The Bank of the Future

- New regulations and tighter margins have depressed 'typical' wholesale banking pre-tax RoE to about 19%; the outlook is not optimistic.
- In our view, future leaders will operate a new wholesale banking model, one which utilises hitherto neglected synergies between the 'traditional' capital markets operations with other areas of the bank; and deploys effective Group-wide treasury and credit portfolio functions and risk management systems.
- By integrating corporate coverage into the global banking and treasury services; and institutional coverage into global markets and security services, 'our' Bank of the Future could achieve pre-tax RoE of up to 25%, well above the current levels.

Background& outlook

For investment banks, 2009 was a record year. As the 2008 financial crisis abated, it seemed as though the pattern of growth seen from 2003 to 2007 had returned. In the event, 2009 proved a chimera. Revenues initially surged on exceptional volumes, which were boosted by pent-up demand and lingering high margins from 2008; we estimate this added some US$42bn to the revenue pool of the 13 capital market players we cover on regular basis[1]. By the end of 2009, however, both volumes and margins retreated to 'pre-boom' levels. In subsequent years, revenues declined further as the Eurozone crisis has rumbled on.

On the whole, the industry has lowered operating expenses with haste (see our 4Q11 Results Update for a comparison of actual comp & benefits-versus-bonuses dynamics), cushioning the impact on cost/income ratios.

The real medium-term challenge, however, is achieving a return on equity (RoE) in excess of the cost of equity (CoE). Using our estimates of equity/capital aligned with the Basel 3 standards[2], we estimate that 'our' top quartile revenue generating players will achieve a FY12E RoE of 16% in their capital markets divisions. Even for the leaders – all globals with diversified funding sources – this is only a precious few percent above their CoE.

The current business models at banks are, in our view, unlikely to facilitate significant revenue growth, in the near or medium term. Our current best-case FY13E scenario (which assumes a more benign Eurozone environment) projects only an 11% y/y growth in capital markets revenues, mainly because we expect that areas of growth will be balanced by a reduction in margins brought about by stronger competition. Indeed, we would argue that in several product areas, incumbents are engaged in a 'war of attrition', hoping they will outlast their competitors.

Market size and competitive forecasts

	Short Term Market Size	Short Term Competition	Mid-Term Market Size	Mid-Term Competition
DCM Bonds	→	≈	↗	≈
DCM Loans	→	≈	↗	○
Corporate Der'v	↗	≈	↗	○
ECM	→	≈	↗	○
M&A	→	≈	↗	≈
EQ Cash High-Touch	↘	●	→	●
EQ Cash Electronic	→	○	↗	≈
EQ Der'v Flow	→	≈	↗	≈
Delta 1	→	≈	→	≈
EQ Der'v Exotic	↗	●	↗	≈
Prime services	→	≈	↗	≈
Treasury Services	↗	○	↗	≈
Security Services	↗	○	↗	●

	Short Term Market Size	Short Term Competition	Mid-Term Market Size	Mid-Term Competition
FX G10	→	≈	→	≈
FX Em Mkts	→	≈	↗	○
Money Markets	→	≈	↘	≈
Rates G10 Flow	→	≈	↗	≈
Rates Em Mkts	↗	≈	→	○
Rates Structured	↗	●	→	≈
Munis	↘	≈	→	≈
Credit Flow	→	≈	↗	≈
Credit Em Mkts	→	≈	↗	○
Credit Exotic	↗	●	↘	●
RMBS	→	○	↘	≈
CMBS	↘	●	→	≈
ABS	↗	≈	→	≈
Commodities	→	○	↗	≈

Legend

Market growing	↗	Competition decreasing	○
Market flat	→	Competition flat	≈
Market shrinking	↘	Competition increasing	●

Source: Tricumen. Note: Tricumen product definitions.

[1] *Bank of America Merrill Lynch, Barclays Capital, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P.Morgan, Morgan Stanley, Royal Bank of Scotland, Societe Generale, UBS.*

[2] *We actively monitor relevant regulatory developments and amend our models accordingly.*

Reviewing the Wholesale Banking model

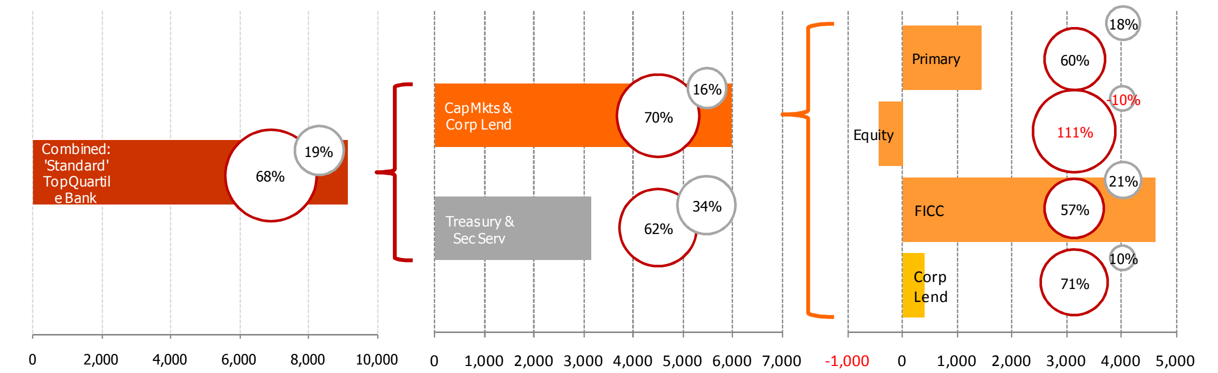
Racing to meet Basel 3 guidelines and prepare for the raft of incoming legislation – while battling a decline in revenues -banks have been fine-tuning the scope of their businesses. Thus far, the most substantive moves have revolved around banks' giving up some revenue (typically 10%) in return for reduced operating costs or lower risk-weighted assets. Such an approach, while valid, is fraught with risks: exiting selective businesses can damage existing business synergies, and repeated 'right-sizing' risks weakening staff morale and bringing about a cycle of decline.

We think additional measures are required to boost RoE. Based on our '360°' analysis of banks' profitability[3], we believe that the eventual winners will operate a new wholesale banking model; one which utilises hitherto neglected synergies between the 'traditional' capital markets operations with other areas of the bank.

For this report, we divided relevant banking activities of all 13 banks in our regular coverage into 28 product areas/segments; and then analysed their revenue, pre-tax profit, operating cost/income, and RoE for each segment[4]. We extracted Top Quartile revenue producers and aligned profitability measures on the bank-by-bank basis[5].

Starting with a high-profile example: wholesale banking includes an often-overlooked division we call 'Treasury and Security Services' (T&SS; known as 'Transaction Banking' at some banks). The chart below plots FY12E pre-tax operating profit(adjusted for exceptional items and DVA) for Top Quartile earners; and cost/income and pre-tax RoE. While a Top-Quartile investment bank's pre-tax profit outstrips that of a comparable T&SS competitor, the latter's RoE is far superior to an Investment Bank or indeed any of its four main 'typical' divisions.

Pre-Tax Profit and RoE: 'Standard' Top Quartile Bank (FY12E, US$m)



Legend: Pre-Tax Operating Profit (US$m); Operating Cost/Income; Pre-Tax RoE.

Source: Tricumen. Note: Tricumen product definitions.

Our definition of T&SS encompasses two main components: Treasury Services (trade finance, investor services, cash management) and Security Services (custody, fund administration, clearing and agented securities lending). In generic terms, these two components can service a corporate/issuer client base and an institutional/investor client base. Both of these are client bases that are in turn covered by the banking and markets businesses in the Investment Bank. We believe that this leads to duplication in client coverage and that merging the Investment Bank and T&SS divisions could deliver tangible cost savings *and* revenue synergies.

Some banks are already moving in this direction, a trend that we expect will accelerate. In Jan-11, Deutsche Bank created a Capital Markets and Treasury Solutions (CMTS) unit, which provides corporate bank coverage, corporate treasury sales, and debt capital markets origination and corporate derivatives marketing. Goldman Sachs has combined equity execution, prime services, clearing and securities services. In July-12, J.P.Morgan announced the merger of its Investment Bank, Treasury &

[3] In Mar-11, we formally expanded our coverage to risk-related profitability. In addition to the 'traditional' revenue and headcount analysis. our '360°' Performance Monitor suite now offers product-level normalised operating income and costs; pre-tax return on risk-weighted assets (RoRWA), Value-at-Risk (RoVaR) and Equity/Capital (RoE). All financials are fully reconciled against the published financial reports and regional reporting differences.

[4] We also analysed RoRWA for triangulation of the final results.

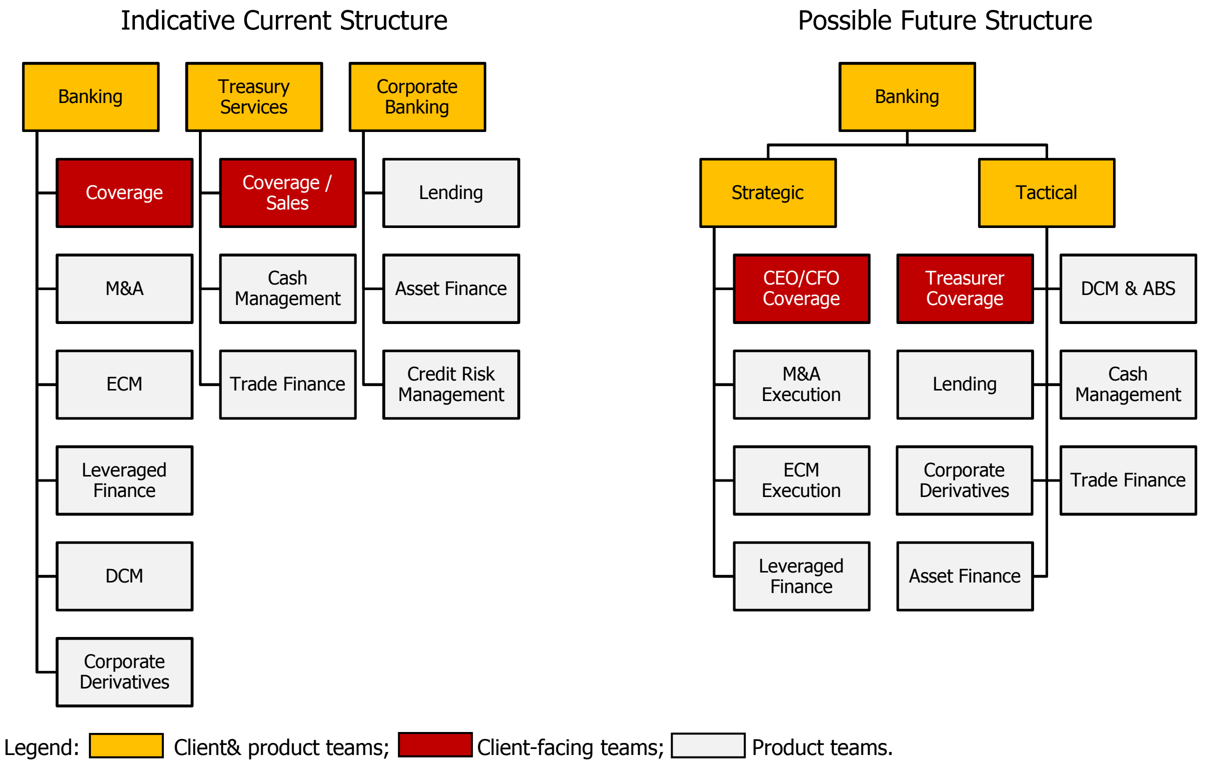
[5] In our view, merging best-in-class revenue and costs and RoE/RoRWA/RoVaR on a product-by-product basis would produce impressive, but quite unrealistic, results.

Security Services, and the Global Corporate Bank divisions. The list of similar initiatives is growing, but in our view, these are early stages. The next wave of restructuring will likely prove much more transformational.

Looking at the Corporate segment first, we see much logic in aligning services around the two key buying points at a company: strategic and tactical. The former includes M&A, equity origination and leveraged/acquisition finance; typically the province of the CEO or CFO. Tactical issues – including high grade bond financing, loans, risk management through the use of derivatives, cash management and trade finance - require a relatively frequent client contact and are usually managed by the client's Treasurer.

In our view, a coverage banker in the Investment Bank could focus purely on the CEO/CFO (strategic) relationship. This would, in turn, allow modest headcount reduction. Creating a similar coverage banker for the Treasurer (tactical) relationship would allow unified delivery of Treasury Service products, debt financing and risk management, and reduce much duplicated coverage. It is early days yet, but our research suggests such integration could boost revenues by 10% *and* reduce costs by up to 20%. The RoE for the new Corporate segment could reach 24% and 31% for the strategic and tactical segments, respectively.

Corporate segment transformation



Source: Tricumen. Note: Tricumen product definitions.

In the Investor/Institutional segment, the most significant trend is the bifurcation of markets into high-touch and electronic/low-touch segments. In the electronic world, the current trend is towards seamless integration of several services. A number of banks are marketing their electronic platforms as offering the best-value 'end-to-end' solution combining execution, clearing and settlement.

Achieving efficiency in this area requires technology and operations excellence. Citi has already taken a number of steps to develop straight-through processing solutions, and J.P.Morgan has merged some of its derivative middle office teams with the fund administration segment in its security services unit. The same unit provides (properly segregated) middle office support to the Investment Bank and an outsourced service to investor clients.

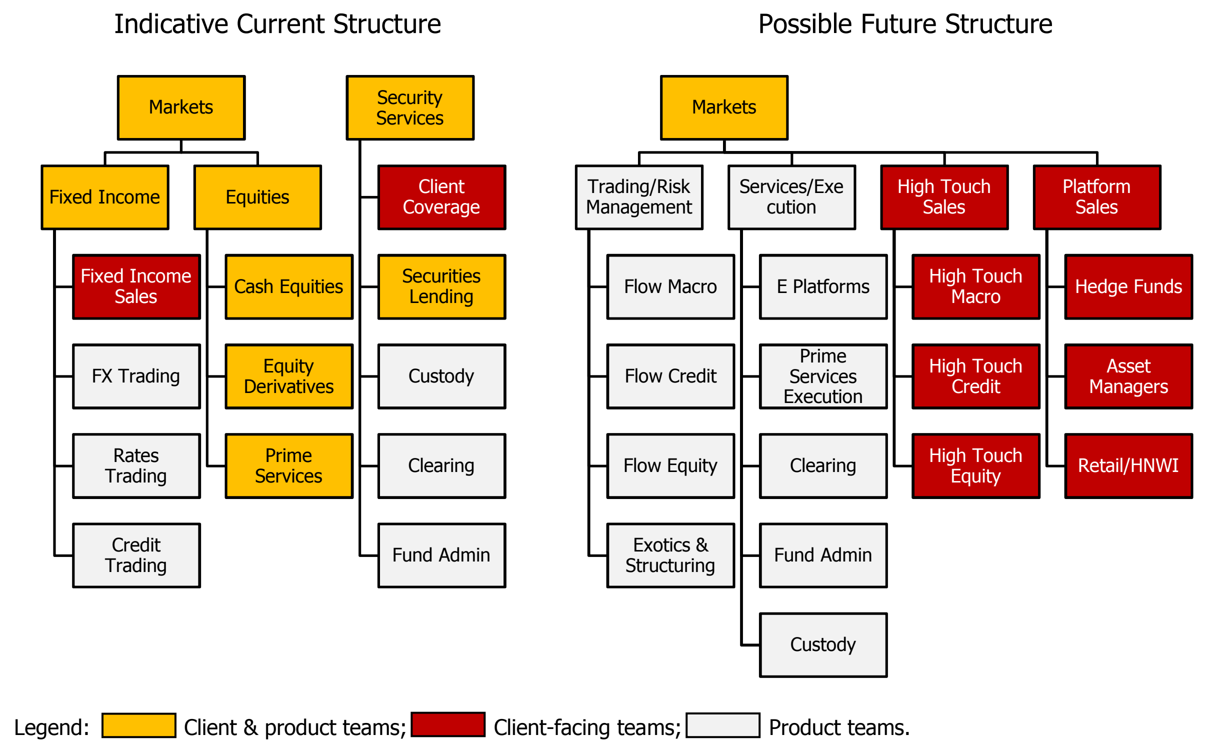
Electronic platforms are also increasingly prevalent in the delivery of retail structured products. UBS was one of the first to provide private bankers with a platform that allowed them to customise structured products to the needs of each high-net-worth (HNWI) client; others have since followed UBS' lead and have opened such platforms up to other client segments.

Considering these trends together, we believe that a full integration of the Markets and Security Services areas is likely. Such an investor-focused group would comprise services/execution/product management units, trading, high-touch sales, and platform sales. High-touch sales may well remain product-aligned, but will focus on the sale of flow products where the 'story' about the product matters and structured products where bespoke solutions are required.

The platform sales force is, in our view, likely to be more generalist and therefore client-aligned. For example, a team focused on hedge funds could market electronic trading, prime brokerage, clearing and fund administration solutions. In the chart below, we outline indicative organisational structures for the current and possible future states.

Under this approach, we believe an integrated electronic offering would yield pre-tax profit synergies in excess of 20%, much of it derived from savings achieved by a reduction in sales headcount and operational efficiency gains. Our research suggests that a Top Quartile (by revenue) electronic player could achieve RoE in excess of 40%, driven by cash equity, FX and certain retail/HNWI revenues. The high touch business would be much less attractive (see 'Pre-tax Profit and RoE chart overleaf), albeit largely due to the high cost of the full-scale high-touch cash equity business[6].

Institutional segment transformation



Source: Tricumen. Note: Tricumen product definitions.

Not all markets products fit neatly into this model; there are a number of businesses that should be treated differently due to their unique characteristics. We classify these products 'Esoteric'; they include commodities (where serving both commodity 'producer-to-user' clients and investor clients is essential), distressed debt (where banks often act more as a principal than a market maker) and mortgages (where integration of trading, origination, and acting as a principal is required). While these products are often capital-intensive, top players tend to have less competition, and the resultant RoE could comfortably exceed 20%.

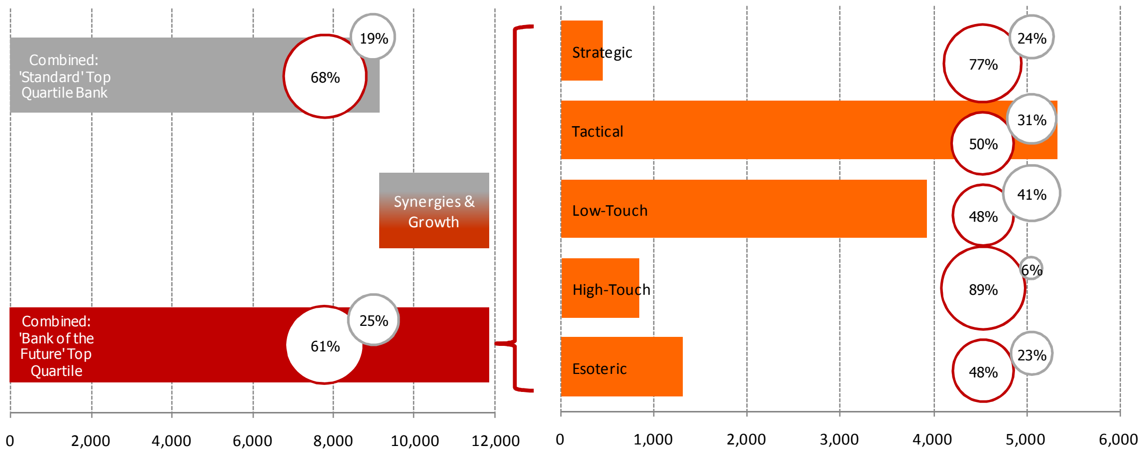
A final component that will be vital to delivering a high RoE for wholesale banking is efficient funding and risk management. This highlights the role of the Group Treasury function in maximising funding levels, and the need for a credit portfolio/CVA trading group that covers the full breadth of wholesale banking and can optimise credit costs across derivative counterparty and loan risk. More generally, unified systems and processes are essential in managing the market, liquidity and reputational risk. Trading losses in recent years provided plenty of evidence how one poorly managed position can impact the wider Group's profitability.

[6] *See our "EMEA Equities: the resilience of 'low touch' ", the summarised version of which we placed on our website in June-12.*

The 'Bank of the Future'

In conclusion, our view is that banks that manage to integrate and align their offering around corporate and investor clients will have an advantage over their peers and will be able to deliver overall pre-tax RoE that is up to 6% higher than the current levels. The chart below shows our most optimistic scenario for our wholesale 'Bank of the Future'.

Pre-Tax Profit & RoE:
The 'Bank of the Future' (FY13/14E, US$m) **vs 'Standard' Top Quartile Bank** (FY12E, US$m)

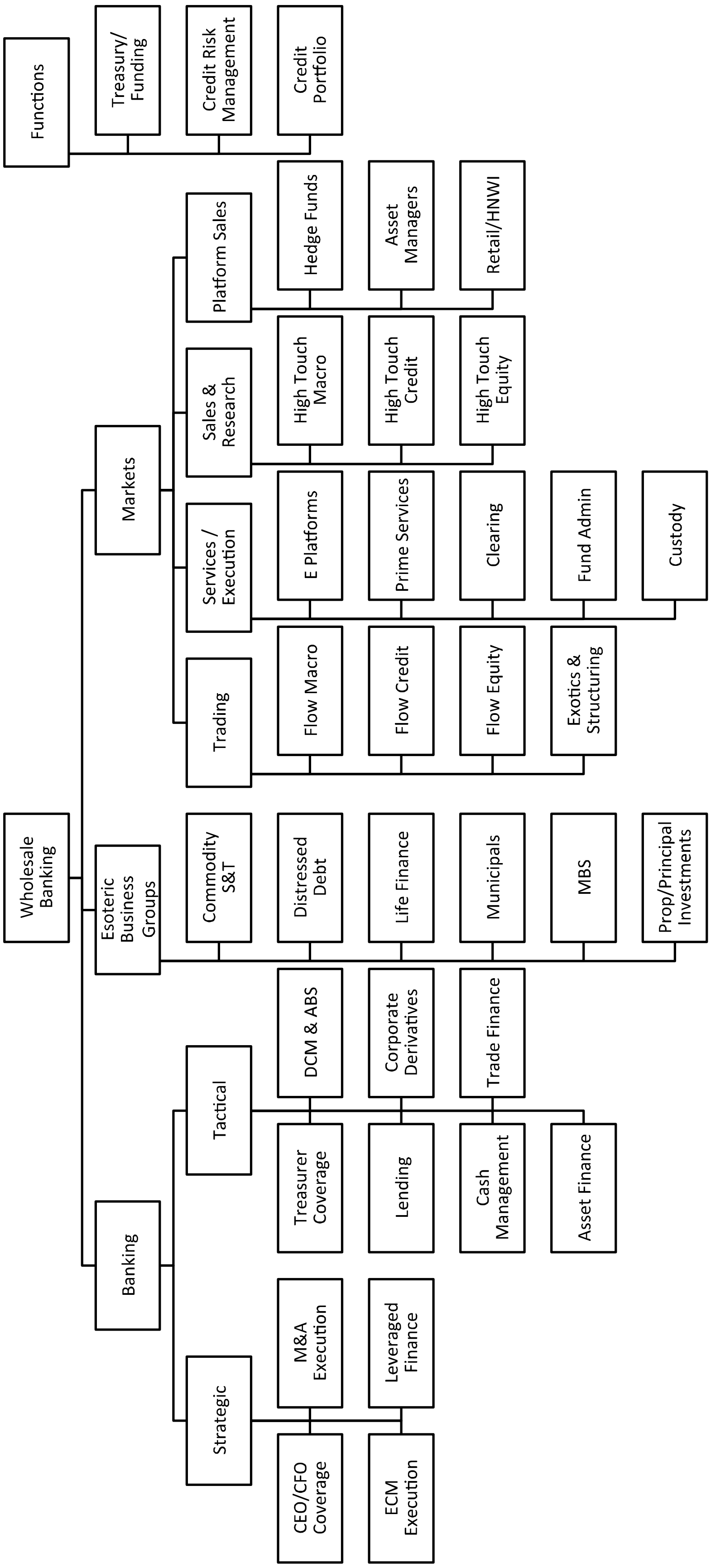


Legend: Pre-Tax Operating Profit (US$m); Operating Cost/Income; Pre-Tax RoE.

Source: Tricumen. Note: Tricumen product definitions.

Appendix 1: Typical Current Organisational Structure of a Wholesale Bank

Appendix 2: Possible Bank of the Future Organisational Structure



Notes & Caveats

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