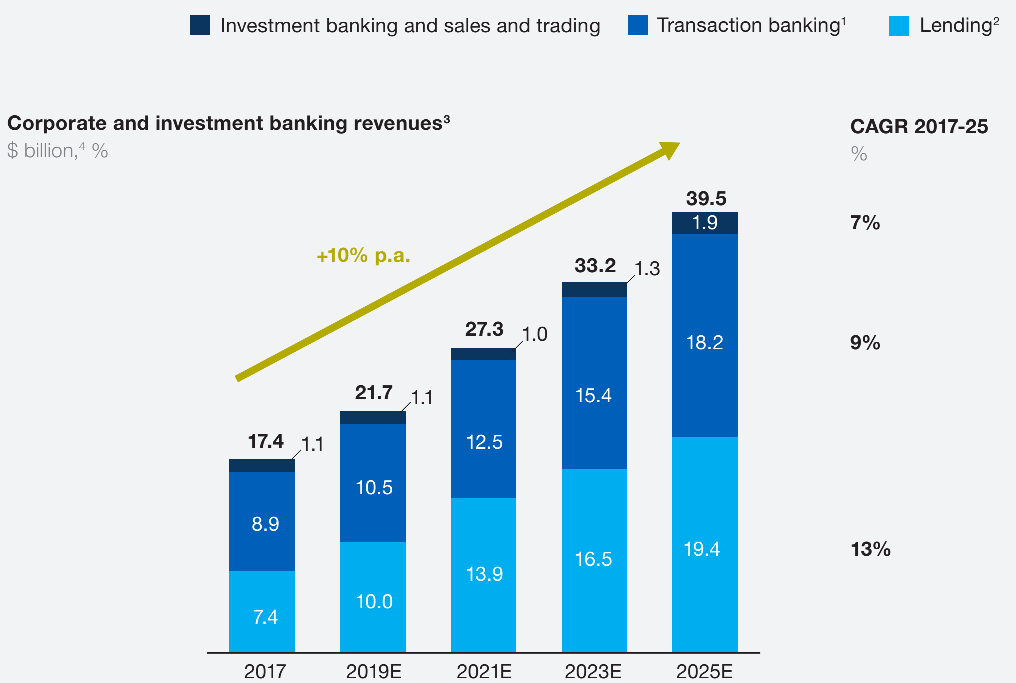
Mexico is expected to continue on a stable growth path, with GDP increasing at an average rate of 2.5 percent per year, reaching 3 percent by 2020. The high inflation observed during 2017 (6.8 percent) is expected to decrease gradually, averaging 4 percent and hitting 3 percent in 2021.

This broader growth should spur CIB revenue growth of around 10 percent (Exhibit 4). The SME segment will be the primary growth engine, as banks continue working to better serve client needs in the sector through more sophisticated commercial models and platforms, and as the formalization of SMEs continues to unfold.

According to McKinsey Global Banking Pools, lending—the primary need for SMEs—is expected to grow 13 percent per year between 2017 and 2025, boosting Mexico's penetration from the current 39 percent to more than 60 percent. Transaction banking is likely to grow 9 percent per year during this period, and investment banking and sales and trading are expected to average 7 percent growth.

Exhibit 4

CIB revenues are expected to grow roughly 10% per year until 2025.



	2017	2019E	2021E	2023E	2025E
Wholesale credit penetration %	39.1	43.4	51.9	58.2	61.6

[1] Includes deposits, payments, and overdrafts of corporates, public sector, and nonbanking financial institutions.
[2] Straight and structured domestic and cross-border loans from financial institutions to corporates, public sector and nonbank financial institutions. Excludes leasing and factoring, but includes nonstructured syndicated loans.
[3] Revenue before risk cost.
[4] MXN/USD exchange rate = $18.9039.
Source: McKinsey Global Banking Pools

McKinsey expects that this revenue growth will be accompanied by a decline in ROE of 1.5 percent. The contribution of interest and fee revenue to ROE is expected to decline by about 8 percent, due to increased price competition and commoditization of the most basic products. These declines will be offset by improved operational processes (e.g., digitization) and risk selection (Exhibit 5).

Credit risk has been under control since the last big crisis in 1995, with NPL ratios ranging between 0.8 percent and 2.7 percent. In terms of regulation and capitalization, Mexico was among the first countries in the region to adopt Basel III standards, although there are still some gaps that leave the country short of full compliance.

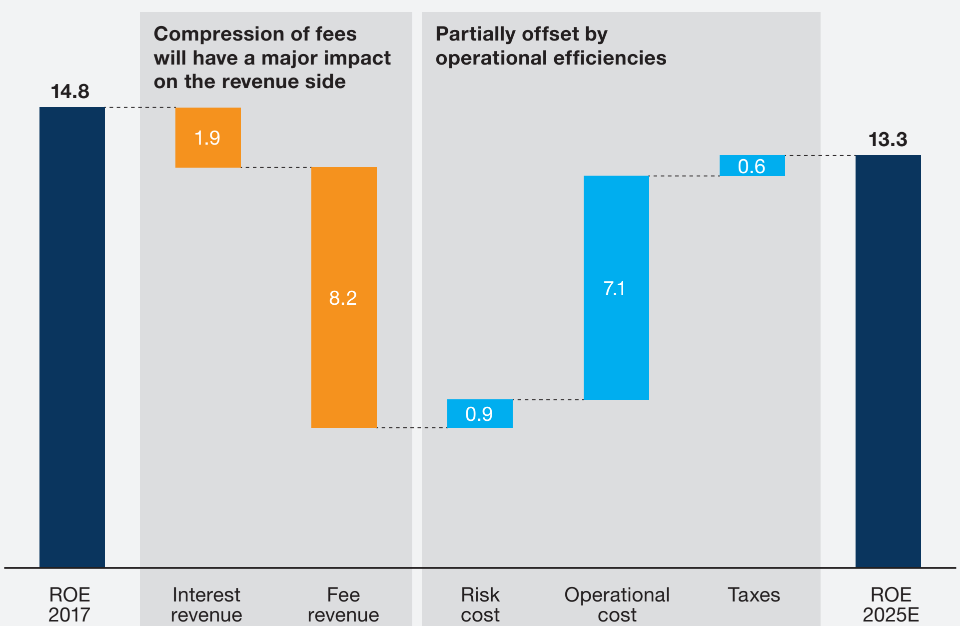
Several factors could alter these projections. In a more positive scenario, external and macroeconomic factors—for example, relaxed monetary policy, enforcement of business formalization, beneficial tax regimes—would lead to an increase in CIB penetration; more rapid adoption of technology and penetration into new client segments would also boost revenues. Under these conditions, industry revenues could outpace our projection by three percentage points, to 13 percent per year on a nominal basis. Alternatively, tighter monetary policy and heightened regulation, and passive industry behavior (e.g., excessive risk aversion, limited competition, and lack of transformation and innovation) could lead to less robust revenue growth of around 8 percent per year on a nominal basis.

Exhibit 5

ROE will decline, but remain at attractive levels

Corporate and investment banking ROE, 2017-25E

%



Source: McKinsey Global Banking Pools

Trends that will shape the landscape

Based on interviews with bank executives, CFOs and treasurers for medium and large corporates, and McKinsey proprietary analysis and expertise (see methodological note, page 14), our view is that five trends will shape the future of CIB in Mexico.

Pressure on profits

Mexico's CIB sector is among the healthiest in the world, with an ROE of 15 percent in 2017; compared to 11 percent for emerging economies and 8 percent in developed economies. However, 68 percent of the CFOs and treasurers we interviewed expect that price competition will lead to a further decline in fee margins. This would be in line with the global trend of CIB economic profit (after capital costs) turning negative.

Five factors could prevent Mexico's CIBs from achieving their full profit potential in a period of lower margins: the low productivity level of relationship managers, who only spend 25 percent of their time on commercial activity mainly due to inefficient processes; poor cross-selling capabilities; unsophisticated pricing models; painful onboarding processes; and increased regulation.

Competition from new entrants and client in-house solutions

Two competitive trends will challenge Mexico's CIB sector. In the first, fintechs will shift their focus from retail banking to CIB, with fee-based CIB businesses as a likely first point of entry.

Secondly, Mexico's CIB firms face competition from an unlikely source: their own clients and potential clients. Multinational companies are developing proprietary banking solutions that generate operational efficiencies in their administrative and financial processes, facilitate their management and reporting, and reduce operational and market risks. Examples include liquidity management, intercompany financing, financial risk management, collections, and payments and netting. This is a development that will challenge banks globally, but for Mexico's banks it is particularly acute: of the 100 largest companies operating in the country, 42 are branches of global corporations, some of which have sophisticated global treasuries or are already developing in-house solutions. The domestic companies, furthermore, are capable of developing in-house solutions as well.

Demand will polarize between commoditized digital products and tailored value-added services

The CFOs and treasurers we surveyed indicated that customer needs are polarizing, with demands for commoditized digital products on one end, and high-touch customized solutions on the other. For simple products, 74 percent of CFOs and treasurers are looking for integrated solutions and "one stop shops" that allow them to control everything from a single digital platform, and for fast, personalized customer service. For their more complex challenges, 53 percent of those surveyed expect their banks and RMs to be strategic business partners. They are looking for tailored solutions and are willing to pay higher fees if the products or services are "worth it."

Mexican CIBs are making the right moves; for example, offering digital cash management solutions. However, clients we interviewed say more works needs to be done to improve integration of modules, and to increase the speed of customer service, whether through the platform or direct contact with RM. Connectivity with other platforms—particularly for companies with international operations—is another area in need of improvement. Even banks that can leverage the sophisticated platforms of their global parent banks are not offering fully functional and integrated access to all their clients.

Digitization as a driver of value creation

As indicated above, Mexican CIBs have made progress in the development of digital solutions; however, 58 percent of the CFOs and treasurers we interviewed feel these advances are still in their early stages. Most banks' digital solutions fall short of best-in-class functionality.

Digitization and advanced analytics have increased in importance as value generators for CIB in recent years, particularly in the following areas:

- **Connecting with clients:** Banks are using digital channels to improve contact with corporate clients and financial institutions. Examples include digitization of sales and transaction channels (e.g., portals, websites) and the provision of digital tools for RMs.

- **Utilizing all available data:** Banks are generating insights from customer data to create value; leveraging incomplete and unstructured data sets to automate data insights and analysis (e.g., cross- and upselling, credit scoring and pricing).

- **Automating processes:** Robotics and automation are being leveraged to reduce costs and errors while improving customer satisfaction; streamline end-to-end transaction processes; and develop customer journeys that are fully automated.

- **Innovation in products and services:** Banks are using technologies such as machine learning to both improve current service offerings and develop new value propositions for clients. One example is the use of blockchain to increase security in payments.

Our analysis shows that Mexican CIBs have a number of improvement opportunities in the area of digitization: improving communication channels with RMs; investment, trade finance, and liquidity management products; and convenience and personalization of dashboards and certain functions.

The battle for talent will grow even more competitive

CIBs have evolving needs that require new types of talent. Digitizing operations and advanced analytics capabilities require the addition of innovative talent that often does not fit the traditional CIB profiles. Banks need to attract employees with backgrounds in computer science, information technology, and systems engineering.

The CIB sector, of course, is not the only business looking to recruit people with these skills, which means competition will only grow more heightened. In Mexico, recent graduates of these programs are not selecting banking as their preferred career path. According to a 2016 INEGI study,[3] only 6 percent of the computer science, 5 percent of IT, and 4 percent of systems engineering graduates chose to work in the financial services industry. Furthermore, the job value propositions of CIBs are less desirable than those of technology and retail, based on a focus group with local graduates of these programs led by McKinsey. Interviewees noted their preferences among five categories of a job value proposition: access to rich data, learning opportunities, working flexibility, ownership and entrepreneurship, and culture and mindset. CIBs were last in every category.

[3] National Institute of Statistics and Geography.

Strategy for a new landscape

Mexico's CIB sector has been highly profitable in recent years, and strong growth is set to continue. However, the landscape is shifting, due to a number of trends—some unique to Mexico's market, others more widespread. To respond to this changing environment, Mexico's CIB banks need to take action along a number of fronts: making their operating models more efficient; automating and personalizing processes and client interactions; and building the analytics capabilities to will deliver actionable insights for their decision-making process. The next generation of CIBs in Mexico need to be more responsive to client needs and ready to compete with disruptive entrants. Our view is that banks should shape their strategy around four coordinated imperatives (Exhibit 6).

Achieve commercial excellence

As Mexican CIBs look to maximize profitability in a highly competitive environment, commercial operations will be a key to their success. To achieve it, they must transform capabilities in the following six areas:

- **Voice of customer:** Tailor value propositions to each client segment, rigorously differentiating coverage and service among segments with established tiers.

- **Processes and organization:** Set up dedicated customer care service to manage client requests, reducing RM time spent on post-sale management and allowing them to focus more on sales.

Exhibit 6

To respond to current trends, CIB banks should shape their strategy around four coordinated imperatives.

Source: McKinsey analysis

- **Team management:** Flatten workload fluctuations for sales team members, avoiding irregularity in activities, and establish performance dialogue structures for predictable feedback.

- **Capability building:** In addition to capability-building programs focused on product and operational skills, provide training on interpersonal skills, and have experienced bankers dedicate time to coaching newer team members.

- **Mindsets and behaviors:** Complement incentive programs with non-monetary incentives, establish transparent criteria for success, and celebrate those who succeed. Foster a continuous improvement mentality, with clear best-practices and plans to achieve them.

- **Digital tools:** Integrate all available information into a single, easy-to-navigate tool, and use digital applications to replace ad-hoc spreadsheets for analysis.

In our experience, banks that focus on these areas have seen increased usage of their client-relationship tools by sales teams, more frequent client meetings, and boosts to profitability.

Digitize processes end-to-end

To compete in the changing CIB landscape, Mexico's banks must digitize customer value chains and core processes. Successful global CIBs are digitizing priority customer journeys from end to end, increasing straight-through-processing and first-time right ratios; streamlining core production processes and reducing processing time; lowering compliance costs by digitizing money laundering, know your customer, and fraud detection processes.

Leading banks are also using advanced analytics to identify total value creation by client, which helps generate automatic leads to the RMs; and building recommendation engines with advanced matching techniques that identify "next product to buy" leads. Some are using value-based pricing algorithms to define the optimal pricing strategy for each client and to provide actionable recommendations. Others are using digital tools to allocate capital allocation in a way that maximizes returns given a defined risk appetite. Finally, some banks are using salesforce optimization algorithms that help strike an effective balance for RMs, level of services, and optimal locations.

Redesign products and pricing strategies

Next-generation CIBs will offer integrated solutions and products that align with clients' evolving value chains, and pricing based on a broader—and deeper—view of the client. Service platforms with a wide array of functionalities—one-stop shops—will be the norm, and by offering value-added service, banks will encourage customer loyalty and improve cross-selling metrics.

Currently, pricing strategies among Mexico's CIB banks tend to be based on market dynamics and competition, and discount offerings are usually based on specific products or on relationship level with clients. A more effective approach is to calculate pricing based on individual price sensitivities. The establishment of customer value as the main driver of discount offerings, along with a comprehensive set of discount rules, will improve profitability.

Develop advanced analytics capabilities

Advanced analytics capabilities will create new sources of value for CIBs, unlocking new insights and enabling a deeper level of automation. To get there, banks will need to make dedicated advanced analytics centers part of their strategic business team, as opposed to a support function. In our experience, the integration of advanced analytics across the corporate value chain generates positive impact at every client segment. The highest impact is often seen in the reduction of churn rates, improved cross-selling, accelerated trading, improved trading insights, and the control of money laundering (Exhibit 7).

■ ■ ■

The task ahead for Mexico's CIB institutions is not simple. Many of the innovations needed to be successful in the coming years will require digitization of the operating platform, a level of technological expertise that may not currently exist within the bank, and the focused commitment of management.

Mexico's banks, or course, have a full agenda even without the imperatives to change: regulatory changes require significant attention, as do budgets and investment priorities for other business areas. Banks will need to prioritize. Many have developed multi-year roadmaps with large change budgets, agreed upon after lengthy internal processes.

But those banks that have made progress in their transformation have aligned behind a genuinely ambitious program. As one leading corporate banker put it: "We have wasted too much time on the next 5 to 10 percent improvement for next year. Now, we go for the big ideas."

Exhibit 7

The impact of advanced analytics will vary depending on client segment.

High impact | Low/medium impact

		Advance analytics themes	Client segments: Small and medium enterprises	Client segments: Large corporates/ multinationals
Revenue increases	Client acquisition and retention	New customer identification	High impact	Low/medium impact
		Churn reduction analytics	High impact	High impact
		Client experience analytics	Low/medium impact	Low/medium impact
	Client profitability	Next product to buy	High impact	High impact
		Pricing analytics	High impact	High impact
		Trade/solution structuring support	Low/medium impact	Low/medium impact
		Productivity optimization	High impact	High impact
Cost reduction	Operational costs	Predictive error analysis	Low/medium impact	Low/medium impact
		Smart ops/trade automation/robotics	High impact	High impact
		Digital credit assessment	High impact	High impact
Risk reduction	Risk losses	Advanced early-warning systems	High impact	High impact
		Trader surveillance	Low/medium impact	Low/medium impact
		Next-generation stress testing	Low/medium impact	Low/medium impact
		Anti-money-laundering control	High impact	High impact
	Compliance/ fraud losses	Fraud detection analytics	High impact	Low/medium impact
		Regulatory checks on contracts	Low/medium impact	Low/medium impact

Source: McKinsey analysis

Methodological note

This report is based on three primary sources of insight:

- **Voice of the market:** Interviews with more than 25 CFOs and treasurers from global corporations and local SMEs; and with top management at five major banks.
- **Data from regulators and proprietary models:** Data from regulators and from McKinsey's proprietary analysis informed revenue and profit growth projections, as well as shifts in dynamics driven by changes in regulation or macroeconomic events.
- **McKinsey experts:** McKinsey's internal and external network of CIB specialists helped us better understand how global trends could impact Mexico's banks, as well as how international banks are responding to the changing global/regional landscape.

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