FICC transformation

- The strategic restructuring plan, announced yesterday, shone the spotlight on specific product areas; in this note, we focus on UBS' strengths and opportunities in key client segments.
- Drawing on our '360-degree' profitability work and on the basis of the information released thus far, we view UBS Investment Bank's RoAE and cost/income targets as very achievable …
- …but struggle to square the severe reduction in RWA with the bank's stated goal of retaining a meaningful presence in fixed income markets.

Client segments

On 30-Oct, UBS formally announced the strategic restructuring plan for its Investment Bank and FICC in particular. The commentary from market participants thus far largely focused on the impact of the restructuring on specific product areas.

This note, by contrast, considers UBS restructuring from the client segments perspective: seen from this angle, UBS' opportunities have, in our view, not been properly highlighted. We review this in order of importance:

- <u>Corporate clients</u> typically require advisory and financing services products, as well as some equity and rate derivatives-based risk management. The key challenge for UBS, in our view, is on the debt side. We suspect that UBS may sacrifice some scale (and so league table ranking) in order to focus on a predominantly high grade client base within their overall corporate franchise; we also expect that UBS Investment Bank will continue to service corporates' FX needs as well as providing equity derivative risk management solutions, and flow interest rate risk management (especially where this supports new bond issues).
- <u>Equity-focused institutional investors (including hedge funds)</u> seek strong capability in cash equities, equity derivatives and equity-related FX arena. Our sources broadly agree that UBS Investment Bank has, in recent times, aggressively strengthened its electronic offering *and* its prime services business; the latter competes with the market leaders. Building on this, the bank could expand further – for example, it could capitalise on links between equities and FX; many banks do not adequately service the full range of equity investors with FX trades due to the challenges of working across fixed income and equities divisions.
- <u>Retail and HNWI clients (in particular those of the Wealth Management division)</u> invest in FX, precious metals, cash equities and retail structured products. Utilising its strong links with the private bank/wealth management divisions, UBS Investment Bank already offers a range of such products: we expect further advances in this area. The bank may need to give up some margins on the fixed income side – as some investor-focused MTN desks source swaps externally - but a loss in revenue will likely be more than offset by lower capital requirements and reduced risk of profit/loss swings. In our view, UBS could challenge the leaders in this market segment.
- <u>Financial Sponsors</u> need high-yield financing when investing, and the support for IPOs/trade sales when exiting investments. We suspect that UBS' high yield financing effort will focus on this sector: banks typically need to have financing relationships with private equity firms in order to participate in the more lucrative exit side of the deals. This, however, is a niche area.
- <u>Bond investors</u> (in an execution-only role, to retain a primary market presence) require market-making for bonds and some CDS capabilities for risk management, as well as the repo capability. This segment is vital if UBS Investment Bank is to retain credibility in the primary/issuance market. We expect UBS will maintain its presence in secondary markets, quite possibly through the strengthened electronic fora; we also expect that the bank will retain its CDS and repo expertise.

The major client segments that UBS is exiting include:

- Fixed income funds focused on structured product;
- Fixed income investors requiring risk solutions or financing;
- Commodity producers, users and institutional investors;
- High return/capital intensive principal-risk taking businesses: including securitisation, distressed debt and non-precious metal commodities.

Outlook

There is little doubt that UBS' restructuring plan extends further than those announced by any of its immediate competitors, including Deutsche Bank, Goldman Sachs and JP Morgan. UBS' press release highlighted three specific goals for Investment Bank, from 1-Jan-13:

- Cost/income ratio of 65-85%.
- Pre-Tax return on attributed equity (RoAE) of 15%+;
- Basel 3 risk-weighted assets (RWA) of below CHF70bn (equal to US$74bn at current FX rates); of this total, 15% will be included in Corporate Client Solutions and 85% in Investor Client Services.

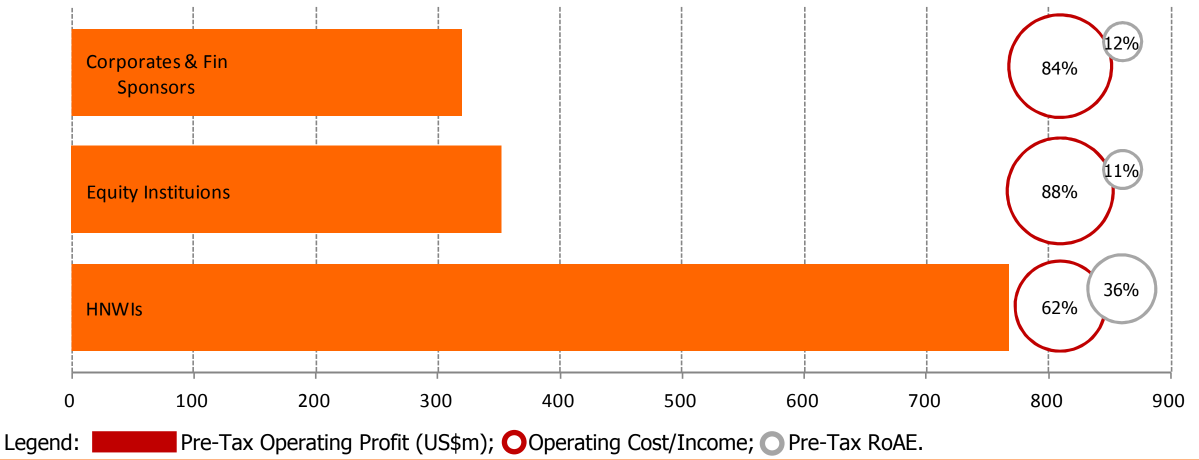
Our '360-degree' profitability modelling – comprising cost/income, headcount productivity, RoRWA, RoVaR, and RoAE – suggests that Investment Bank will have little trouble meeting the first two goals. The chart below groups product areas into our 'Bank of the Future' structure, the summary version of which we published in Sept-12.

Even without taking into account inter-divisional synergies and growth (which can be considerable – see out 'Bank of the Future' report, published in Sept-12); and omitting treasury services, security services (both of which boast RoAE well above the 'typical' capital markets units) and corporate lending, we expect UBS' 'new' Investment Bank will, in FY13E, report operating cost/income of 79% and pre-tax RoAE of 18% (the latter 'Swiss-plated').

The most challenging part of the bank's transformation will be achieving the credibility necessary to support the DCM business in the secondary markets while at the same time exiting businesses which account for c.60% of Investment Bank's CHF162bn at end-3Q12 RWA. Credit and rates markets will 'contribute' CHF30bn and CHF40bn of the reduction, respectively.

Notwithstanding UBS' commitment to heavy investment in areas it will continue to compete in, the main caveat to our projections is the execution risk associated with selective exit from hitherto interconnected businesses. We will continue to monitor developments.

UBS Investment Bank profitability by major client segment (FY13E, US$m)



Source: Tricumen. Notes: (1) Tricumen product definitions; see 'Bank of the Future', Sept-12; (2) Excludes inter-divisional synergies and growth, treasury services, security services, corporate lending.

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