Ground Europe

Markets overview

The 4Q11 brought to a close a year of extraordinary events. Here, we highlight two 'favourites'. First, European political leaders continue to do their level best to effect Germany's Chancellor Angela Merkel's May-10 call to 're-establish the primacy of politics over the market'. Such increasing political influence, said the founder of Odey Asset Management Crispin Odey in his Nov-11 letter to investors, has 'misted up' his crystal ball, but also brought out a swathe of new opportunities. Considering European governments' track record in finding 'solutions' (including the latest merry go-round of banks borrowing money from the ECB at 1%, then investing [some of] it, with political encouragement, into GIIPS sovereign bonds paying out say, 4-5% interest; concerned about its reputation, Deutsche Bank publicly shunned these loans), it is hardly surprising that Mr Odey's sentiment is echoed by most of our sources; the essence of 'the market', after all, is its flexibility. The ongoing *sovereign* crisis – which entered a whole new phase with Germany's Jan-12 proposal for Greece to surrender its budgetary, (i.e. the state) sovereignty to the EU, a move which might well nudge Greece towards an exit from EUR and/or a default - remains, to paraphrase, 'Ground Europe' of the global economic outlook.

Second, in Nov-11, S&P cut credit ratings of Bank of America, Citi and Goldman Sachs to A-, while upping Bank of China and China Construction Bank (CCB) to A. For China – and therefore the wider world - these two are certainly 'too big to fail' (though we note that FSB, rather surprisingly, left CCG out of its initial Nov-11 G-SIFI list), but we rather doubt the wisdom of the wider message this implies, even to a (shrinking?) minority that find the mainstream credit ratings agencies' recommendations particularly informative.

The 4Q11 also witnessed an unprecedented consolidation among UK's small-/mid-caps stockbrokers[1]. We note these events here not only because we know a number of people that work(ed) at these firms, but also because we see this as a further proof – if any were needed – of the accelerating ascendance of electronic equities (dark pools, algo, DMA) and (very few) banks that can bear the ever-rising cost of it. This trend is by no means unique to the UK; the UK merely offers most high-profile examples, due to its unusual corporate-broker arena.

Over in the USA, small brokers are in trouble, too. Compliance-related costs have risen in recent years, and the collapse of MF Global in Oct-11 underlined investors' weariness of small brokerages. These two factors, combined with the generally muted client activity in equity markets, led to the closure of WJB Capital, Ticonderoga Securities (brokers), and Kaufman Bros LP (a specialised investment bank) in Jan-12. Larger firms are not immune, either: in Jan-12, Raymond James agreed to buy its main Southeast rival, Morgan Keegan, for $930m.

In our view, specialised firms' key future challenge is that a truly sustainable/scalable ECM operation requires a matching 'traditional' trading ability. Absent ECM (and electronic) revenue stream, we do not see how they could fund the competitive/beyond-the-niche offering of the latter, so we expect continued consolidation in both voice-brokered equities and ECM, in Europe and the USA:

- 'Traditional' voice-broked cash equities continue to suffer margin compression: as we noted in our 1Q11 Capital Markets Update, Top 3 players *may* be achieving *low* double-digit returns, but Tier 2 players and new entrants – e.g. Barclays Capital and BNPP – may be struggling to break even.
- In good times, stronger specialised firms could probably get by – for a while, anyway - on ECM and advisory revenue; but the stock market volatility in recent quarters caused a huge rise in the number of deals that were postponed or cancelled, in many cases leading to losses. Barring a (semi-)permanent resolution to the EU sovereign crises in 1H12 – and we do not see how that could be achieved so fast, seeing as Europe's politicians seem determined to follow their own interpretation of Publicis Groupe's famous 'Viva La Difference' slogan – it is difficult to forecast a *lasting* improvement in European ECM anytime soon.

[1] *Month-by-month summary of key sales/disposals/closures of securities/investment banking units agreed/effected: Sept-11: Evolution Group; Nov-11: Ambrian Capital, Altium Capital; Arbuthnot Banking, Merchant Securities; Dec-11: Collins Stewart Hawkpoint, Rivington Street Corporate Finance; Feb-12: RBS sold Hoare Govett to Jefferies Group Inc, as part of the wider reorganisation programme. As of Feb-12, a number of other firms – including Panmure Gordon, Arden Partners, Finncap, Matrix Group – are rumoured to be considering cost-cutting programmes.*

Primary fees were mixed in 4Q11. At the global level, the leading competitors – i.e. the banks in this report plus regional/products specialists – saw M&A volumes continuing a decline that started in 2Q11, though anecdotal evidence suggests banks were able to arrest some of the decline in fees charged. ECM continues to suffer from volatile markets and – in places - low stock valuations: 4Q11 volumes and estimated fees were in-line with the very weak 3Q11, down by about 70% y/y for the Top 10 global competitors, according to Thompson Reuters. Following a reasonably steady 4Q10-3Q11 period, DCM sub-investment grade bond *and* syndicated lending volumes declined both sequentially and relative to 4Q10; we also note that securitisation failed to sustain the promising momentum seen in late 2010 and early 2011. Highlights:

- The 2012 M&A global outlook appears positive. European valuations are attractive - at end-2011, one commentator put MSCI Europe Index P/E at below 11x reported earnings – and EUR has been rather depressed relative to the basket of other main currencies in 2H11. The combination of these two factors should attract interest from Asian and the US corporations, not least because they are sitting on a proverbial mountain of cash: $5tr+ just for companies in MSCI World Index, estimated Bloomberg in Dec-11. Thus far, these supportive factors have been overshadowed by the lack of *any* sign of a lasting resolution to the ongoing European macro crisis, though some specialised areas – e.g. spin-offs – saw accelerated activity. Barring a second strong recession in Europe – or despite of it, if the 'crisis fatigue' becomes the 'new normal' - we expect a (slight?) recovery in USA and the Far East M&A volumes, and corporates from both regions looking for European acquisitions.
- Similarly, we hear that European and the US funds (including hedge funds) investing in converts saw healthy AuM inflows in 2011. Judging by the paucity of primary issuance in 2011, we imagine a lot of specialised converts investors (including hedge funds) have considerable amount of cash ready for investment.
- The 'sub-investment grade' DCM may well be the most visible 'Ground Europe' territory. Leveraged loans issuance hit new lows in 4Q11; and high-yield bonds remained depressed, barely above the weak 3Q11. Investors generally deserted leveraged assets, with some specialised funds in both Europe and the USA reportedly suffering 30%+ redemptions in 2H11; corporate defaults may be declining but the possibility of a renewed recession caused by European macro crisis removed the risk appetite. Not surprisingly, prospective corporate issuers looked at the terms of a few leveraged deals completed in 3Q11 and decided to stay away, if at all possible. On the sell side, there are signs that Eurozone banks – led by French banks, probably Europe's most exposed to GIIPS debt – are losing the market share gained during the original 'credit crunch'.

In secondary markets, as 2011 drew to a close, investors remained focused on avoiding losses - rather than chasing profits – to the general benefit of 'safe haven' and liquid assets. Barring a sudden improvement in Western economies' (especially EU) outlook, we do not expect a significant change here. By extension, we retain our long-held view that capital markets *profits* from export-dependent BRICs (not to mention smaller emerging economies/regions) will not fulfil lofty expectations of some of 'our' global banks, Citi and UBS being the most high-profile examples.

Equity markets in Europe and the USA saw a small year-end rally, as we predicted in our 3Q11 Results Update: STOXX Europe 600, S&P 500, FTSE All-World APAC ex-Japan all gained handsomely in 4Q11, with the former two advancing in Dec-11. The gains extended into the new year, too: in Jan-12, the MSCI All-World Country Index added nearly 6% (including dividends, the most in nearly a decade), outpacing every other asset class. Market observers generally put the Jan-12 rally down to the improved macro outlook; notwithstanding attractive valuations and stay-low interest rates, we side with those that expect a bumpy ride ahead (at best), as we cannot see how European governments could put in place a lasting solution during 1H12.

The regulatory/political factors may also weigh in. For example, in recent past, Europe severely restricted 'short-sellers' activity (see 2Q11 and 3Q11 Results Update), and both Europe and the USA curtailed (or, rather, will curtail, as soon as they finalise the scope/definition of) prop trading. In our view, political interference – often excessively populist and therefore rarely predictable - increases the likelihood that the only sustained capital markets investment in Europe will, ultimately, come from 'long-only' funds. To politicians, these funds may be a preferred option over 'speculators'; but long-only funds, by definition, are unlikely to commit until there are signs of macro stability.

The leading capital markets players featured in this report suffered, on average, a 27% y/y decline in non-prop equity revenues in 4Q11, a decline driven by weakness in cash and derivatives. Highlights:

- The absence of macro improvement in Europe may lead to (further) reduction in trading volume and hence 'traditional'/voice-brokered equity trading revenue. The fixed cost component of this business being relatively high, we expect banks will increasingly shift resources (including staff) away from cash equity trading and into flow derivatives, a trend we commented on in previous publications. As an aside, Citi recently suggested that ETFs – hardly the most complicated instruments available – achieve margins approximately 3x above purely electronic cash trading.
- Centralised clearing is widely expected to impact the profitability of OTC derivatives (across equity and fixed income) offerings, mainly due to the higher cost of collateral management and infrastructure. This trend may be most visible in the fragmented APAC market, where the business may well move to large banks and regional hubs.
- In Jan-12, rumours surfaced that Samsung Securities – in a sharp reversal of regional expansion following the 2008 crisis and a high-profile hiring of ex-CS Sung-June Hwang as ex-South Korea APAC CEO in 2010 - was shutting down APAC operations outside Korea. Ex-Korea, the firm is small (130-160 staff in the region, 100 of them in Hong Kong, according to Reuters, compared to 3,700 total employees) and focused on 'traditional' equity brokerage and research business. In short, hardly the regional bellwether; still, we see this as an extension of the trend we have commented on since late 2009: the competition has thinned the equity brokerage margins to the point where smaller players/newcomers struggle to (profitably) compete. We doubt this will change anytime soon, for three reasons. First, the market is concentrated: our local sources generally put the market share of institutional fee pool of the Top 10 APAC ex-Japan players at about 80%, but Top 3 peers may be taking in as much as one-third of the regional total, giving them a considerable staying power. Second, the leaders are hardly sitting still: e.g. in Apr-11, Credit Suisse – with sales/trading capability in 16 APAC markets – officially commenced local operation in Philippines, to our knowledge the first global player to have done so. In summary, barring an improvement in the region's economic outlook, we expect incumbents to increase their dominance in 2012; and announce redundancies along the way.
- We expect 1H12 will prove tough for prime brokers. While global providers with strong balance sheets (including the banks in this report) may benefit from hedge funds generally abandoning the 'multiple broker' model, gains in the wider industry may be offset by factors rendering stock-picking difficult, or worse: we highlight volatility (as seen in late 2H11) and high correlation between global markets. Among other significant trends in 2012 we expect: (1) macro and special situation funds' will continue to increase their share of the institutional wallet during this period; (2) following the collapse of MF Global in Oct-11, counterparty risk will likely remain the key consideration for investors. The custody model – or variants which move client's money to a separate account under certain conditions, some of which are tied to brokers' CDS spread – is very much on the providers' agenda, as are (3) innovative solutions from industry participants and providers. For example, Goldman Sachs Asset Management (see Company Section) in 2011 raised $600m of institutional money for a new fund-of-funds which will seed 8-10 hedge funds; GS would earn fees on AuM managed by its fund and from trading with hedge funds it seeded.

In Fixed income markets, the US Government (shouldering the 4th consecutive quarter of US$1tr+ budget deficit) likely benefited from the investors' caution reluctance to invest in European sovereign paper. Ignoring the Aug-11 S&P sovereign downgrade (probably because that was priced in well before S&P put the proverbial pen to the proverbial paper), investors in 2011 pushed the demand for US Government debt to record levels; the 20-Dec-11 auction of 4-week T-bills drew demand 9x above the $30bn offered – despite these bills paying no interest.

In currencies, as interest in carry trades continued dwindling (thus weakening some of the major emerging markets currencies), investors piled into liquid assets: JPY gained against every other major currency, followed by GBP, CHF (in spite of the Swiss Government's decisive intervention) and, of course, the US$. On a related note, with advisory and capital markets businesses languishing, we would not be surprised to see FX, (corporate) bond and commodity traders becoming the favoured sounding board for Boards of Directors.

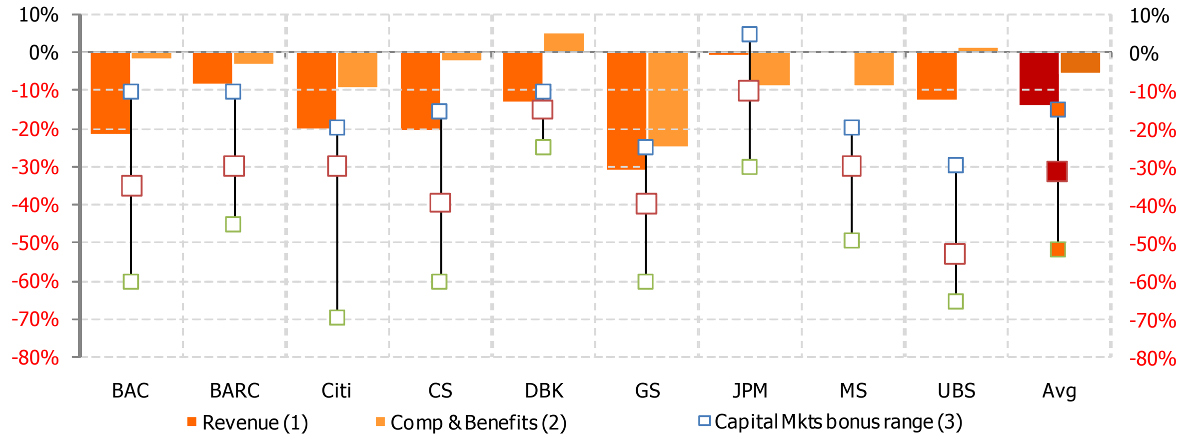
The overall fixed income markets 4Q11 revenue for the banks in this report was flat y/y, but up 22% relative to 3Q11; the robust sequential performance, however, was mostly due to credit trading recovering from - i.e. not suffering losses to the extent seen in – the previous quarter. Commodities underperformed, declining 41% y/y and 13% q/q. Highlights:

- With the wholesale review of the composition of risk-weighted assets (RWA) accelerating, banks are increasingly focused on the underlying RoRWA profitability of their individual FICC product mix. It seems to us that, thus far, the industrywide scaling down of RWA-intensive FICC business lines – primarily securitisation, long-dated and/or complex rates, correlation, and some credit risk, especially in Europe – shifted client flows from one set of big banks to their immediate peers. It is difficult to foretell the ultimate extent of the change, and what the industry will look like by the time the new 'state of play' is settled. Exiting/downsizing businesses selectively is, at best, a huge challenge, so we expect reorganisation-related losses along the way.
- We do not expect a recovery in European high-yield market revenues in 2012. A mere suggestion of a renewed recession in Europe (in our view, not at all an unlikely prospect) would probably tip the balance firmly against sub-investment grade borrowers, so we believe investors will take the view that the downside is a lot bigger than the potential upside - and stay away. We also hear that in the USA, secured bonds and loans form an increasingly important 'top-up' to HY product.
- In an interesting development in the subprime saga, The New York Fed in Jan-12 sold subprime bonds with the face value of $7bn to Credit Suisse. The sale was competitive, but private, so the proceeds from bonds – which were part of the Maiden Lane II assets, managed by BlackRock Solutions – will not be publicly announced until Apr-12. The bank's winning bid beat offers from the units of GS (which originally approached BlackRock with a proposal to buy a portion of Maiden Lane II assets), Barclays Capital, and Bank of America/Merrill Lynch. This could be interesting, and not only because of how it relates to Basel 3-mitigation efforts (especially in view of Swiss regulators' 'gold plating' capital requirements): Credit Suisse's bold investment may suggest the market has bottomed out. If so, there could be plenty more such securities looking for a new home: $1.2tr held by European and the US financial institutions (20%+ of which is in banks), according to one estimate quoting Barclays Capital.
- In our Jan-12 report on munis, we acknowledged that the market remains under pressure, but still took a cautiously positive view of the outlook, based on (1) the resilient trading volumes; (2) evolution in the investor 'mix' and (3) some of the key players hiring in 2011.
- In Commodities, 4Q11 saw hedge funds reducing their trading levels; and, as expected (3Q11 Results Update), banks are indeed reviewing the size of their Commodities teams: among the players we follow, Barclays Capital, JPM, Societe Generale and UBS all reduced the headcount and/or the scope of operations in Nov/Dec-11. As the market continues to reshape itself, we expect four main trends in 2012. First, barring some new macro calamity, Asia will continue to grow in importance, propelled by demand from financing clients building new infrastructure especially in Australia and Indonesia, and from investor clients such as pension funds, sovereign wealth funds and private clients. Second, metals and agriculture will continue to fare better than energy, especially in physical trading; we expect JPM will be the key beneficiary of this trend, having emerged as the client's favourite in 2011. Third, the increasing importance of highly customised hedging solutions, although the corporate market will remain highly competitive. Fourth, Tier 2 trading firms may find themselves severely short of funding following BNPP, Credit Agricole and maybe Societe Generale decision to reduce the scope of their trade finance activities announced near the end of 2011; a sell-off of inventories may well depress price of various commodities.

On the operating cost front, the 'bonus wars' – the public outcry against vast bonuses of 'bankers', the critics of whom rarely trouble themselves with a more precise description – is well underway. In what could prove to have been a watershed moment, the UK Government (the majority owner of RBS) pressured RBS' CEO Hester to give up his £963k bonus (all-shares, deferred to 2014) for FY11. Even leaving aside the question of whether RBS should be governed by its Board of Directors (which awarded the bonus) or directly by members of the UK Government, to us, it is by no means clear that he has not earned this bonus (his second since he joined RBS in 2008) for carrying out rather difficult restructuring of RBS. Elsewhere, our research suggests that top global banks, on average, reduced FY11 'front line' bonus pool for middle-ranked and senior staff in London and the USA by 35-45% versus FY10 (in US$). Areas of particular weakness (e.g. credit trading) are said be down as much as 70%+; and 'doughnut' bonuses are moving deep into senior ranks.

There is little doubt that banks invested a good portion of 4Q11 'managing expectations'; a number of them announced wide-ranging caps on individual bonuses; and in Feb-12, Goldman Sachs and Morgan Stanley publicly stated their intent to clarify their clawback policies, which are expected to cover both employees *and* their supervisors. Perhaps not surprisingly, anecdotal evidence suggests that the level of employee dissatisfaction is lower than could have been expected, even though the current-year discretionary bonus pools of nine leading investment banks plunged, on average, 15-50% FY11/FY10 (albeit with huge differences between activity/asset classes/departments), compared to 14% fall in revenue and 6% in the overall comp & benefits.

Capital Markets Revenue & Comp & Benefits (TRIC definitions, global, FY11/FY10, US$m)



Source: Tricumen analysis, banks. Notes: (1) Revenue is post-writedowns, excludes CVA/DVA/equivalent and one-offs. (2) Total period staff compensation & benefits: salary, discretionary bonus, amortised equity awards and equivalents, severance costs. Excludes UK bonus tax, largely booked in 2Q10. (3) 'Front-line staff' bonus. Includes unrestricted cash, sign-on payments, unamortised equity awards and equivalent. Excludes salary, severance costs, amortised equity awards, and UK bonus tax.

In the 1Q11 Results Update, we commented on the regulators the world over introducing stringent new regulation/'guidelines' on bonuses. We have followed regional comp trends and dynamics across capital markets products since, continually refining our operating costs modelling.

The new regulation was designed to curtail the much-derided culture of short-term rewards by deferring a major portion of the discretionary element of overall compensation & benefits. In response, most banks increased basic salaries, while reducing the discretionary component of comp; by the FY10 bonus round, the size (and shape: cash/shares/clawbacks[2]/etc) of the deferred portion quickly became as important as – if not more than – the overall comp package in the competition for top staff. In London/EMEA, Goldman Sachs and JPM – both having weathered the credit crunch better than most – and somewhat surprisingly Citi, were all said to favour cash bonus over alternatives, paying out between 65-75% of total comp in that way. We hear Bank of America, Deutsche Bank, and Morgan Stanley were at the other end of the scale, deferring far greater-than-necessary portion of the comp packages. Credit Suisse was somewhere in between these two groups, focused instead on its highly imaginative pay structures, which reportedly range from handing out shares in HY corporate bonds and loans backed by commercial mortgages in 2008 (which, incidentally, did far better in 2009 and 2010 than the bank's share price, according to public sources) to bonds referencing portfolio of derivatives counterparty risk ('PAF2') in the current bonus season. With cash bonuses becoming endangered species, we expect Credit Suisse-like comp 'model' – with its attendant transfer of financial exposures to staff – will spread.

[2] *In Feb-12, Goldman Sachs and Morgan Stanley publicly stated their intent to clarify their clawback policies; the new policies are expected to cover both employees and their supervisors.*

A year on from first visible effects of the original regulatory push against bonuses, it is difficult to identify tangible benefits to banks and their employees, shareholders (including the long-suffering 'taxpayer') or indeed, the wider public. Banks' earnings in 2H11 were, on the whole, depressed, so we doubt FY11 bonuses would have been generous even without the regulatory/political pressure; and that's before various costs (or foregone income) of RWA mitigation, restructuring, right-sizing etc incurred in 2011 are taken into account. Further, there is little doubt that shrinking the cash element of the discretionary bonus reduced banks' cost flexibility, which in turn may have exacerbated the extent of redundancies announced from the start of 2H11 to date.

Finally, a surge in deferred bonuses dramatically lowers the transparency of banks' reporting; perhaps not for regulators who presumably get to scrutinise the internal detail of pay packages, but certainly to outside investors. We expect that unpicking current-vs-deferred comp & benefits – and therefore underlying profit margins – will be *the* focus of the analyst community in the coming quarters.

Results Summary

Product Revenue: Summary

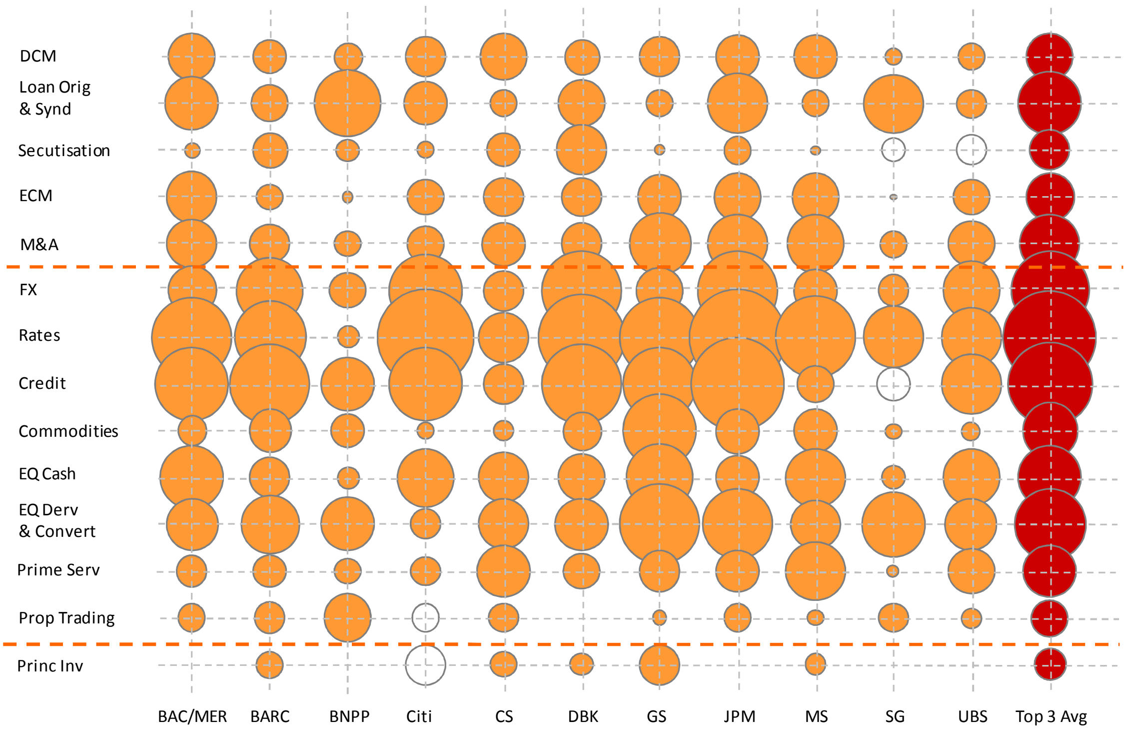
(Peer Group Average*, TRIC product definitions, post-writedowns, US$m, Level 1 estimate)

	FY09	1Q10	2Q10	3Q10	4Q10	FY10	1Q11	2Q11	3Q11	4Q11	FY11	4Q11/4Q10: Top 3 growth
Total: TRIC definition	20,206	6,373	4,135	3,749	4,152	18,409	5,665	4,461	2,691	2,651	15,467	MS / Citi / UBS
Primary	3,142	1,179	1,045	767	1,368	4,360	1,210	1,222	784	737	3,952	BARC / BAC/MER / JPM
DCM	1,083	373	266	128	257	1,024	268	212	94	197	770	CS / MS / BAC/MER
Loan Orig & Synd	597	211	247	223	332	1,012	284	338	244	207	1,073	Citi / BARC / JPM
Securitisation	-670	173	151	-7	106	423	178	82	81	-28	313	MS / GS / DBK
ECM	1,171	212	168	170	362	912	224	262	116	116	717	BARC / BAC/MER / CS
M&A	961	211	214	253	311	988	256	328	249	245	1,078	UBS / DBK / JPM
Secondary	17,175	5,116	3,124	2,844	2,693	13,777	4,404	3,199	1,952	1,858	11,412	MS / UBS / Citi
FX	1,771	1,017	886	-518	401	1,786	460	420	425	392	1,698	MS / BNPP / Citi
Rates	5,108	1,104	842	884	530	3,360	995	770	609	547	2,919	MS / UBS / JPM
Credit	3,060	1,150	219	1,264	352	2,983	1,163	676	36	32	1,906	UBS / Citi / MS
Commodities	1,130	243	278	2	242	766	267	142	200	136	745	BNPP / BAC/MER / DBK
EQ Cash	1,643	383	249	391	352	1,374	426	323	308	268	1,325	BAC/MER / MS / GS
EQ Derv&Conv't	2,047	620	335	477	451	1,883	611	508	322	261	1,701	MS / GS / DBK
Prime services	870	194	225	163	203	786	207	212	199	191	809	UBS / GS / JPM
Prop Trading	1,545	405	91	181	162	839	274	147	-146	32	308	SG / BNPP / BARC
Principal Inv	-111	78	-35	139	90	272	51	40	-45	56	103	DBK / GS / MS

** (1) Peers: BAC/MER, BNPP, BARC, Citi, CS, DBK, GS, JPM, MS, SG, UBS. (2) 'Averages are calculated on a line-by-line basis.*

Product Revenue: Absolute* 4-quarter moving average

(TRIC product definitions, post-writedowns, US$m, Global Level 1 estimate)



Source: Tricumen. (1) Bubble size = absolute revenue; empty bubbles = negative revenue; missing bubbles = no revenue.

Product Revenue: Momentum*

4Q11/4Q10 (TRIC product definitions, post-writedowns, % change, Global Level 1 estimate)

	BAC/MER	BARC	BNPP	Citi	CS	DBK	GS	JPM	MS	UBS	Top 25%	Bottom 25%
Total capital markets	→	↑	↓	↑	↓	↓	↓	→	↑	→	-21%	-45%
Primary	↑	↑	→	↓	↓	↓	↓	↑	→	↓	-41%	-48%
DCM	↑	→	↓	→	↓	→	↑	↓	↑	↓	-47%	-60%
Loan Orig & Synd	→	→	↓	↑	↓	↓	↑	→	↑	↓	-20%	-37%
Securitisation	→	↑	↓	↓	→	↑	↓	↓	↓	N/M	-6%	-67%
ECM	↑	↑	↓	↓	↑	↓	→	→	→	↓	-62%	-76%
M&A	→	↓	↓	→	↓	↑	↓	↑	→	↑	-11%	-39%
Secondary	→	→	↓	↑	↓	↓	↓	→	↑	↑	-10%	-46%
FX	↓	↓	↑	↑	↓	→	→	→	↑	↓	9%	-6%
Rates	→	↓	N/M	↑	↓	↓	↓	↑	↑	→	55%	-16%
Credit	↓	↑	→	↓	N/M	N/M	↓	↑	↓	→	-7%	-52%
Commodities	→	↓	↑	N/M	N/M	↓	↑	↓	↓	N/M	0%	-30%
EQ Cash	↑	↓	→	→	↓	↓	↑	→	↑	↓	-19%	-42%
EQ Derv & Converts	↓	↓	↑	↓	N/M	→	↑	→	↑	↓	-29%	-51%
Prime services	↓	→	→	↓	↓	↓	↑	→	↑	↑	0%	-25%
Prop Trading	N/M	→	↓	N/M	N/M	N/M	N/M	→	↓	N/M	44%	-37%
Principal Inv	N/M	→	N/M	N/M	N/M	↑	↓	N/M	↓	N/M	1%	-57%

FY11/FY10 (TRIC product definitions, post-writedowns, % change, Global Level 1 estimate)

	BAC/MER	BARC	BNPP	Citi	CS	DBK	GS	JPM	MS	SG	UBS	Top 25%	Bottom 25%
Total capital markets	↓	↑	→	↓	↓	→	↓	↑	↑	↓	→	-11%	-21%
Primary	↑	↓	→	↓	↓	↑	→	→	↑	↓	↓	-5%	-13%
DCM	→	↓	→	↓	↑	↓	↑	↓	↑	→	↓	-20%	-33%
Loan Orig & Synd	↓	↓	↓	→	→	↓	↑	↑	↑	↓	→	45%	1%
Securitisation	→	→	↑	↓	↑	N/M	↓	↓	↓	N/M	N/M	-22%	-47%
ECM	↑	↑	↑	↓	→	→	↓	↓	→	↓	↓	-6%	-28%
M&A	↑	↓	↑	↓	↓	→	↓	→	→	↓	↑	22%	-4%
Secondary	↓	→	↓	↓	↓	→	↓	↑	↑	→	↑	-6%	-24%
FX	↓	↑	→	↓	↓	→	↓	→	↑	↑	↓	2%	-10%
Rates	↓	↓	↓	→	↓	↓	→	↑	↑	N/M	↑	-5%	-28%
Credit	↓	↑	→	↓	↓	→	↓	↑	↓	↑	↑	-23%	-44%
Commodities	↓	→	↑	↓	↓	↑	↓	→	↓	↑	N/M	41%	-17%
EQ Cash	↑	↓	↑	↓	↓	↓	→	↓	↑	→	→	13%	-17%
EQ Derv&Conv't	↓	↑	→	↓	↓	↓	↑	→	↑	→	↓	-5%	-15%
Prime services	↓	↑	↓	→	↓	↓	→	→	↑	↓	↑	5%	-16%
Prop Trading	↓	↑	→	N/M	↓	N/M	↓	→	↓	→	↑	16%	-56%
Principal Inv	N/M	↑	↑	→	↑	↓	↓	N/M	↓	↑	N/M	-20%	-61%

*Source: Tricumen analysis. * Arrows show % change rankings versus peers. Up-/down-arrows: top-/bottom-quartile.*

Theme: RWA/capitalisation updates

In 2Q11, we formally expanded our coverage of global capital markets to include RWA and Capital (alongside VaR and operating costs) and consequently monitor developments in this arena.

Part 1 of 2: Basel 3 and GIIPS

We note there is increasing speculation that the two central tenets of Basel 3 calculations may be under threat; and expect the framework to be adjusted yet again, probably during 2012:

- For purposes of RWA calculation – and that's under Basel 3, the new and improved framework, only approved in 2010 - sovereign bonds are defined as risk-free, even though Greece defaulted (the Feb-12 rescue blueprint called for 70%+ loss to bondholders - unsurprisingly, not referred to as 'haircut' anymore - in a voluntary debt exchange, and loans in excess of EUR130bn), and yields on [G]IIPS peers' paper soared since then. Among the ideas being floated to square this particular circle, we note the analysis presented by the UK's FSA chief Adair Turner, from his speech in Frankfurt in Nov-11: '…at the core of the Eurozone's problems was a failure to recognise that sovereign debt issued by a nation which no longer has its own currency is quite different from sovereign debt issued by a currency issuing power.' From a purely financial standpoint – i.e. ignoring a host of potentially explosive (geo)political difficulties such approach could engender – this, to us, seems like a credible starting point for discussion, largely because it reflects the existing reality: regardless of economics, right now no banker wants to spend his days answering questions about GIIPS bonds/loans on his books …

  … not least because of the uncertainty arising from ad-hoc regulations and/or (evolving) interpretation of those. Our latest favourite is International Swaps and Derivatives Association's (ISDA) statement from Oct-11, originally related to Greek 50% 'haircut'. Aiming to '…ensure accurate understanding of how credit events are determined for credit default swaps contracts', ISDA stated: 'Based on what we know now, it appears from news reports that the Eurozone proposal involves a voluntary exchange that would not be binding on all holders. As such, it does not appear to be likely that the Eurozone proposal will trigger payments under existing CDS contracts. However, whether or not it does so will be decided by the D[etermination' C[ommittee] on the basis of the specific facts, if a request is made to them.' Coming mere days after Eurozone negotiators reportedly asked Greek debt holders to accept 60% 'haircut' (which then grew to 65-75% by late Jan-12, according to the private bondholders' chief negotiator Charles Dallara; at end-2011, BNPP Group lifted provisions to 75% of its exposure to Greek debt) and yet reportedly trying to avoid 'a credit event', we see this as hugely important: 'credit event' triggers CDS contracts, but 'voluntary exchange' may not. In the lights of this development, we would expect the debate about banks' true worth to widen to which banks face CDS losses – a tricky task, to say the least.

- Basel 3 also emphasises the importance of liquid assets. With investors busily reducing their GIIPS exposure, how liquid sovereign bonds really are and what could be the substitute for them? High-grade corporate bonds, maybe; but then, which 'grading' could be used globally, seeing as the US' Dodd-frank Act specifically (and justifiably, as we opined in our 3Q11 Review) bars the use of rating agencies' ratings and EU – pointing its proverbial finger at the effect, rather than the cause – in late Jan-12 proposed tougher regulation of rating agencies. Equities, perhaps? Certainly liquid, but also too volatile; and, more importantly, the scale of the demand could well turn out to be so high that every bank would end up buying blue chips/big caps, thus seeding a potentially systemic selling spiral.

Discussions are reportedly underway, with the next update due by early 2Q12, or earlier.

Part 2 of 2: Financial Stability Board and G-SIFIs

On a related note, Financial Stability Board (FSB) and G20's 4-Nov-11 initial designation of 29 banks (including all 13 of 'our' banks) as global 'systematically important financial institutions' (G-SIFIs) again reminds us of a wise man once saying: 'Every change in legal code is another arbitrage opportunity.'

FSB defines G-SIFIs as '…financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.' Aiming to define a framework '…to strengthen [national] authorities' powers to resolve failing financial firms in an orderly manner and without exposing the taxpayer to the risk of loss', the FSB introduces, among other measures, capital requirements for G-SIFIs that exceed the Basel 3 by 1-2.5% (potentially rising to 3.5%) and should be met by common equity, starting in 2016.

We find the initial list of 29 G-SIFIs somewhat surprising, for two reasons. First, it includes banks that we would see as more important at the national, than the global (or even 'wider', vaguely defined though it is – e.g. EU or the Western world?) financial system: for example, Commerzbank, Lloyds TSB, Nordea. Second, FSB left out banks whose demise/difficulties would, in our view, impact the named G-SIFIs. For example, we rather doubt that investors would not take a long hard view in their exposure to Bank of China (G-SIFI) if any of the other 'Big 4' (ABS, ICB, CCB – none on the G-SIFI list) or even their smaller peers were to stumble. We expect this initial list – which FSB said will be reviewed annually, in November – to grow over time, and not only in response to crises.

Of more immediate importance to the banks on the list is the negative impact of a G-SIFI label on their underlying return on equity (RoE), especially in the environment characterised by falling returns in what were, prior to the Credit Crunch, very profitable banking segments, chief among them capital markets. With Governments now officially committed to supporting them come what may, G-SIFIs could well use this label to their distinct advantage over their smaller peers – even those that proved equal to turbulence of recent years - thus potentially more than offsetting the impact of higher capital requirements. On the funding side, there is little doubt that large banks can source funds – both from customer deposits and wholesale markets - at rates (often substantially) lower than smaller players; we expect G-SIFI label would support this trend. Revenues could, in our view, also benefit: in capital markets specifically, the (perception of) the counterparty risk has in recent years become a key differentiating factor in a number of businesses. It is early days yet, but this initial G-SIFIs designation may well enable big banks to become even bigger; we doubt this was FSB's original intent.

Notes & Caveats

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