Morgan Stanley: FICC re-tasked

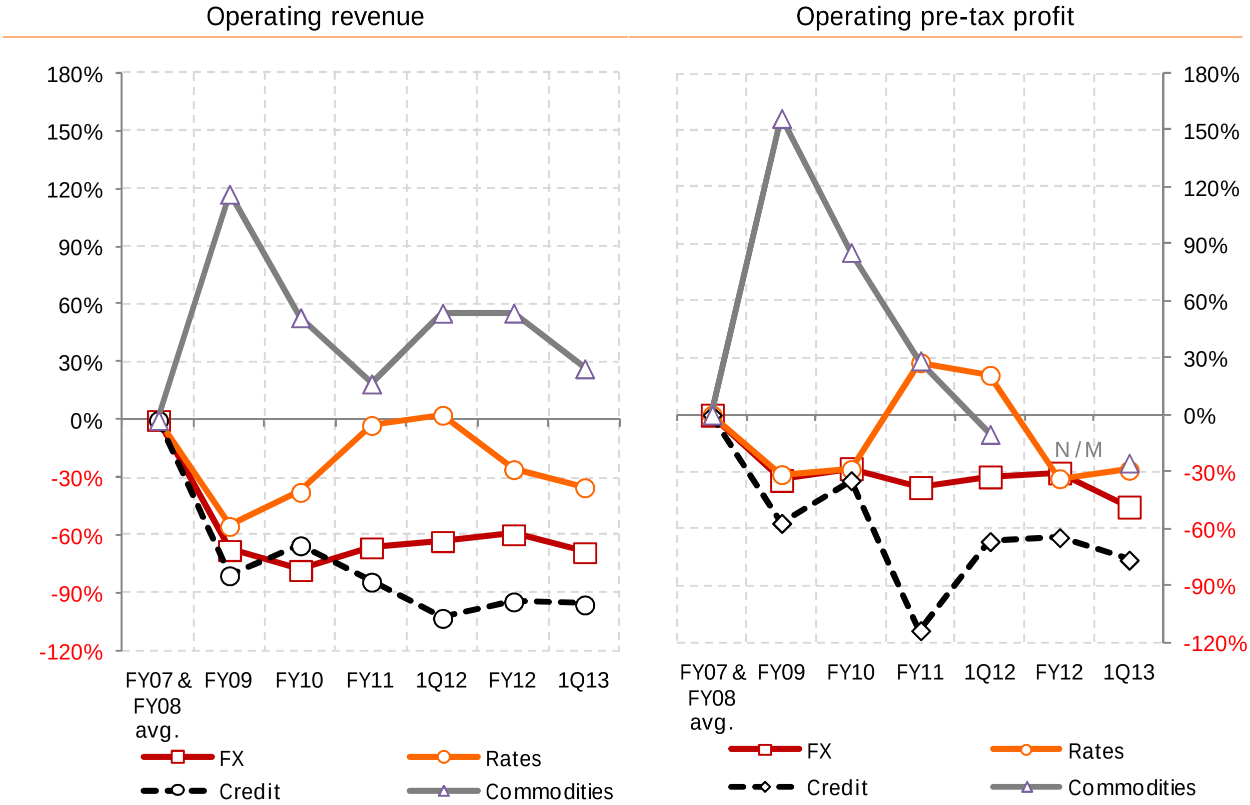
- The FICC division's new revenue target of $1.5-2.5bn per quarter appears attainable...
- ... but challenging. Specifically, revenues may be impacted by RWA cuts; and we doubt the integration between Institutional Securities and Global Wealth Management will be smooth. Our quick analysis of the balance sheet, however, indicates that FICC is already repositioning.

In a flurry of interesting news regarding Morgan Stanley last week, the one that attracted most interest is Thursday's article from The Wall Street Journal. The paper quoted Colm Kelleher, the Head of Institutional Securities[1], as saying that FICC optimal quarterly revenue is in the $1.5-2.5bn range. MS previously said it targets Group return on equity (RoE) of 10% and FICC Basel 3 risk-weighted assets (RWA) of below $200bn by end-2016, the latter representing a sharp reduction from FY12. In this note, we comment on two key elements of MS revenue generation: the greater cooperation between Institutional Securities (IS) and Global Wealth Management (GWM).

Background

Few were surprised by this development. In the wake of the original 'Crunch', MS steadily fell behind leaders in key FICC products. The management revamp of recent months indicated, and not very subtly, imminent changes. A few days before Kelleher announced the new revenue targets for FICC, Kenneth deRegt, the Head of FICC, announced he was planning to leave MS in June-13 to work at an investment firm, Canarsie Capital. The new FICC co-Heads are Michael Heaney (ex-Global Head of Credit, Municipals, and Emerging Markets) and Robert Rooney (ex-EMEA Head of Fixed Income Sales and Trading and Global Head of Fixed Income Client Coverage); both of them are said to have worked with Kelleher for a number of years.

MS vs Top 25% composite (US$, % share of the revenue/profit pool, indexed to FY07/FY08)



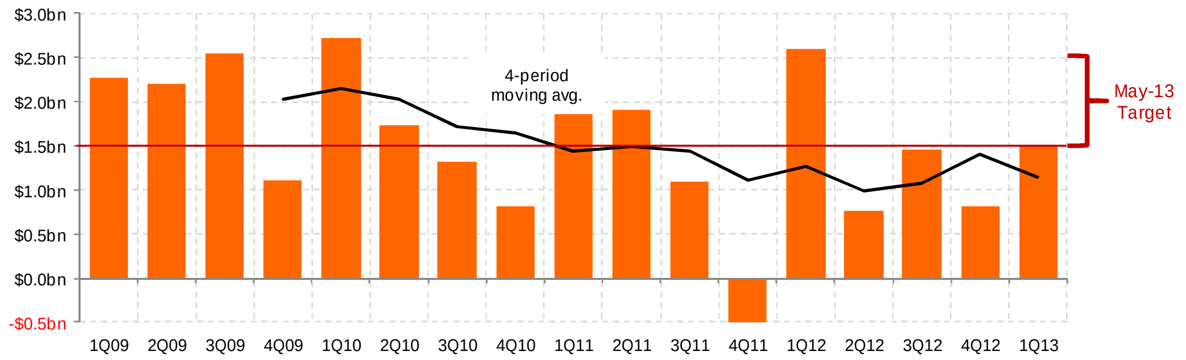
Source: Tricumen. Notes: (1) Negative values indicate MS underperforming Top 25% peers; (2) Top 25% calculated separately for each period and product area, from the peer group comprising capital markets units of 12 banks: Bank of America Merrill Lynch, Barclays, BNP Paribas, Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P.Morgan, Royal Bank of Scotland, Societe Generale, UBS. (3) Tricumen product definitions apply throughout. (4) Revenue shown includes writedowns; excludes dedicated prop trading operations, one-offs and DVA/equivalent. (5) Operating profit is based on fully-loaded expenses.

[1] Paul Taubman co-led (IS) until his high-profile departure in Nov-12; Kelleher was then named sole Head of IS.

A sharp reduction in RWA may impact revenue

Some have opined that the new $1.5-2.5bn FICC revenue targets lacks ambition. We, by contrast, believe that MS is simply being realistic – or even slightly optimistic. The FICC division's revenue undershot even the low end of the new revenue target in 8 out of the last 17 quarters …

Reported FICC revenue (excl. DVA/equivalent, 1Q09-1Q13)



Source: Morgan Stanley.

… and there is a good chance that aggressive reduction in FICC RWA will depress future revenue, in the near term at least. At the end of 2012, FICC Basel 3 RWA totalled c.$280bn; this is expected to fall to $255bn by the end of the current year and to <$200bn by end-2016. Understandably, MS will adjust this target to shifts in the market environment and the competitive landscape.

Almost half of the total, $35bn, will come from cuts to the credit correlation book. This is a sharp reversal from recent years: according to Bloomberg, MS bought c.$50bn of such assets from Natixis ($35bn+, in 2010), Royal Bank of Scotland (2011) and Credit Suisse (2012). MS' own reports broadly confirm the story.

The bank believes it can do both – cut RWA without impairing revenue or client franchise. We, on the other hand, believe that revenue may be impacted by 5-10% over the next 12 months or so.

What are the key elements in MS' approach?

Cooperation: Institutional Securities & Global Wealth Management

The ever-closer cooperation between IS and GWM is expected to play a key role. In late 2012, MS appointed Eric Benedict (said to be a confidant of Kelleher) to run the capital markets unit in GWM, and he needed little time to make his mark. In Oct-12, the bank formed a new structured products group as a revenue-sharing JV between IS and GWM; a month later, it added a new FICC sales group (expected to grow headcount to 50-75 in the near term) to GWM to serve middle-market clients; the team is led by Tom Driscoll. Similar moves were made by other departments: for example, banking coverage team has passed smaller corporate clients over to GWM; and a middle-market equities sales group (run by Trey Thomas) has been operational since 2010. As of Jan-13, there were 35+ 'live' initiatives. However, in view of the difficulties the bank faced in its previous attempts to foster cooperation between IS and GWM, we would be surprised to see smooth progress on all.

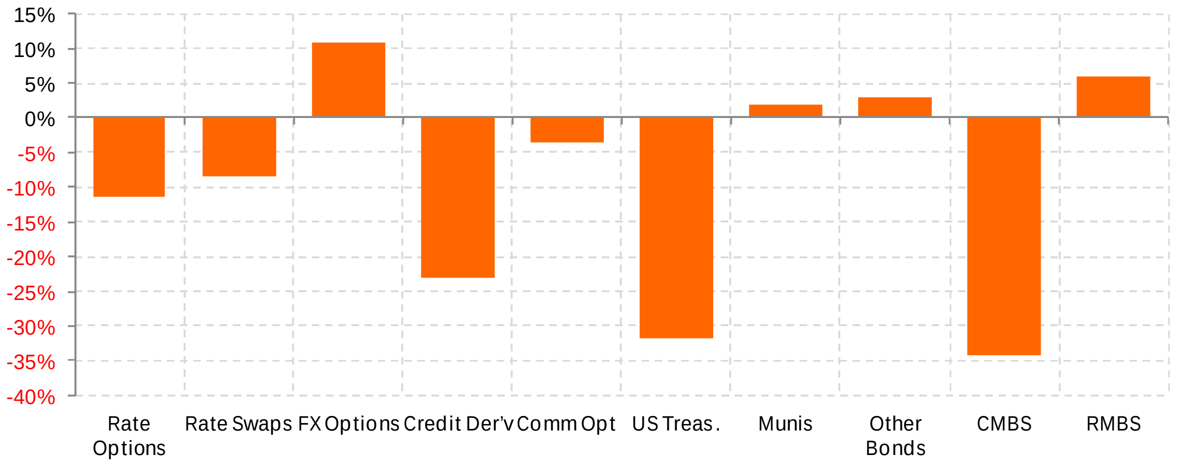
Re-focusing FICC

From the traditionally US-centric product perspective, we expect swaps business will be trimmed and exotic rates cut. The focus, we believe, will shift to the provision of (rate-based) retail structured products, most likely to be bought by GWM clients, and products such as inflation that can be sourced from project finance deals and turned into product for pensions. MS stated its intention to grow FX derivatives capability; we anticipate greater efforts to sell more FX to GWM clients.

We anticipate that MS will seek to distribute muni, RMBS, corporate bonds and some emerging market bonds through GWM; and note that one of the new co-Heads of FICC, Michael Heaney, previously ran Credit, Municipals, and Emerging Markets. Commodities is an area of uncertainty; on balance, and given the ongoing difficulties in the commodities market, we expect MS will make further cuts to its commodities franchise.

Much of this is an extension of actions MS has already taken. Below, we observe some changes in the composition of balance sheet items between 1Q13 and the prior year period: note the sharp reduction in CMBS, US Treasuries, credit derivatives, rate options and rate swap; and, in parallel, increases in FX options, munis, RMBS and other bonds (comprising non-US government and corporate paper).

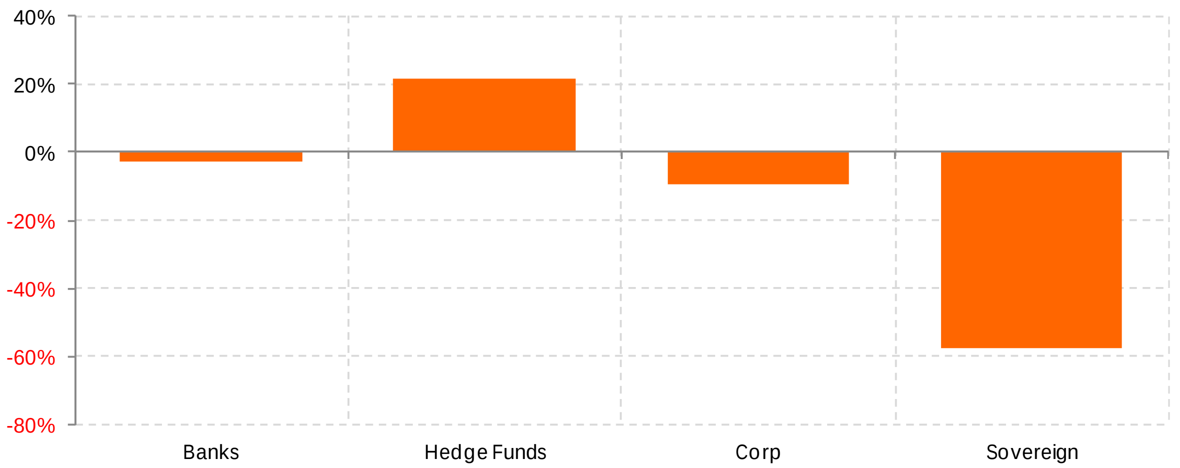
Trading Balance Sheet and Derivative notionals (% change, US$, 1Q13/1Q12)



Source: Morgan Stanley, Tricumen analysis.

Turning to client segments, hedge funds are being given more focus; not only are they already an area of strength in the Equities division but they also provide part of the MS offering to HNWIs through GWM. This move is already reflected in the Bank's counterparty exposure to Hedge Funds, which has grown 22% between 1Q12 and 1Q13.

Counterparty exposure by client type (% change, US$, 1Q13/1Q12)



Source: Morgan Stanley, Tricumen analysis.

MS' moves echo very sensible steps taken by Credit Suisse and UBS in utilising links between the capital markets and wealth management units. All three, however, lack substantive transaction or commercial banking divisions; banks that have those – among them, J.P.Morgan, Deutsche Bank, and Royal Bank of Scotland – are, in our view, more likely to grow their RoEs faster, and higher.

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