Future Business Models in Wholesale Banking
Part 1: Macro Business Models

- In an environment of shrinking margins, capital and liquidity constraints, and efficiency challenges, banks are rethinking their wholesale banking operating model.
- We see four distinct models emerging, centred around: (1) global universal banking, (2) global investment banking & wealth management, (3) a blend of electronic and high margin business, and (4) regional universal banking.
- Whichever strategy is adopted, efficient client coverage, tech & ops excellence and clarity of strategy will be key for success.

As the new regulatory environment settles into place, it has become clear that old banking business models are having to change. In this paper, we look at the attributes of successful emerging models.

Shrinking Margins

One of the most significant changes in the new norm has been shrinking margins. This has been driven by a combination of market regulation, low volatility and bank regulation. In the aftermath of the crisis, regulators have been keen to make markets more transparent, promoting price discovery through systems such as TRACE. However, as price transparency has increased, so bid-offer spreads have decreased. At the same time, moves to require the use of SEFs and CCPs has increased the use of electronic platforms, which has also compressed spreads. Volatility has also not been kind to banks. In many areas, low volatility has made it harder for banks to generate revenues off the back of client trades while in others, volatility spikes have caused trading losses. Banks have also found regulators frowning on 'principal' business and encouraging 'agency' trading models. LIBOR and FX rate fixing scandals have played their part in this, as have capital requirements that have led to banks shedding inventory from their balance sheets.

Capital and Liquidity Constraints

More generally, the new requirements of global regulations (including, but not limited to, Basel 3, leverage, LCR, NSFR and G-SIB surcharges) have led banks to review their businesses. Revenue creation is no longer the key goal; instead, banks need to deliver revenue/RWA and return on equity (RoE) under the new leverage, liquidity and G-SIB constraints. Local regulations are also constraining businesses with rules on locally held capital, separately capitalised swap dealing business and ring fencing. The key impacts of these changes have been for banks to:

- withdraw from business segments that consume high amounts of capital, but have low RoE;
- withdraw from business segments that require significant capital to be held outside the bank's home jurisdiction;
- seek to build deposits to meet liquidity and leverage requirements.

Efficiency

While banks have to be more efficient with their risk capital, they also have to be more efficient in their deployment of human capital and technology. Key areas of focus have been to look at how clients are being covered for the full range of services across investment banking, capital markets, transaction banking and private banking; the aim being to both increase cross-divisional sales and consider where staff cuts can be made. Technology is also utilised in bringing efficiencies in client coverage as electronic trading platforms are increasingly the main way that clients access flow trading products.

At the same time, a number of banks (especially in the US) have been investing in technology architecture simplification. Their aim is to deliver end-states that are both more cost-effective and also allow for better risk consolidation across divisions and regions (which can be used to lower capital consumption through netting and diversification).

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Four models

Against the backdrop of the above, we see four broad models emerging:

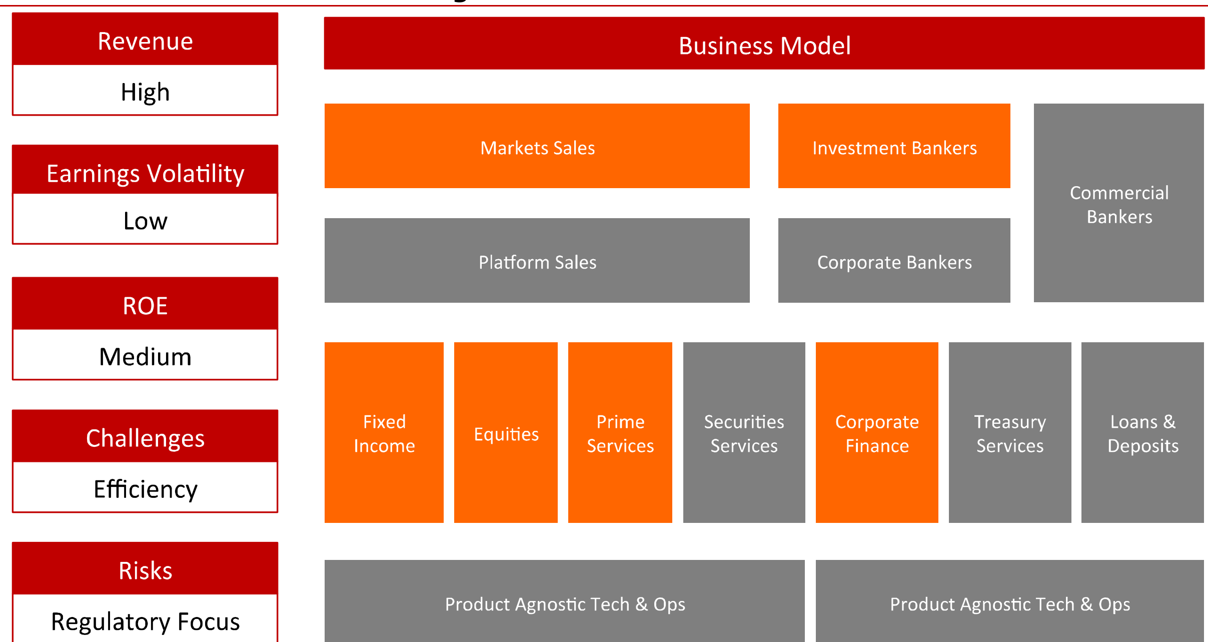
- Model 1: Global Universal Banking. Examples: Bank of America, Citigroup, HSBC and J.P.Morgan.
- Model 2: Global Investment Banking and Wealth management. Examples: Credit Suisse, Morgan Stanley and UBS.
- Model 3: 'Barbell' across high margin and electronic business. Example: Goldman Sachs.
- Model 4: Regional Universal Banking; which may be adopted by Barclays, BNP Paribas, RBS, Societe Generale, Standard Chartered and Wells Fargo.

Model 1: Global Universal Banking

Under this model, a bank seeks to make efficiencies in its client coverage and tech & ops by bringing together capital markets, transaction banking and commercial banking. Typically, coverage of large cap corporate clients is split between investment bankers who manage the CEO/CFO relationship and corporate bankers who manage the treasurer and deputy treasurer relationships. The commercial banking division also has close links to the key banking product teams, to help maximise the sale of product to SME and mid-cap corporate clients. Institutional investors are covered by a combination of 'high-touch' sales teams and electronic platforms; the latter being marketed by 'platform sales' teams. Underpinning the banking and markets front office groups is an integrated and largely product-agnostic Tech & Ops organisation.

With a large corporate client base, a bank using this model is able to leverage corporate deposits to fund its wholesale business. While the scale of the business generates large revenues, the expense of the infrastructure and capital costs mean that RoE will be solid, though not top-of-the-range. However, the broad diversity of business is likely to reduce earnings volatility. The greatest challenge to banks adopting this model is likely to be the need for operational efficiency and cohesion in running an organisation of such size and complexity; both of these factors are also likely to be in the minds of regulators who will mark such banks as the G-SIFIs and, in the case of the US, apply additional capital surcharges.

Model 1: Global Universal Banking



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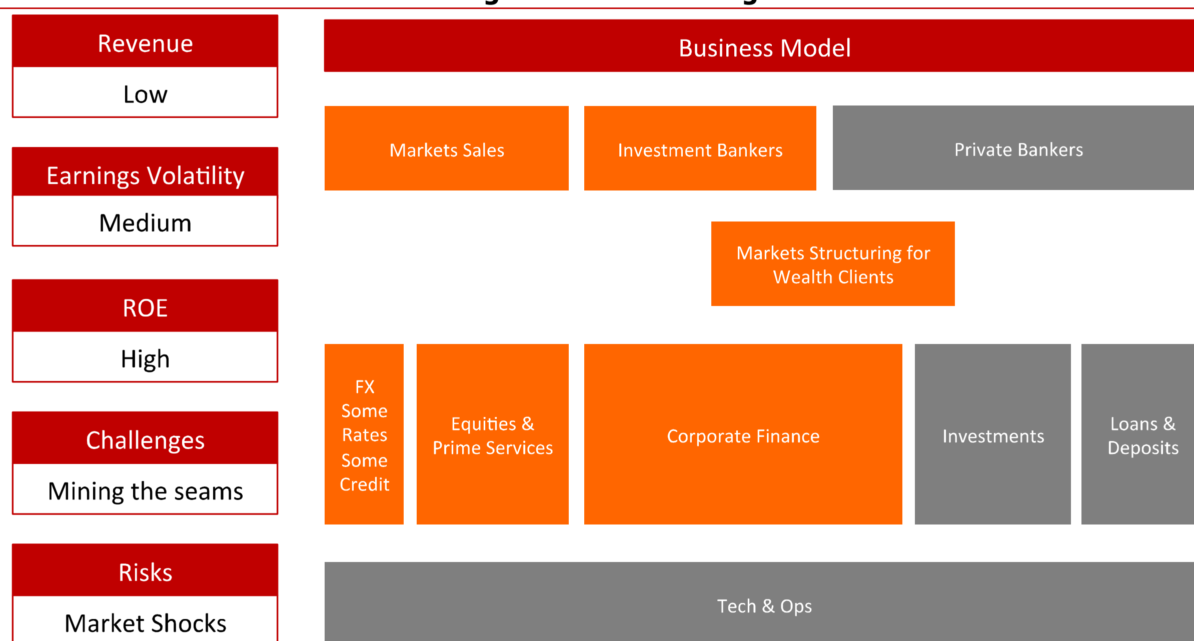
Model 2: Global Investment Banking and Wealth Management

This model is likely to be adopted by banks lacking significant corporate and transaction banking capabilities. The model builds on synergies between investment banking and wealth management.

Organisationally, key changes may involve passing coverage of some corporate accounts to private bankers and the creation of bridging teams to structure markets products for wealth management clients. Focusing on this client base allows for reductions in the more capital-intensive parts of fixed income trading and should result in improved RoE for the Markets business. Efficiency savings are also possible through the creation of common tech & ops platforms across capital markets and wealth management. While the model does not allow for the gathering of large-scale corporate deposits, deposits from private wealth or brokerage clients go some way to improve the organisation's funding profile.

Compared to Model 1, revenues are usually lower and earnings are subject to greater volatility. However, RoE is often above that of Model 1 due to the lower capital base. Key to success is the bank's ability to fully utilise the seams between capital markets and wealth management, as well as managing the risk of market shocks to which the bank may be more vulnerable given its lower capital base.

Model 2: Global Investment Banking and Wealth Management



Source: Tricumen.

Model 3: 'Barbell' across high-margin and electronic business

The third model is perhaps the most innovative, as it seeks to combine the merits of high-volume low-touch business with high-margin, high capital usage, principal business.

The key premise is that business segments that have mid-scale margins and mid-size capital usage are the least attractive. Under this model, such segments are only supported where they are required to fulfil the needs of clients that are key to profitable segments. Adopting an electronic approach means that the bank can push most trading through DMA or e-platforms using an agency or 'near-agency' model. This, combined with crossing and smart order routing allows the sales headcount to be kept to a minimum, and ensures that manual processes in the tech & ops units are minimised. As electronic sales tend to go through an exchange or SEF, capital is reduced in comparison to bilaterally settled trades. A high-touch salesforce is retained, but its focus is on the most profitable client accounts and products where margins are high.

Running parallel with the client business is a strong principal investing capability where each line is run as in investment portfolio with appropriate RoE hurdles. Combining this with a UHNWI private banking and investment management businesses allows for efficiency to the organisational model,

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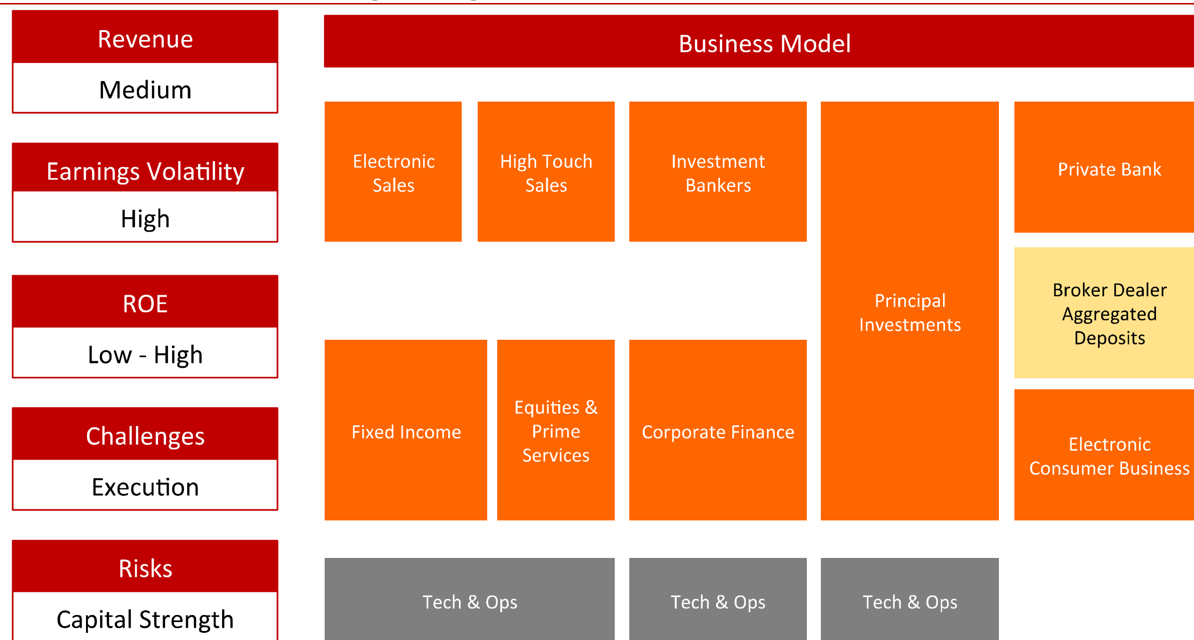
mostly through common staffing, platforms and risk management. Deposits are sourced from the UHINWI private clients, but also using low-touch methods. These may include providing a broker deposit aggregation service and/or through an electronic consumer deposits business.

Over the cycle, this model should provide medium-scale revenues; the potentially varied success of the principal investments portfolio, however, is likely to lead to higher volatility in both earnings and RoE. The biggest challenge therefore is execution and the need to maintain capital strength.

Model 3: 'Barbell' across high-margin and electronic business



Source: Tricumen.

Model 4: Regional Universal Banking

The final model that we see is a modified version of Model 1.

The key difference is that the full-scale business is limited to one or two geographical regions (e.g. Europe, Europe and Africa, or Asia and Middle East/Africa). The benefits and rationale are exactly the same as is the case for Model 1 but any bank adopting this model also needs to decide which global capabilities are required to support their core home region business.

Some decisions are easy. Multinationals domicile in the bank's home region will want their overseas subsidiaries to be covered and international payments taken care of. Similarly, institutional investors will want access to the major government bond markets and key products such as US Swaps. However, each product area will need to be looked at on its own merits in view of its importance to the home client base and the RoE impact of providing (or not providing) a service. There will also be cases where selected businesses can be run on a truly global basis, especially where the bank in question has or can gain a leadership position and cost and capital impacts are acceptable.

We see this model as offering medium-scale revenues but - as with its global counterpart - the level of earnings volatility should be small given the diversity of the business. That said, it is likely that RoE will be lower than that for Model 1, due to the potential cost and capital burden of the segments of the business that operate outside the home region; managing this will be the key challenge. As with any region-centric model, the main risk is that the home region stagnates or suffers an economic crisis, which would see any bank relying on this model being more exposed than global peers.

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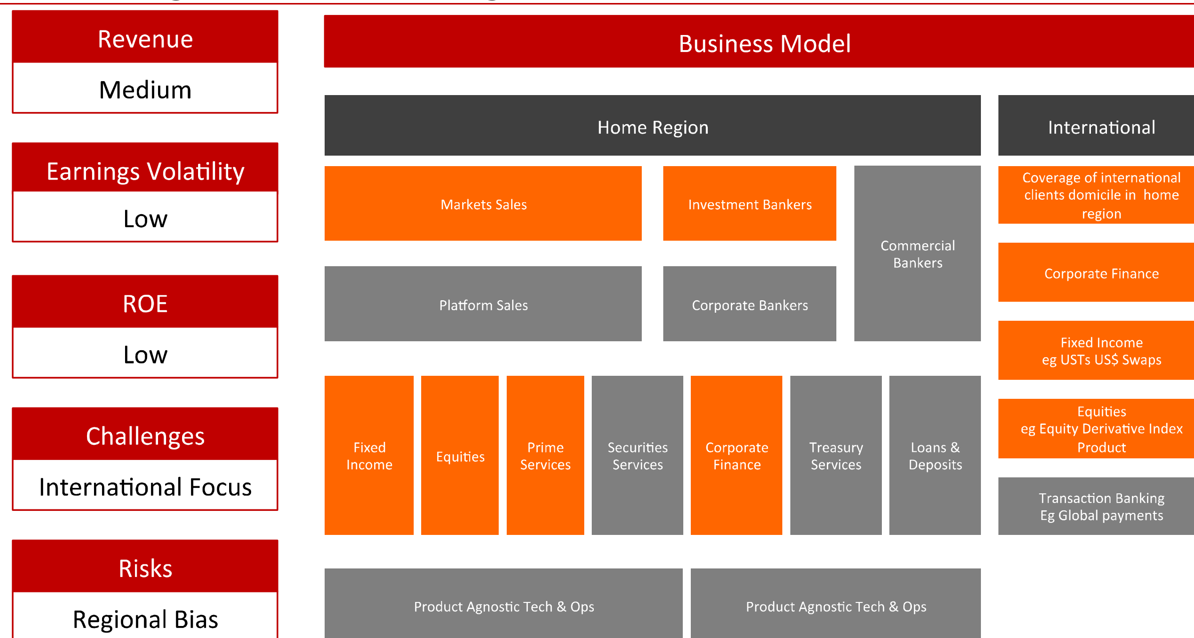
Model 4: Regional Universal Banking



Source: Tricumen.

Key to success

All of the above models described above have a number of common requirements. From the front office perspective, smart client coverage is critical. Client segments need to be clearly defined and targeted and coverage arranged to meet the needs of each client base rather than traditional organisational structures. Similarly, tech & ops excellence is increasingly a differentiator, marking out the leaders as they have the ability to process trades or loans more efficiently and aggregate risk across the group with both cost and capital efficiency benefits.

Most important, however, will be clarity of strategy. The temptation for local business heads will always be to expand into local opportunities, but too many ventures may blur the clarity of the bank's overall strategy and cause inefficiencies. A key first step for the top management, then, is to set out a clear strategy and then to hold the course so that both the bank's investors and managers at all levels understand the path that is to be trod.

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Situated near Cambridge in the UK, Tricumen is almost exclusively staffed with senior individuals with an extensive track record of either working for or analysing banks; and boasts what we believe is the largest capital markets-focused research network of its peer group.

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