

# Regulatory Change and the Changing Face of Wall Street Trading

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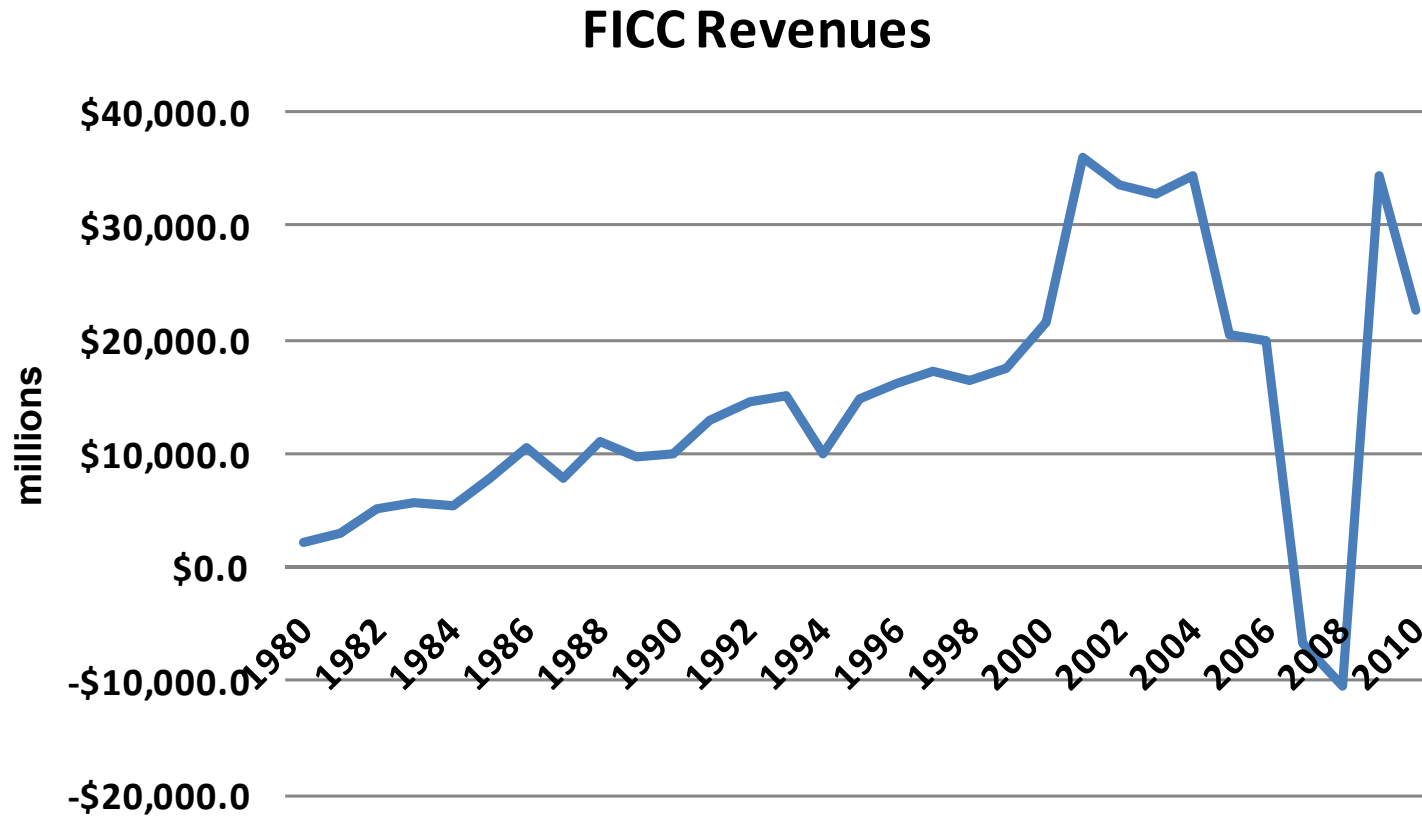
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*Bernstein Research*

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# FICC Rebound

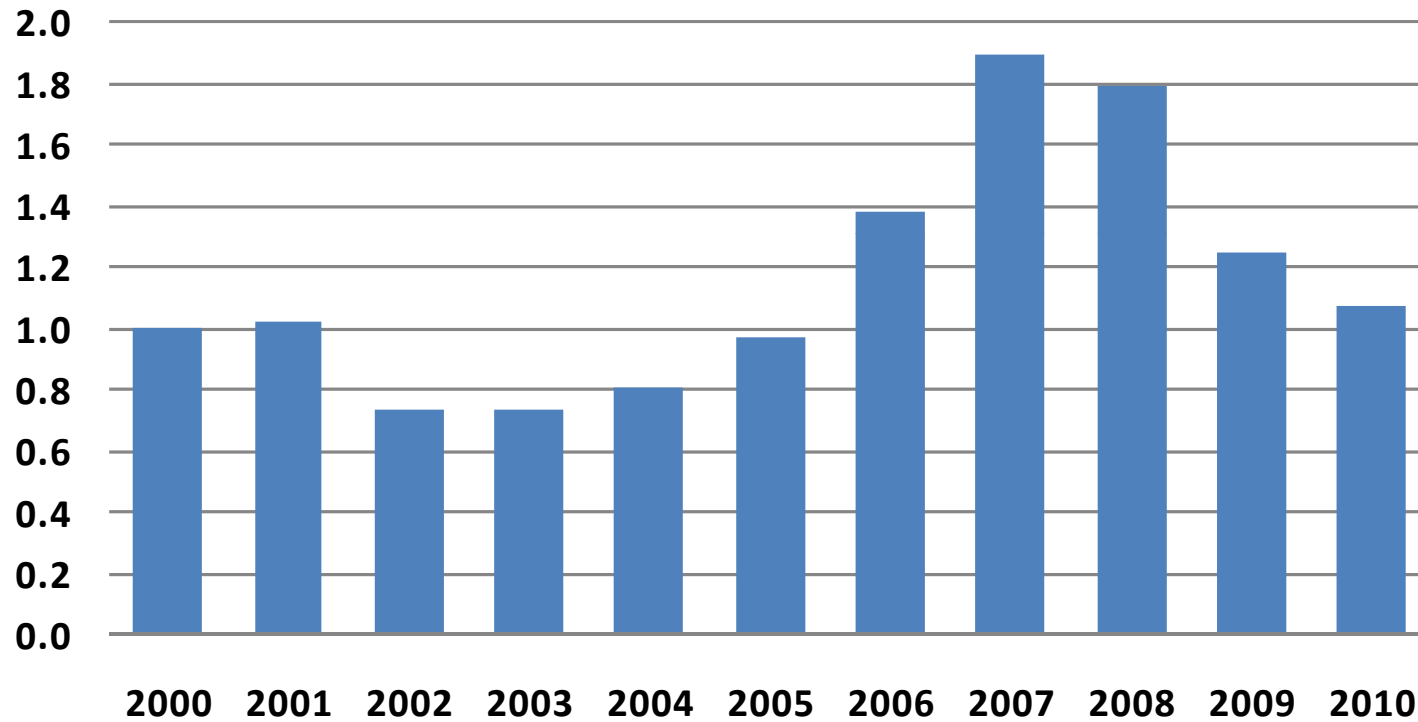
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# Institutional Equities

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## Indexed Inst. Equities Net Revenues



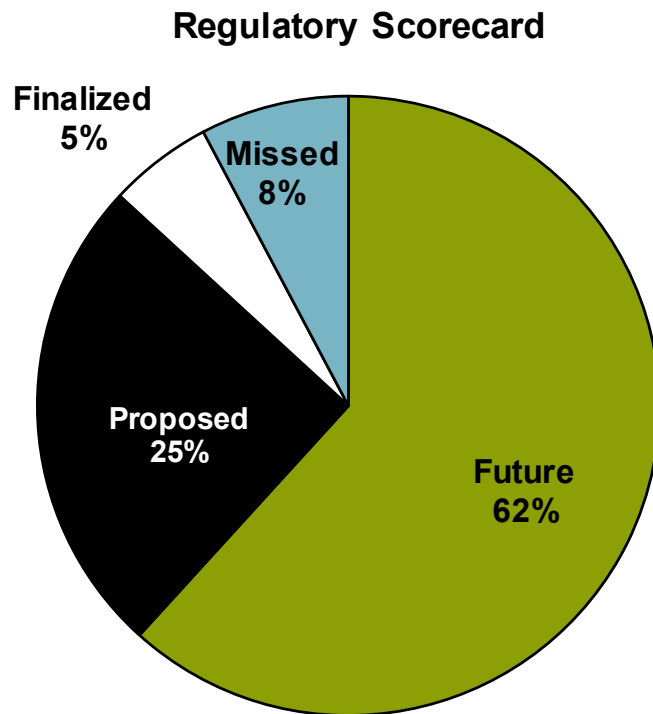
## Major Changes to Trading Business Model

- **Basel 3.0. Minimum capital ratio for common equity increases to 4.5%. New capital conservation buffer will be required comprising 2.5% of common equity. Three percent Tier 1 leverage limit effective 2018. Banks expect a SIFI buffer of ~3%.**
- **Proprietary trading is prohibited. All trading in US Government securities is exempt. Total investment in all hedge funds and private equity funds must not exceed 3% of an institution's Tier 1 capital.**
- **All OTC derivatives selected by the CFTC / SEC must be centrally cleared. All transactions involving OTC derivatives that are subject to clearing requirements must be traded on an execution facility.**

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage ratio	Monitor	Monitor	Monitor	Monitor	Effective	Effective	Effective	Effective	Effective
Min. Common Equity Ratio			3.50%	4.00%	4.50%	4.50%	4.50%	4.50%	4.50%
Capital Conservation						0.63%	1.25%	1.88%	2.50%
Min. Common Equity plus Capital Conservation			3.50%	4.00%	4.50%	5.13%	5.75%	6.38%	7.00%
Minimum total Capital plus Conservation			8.00%	8.00%	8.00%	8.63%	9.13%	9.88%	10.50%
Liquidity coverage ratio	Monitor	Monitor	Monitor	Monitor	Effective	Effective	Effective	Monitor	Monitor
Stable Funding		Monitor	Monitor	Monitor	Monitor	Monitor	Monitor	Monitor	Monitor

## Regulatory Delay – Good or Bad

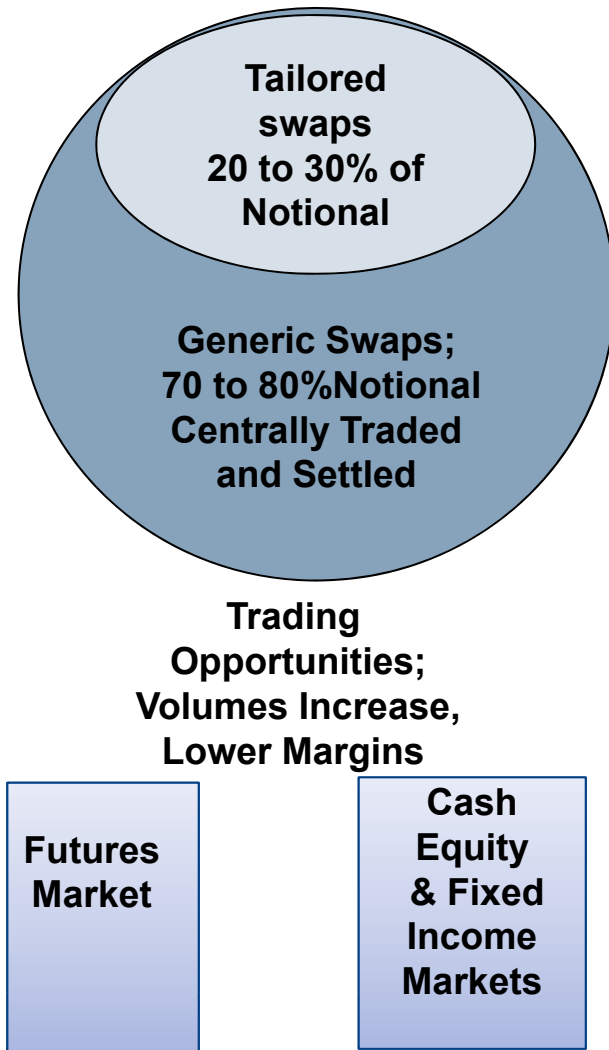
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- The drafting of regulation is taking longer than anticipated
- According to Davis Polk >20% of deadlines have been missed. Even larger portion of the rules are behind schedule.
- Is this good or bad? It appears that regulators are being cautious in drafting new rules to minimize unanticipated results.
- Leaves many open issues unanswered.

# Derivative Regulation

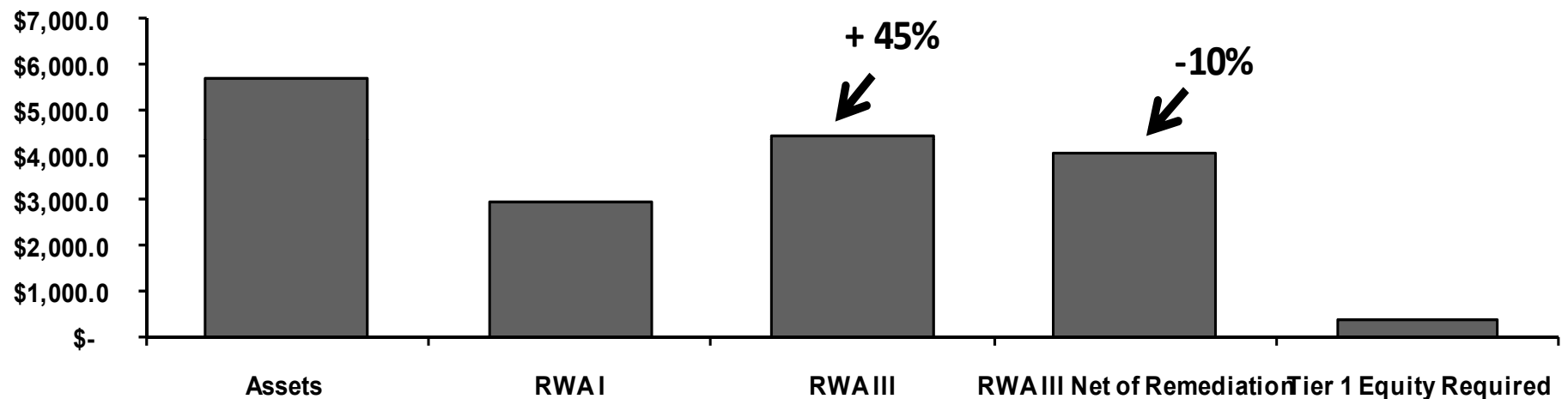
## OTC Derivatives Market



- Derivatives make up approximately 20% of institutional equity net revenue and generate 15% of fixed income net revenue.
- Expect 70% to 80% of derivatives notional amounts to trade in new venue. This portion of the derivatives market generates 50% of total earnings.
- Highly tailored bespoke derivatives will remain bilateral, albeit with higher capital charges.
- Derivatives pricing will fall and margins will contract in a 'new' electronic market. PTM falls from  $\approx 35\%$  to  $\approx 23\%$  for originators.

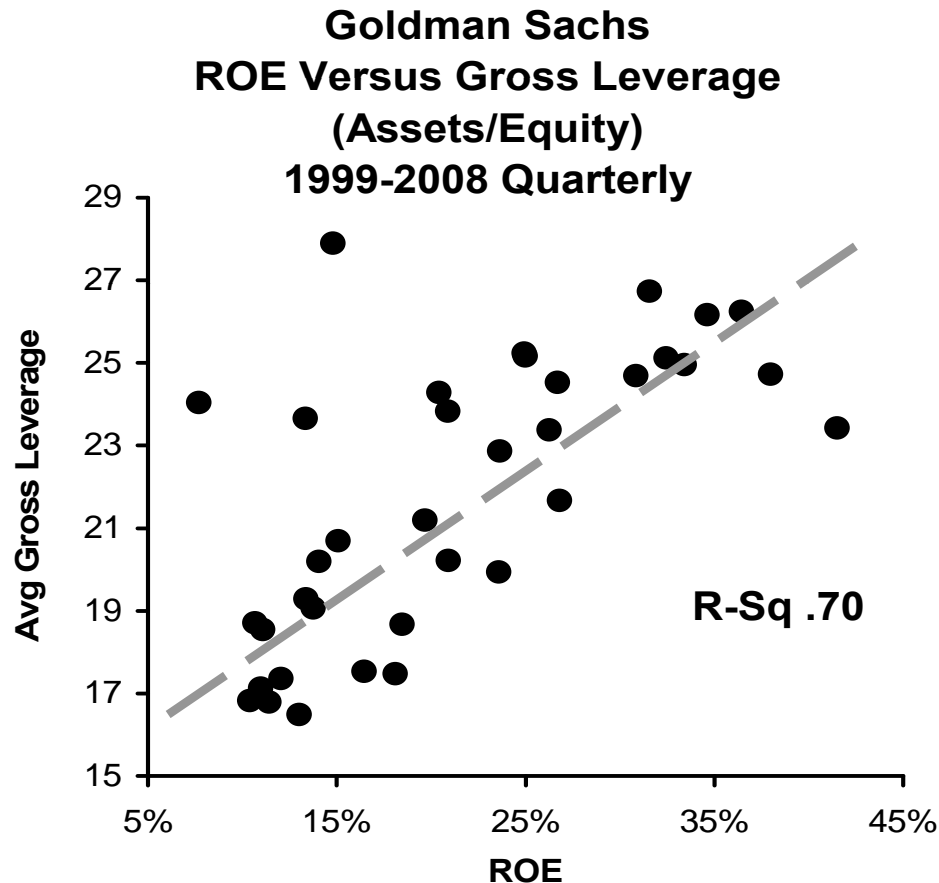
# Basel III

## Pro Forma Impact of Basel III Q3 2010



**Under Basel III minimum common equity capital to risk weighted assets from 2% to over 7% . These regulatory changes will make it virtually impossible for any major capital market oriented bank to maintain leverage ratios in excess of 15X**

# Higher Capital Will Certainly Limit Trading ROE



- Higher capital charges, lower leverage limits, and more matched funding will negatively impact the ability to achieve returns over costs of capital.
- Certain low margin balance sheet intensive businesses such as repo will decline or be exited

## FICC – Capital, Leverage and Funding Impact Margins

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- FICC will bear the brunt of the new capital charges. RWAs related to FICC will increase >50% due to its credit and balance sheet intensity. Investment grade credit, commodities, securitized products, emerging market, high yield, loan syndication and structured products Foreign exchange trading and government trading are less impacted by regulation. Approximately 50% of fixed income revenues will be significantly impacted by either the increase in regulatory capital or the limitation on leverage.

### Fixed Income Average Pre Tax Margins

	Cash	Proprietary Trading	OTC Derivatives	Avg. PTM
Current	23.0%	24.0%	35.0%	24.9%
Post Dodd Frank	23.0%	-	23.0%	23.0%

## Institutional Equity Is Also Impacted

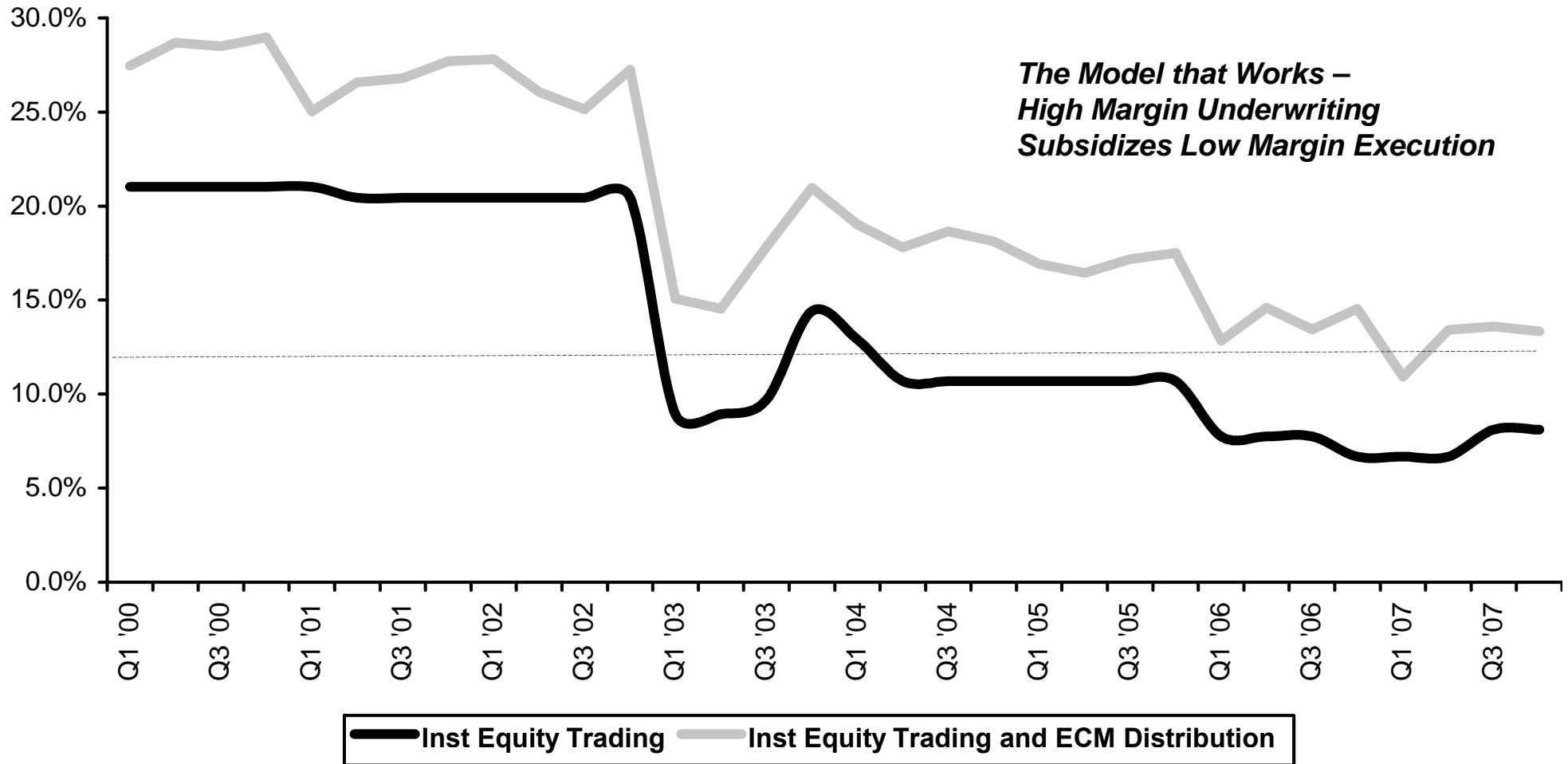
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### Inst. Equities Average Pre Tax Margins

	Cash	Proprietary Trading	OTC Derivatives	Avg. PTM
Current	6.3%	24.0%	35.0%	12.4%
Post Dodd Frank	6.3%	-	23.0%	9.1%

- RWA in equities is expected to increase 30% on average under Basel III. Leverage limitations will negatively impact the ROE of prime brokerage.
- Higher return equity businesses such as proprietary trading (24% PTM ) and OTC derivatives (35% PTM) are prohibited or constrained by new regulation.
- Equities margins will decline by 26%, increasing the reliance of the business on ECM shared revenues to achieve acceptable returns.

# Equity Trading Needs ECM to Achieve an ROE





# Trading Cannot Beat Its Cost of Capital

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## Revenue Return On Net Assets

Data 2000-2009 US Securities Industry

Qrtly Annualized S&T & U/W RONA

Mean = 2.27%       $\sigma$  = 1.22%

Qrtly. Annualized S&T RONA Ex Crisis Period

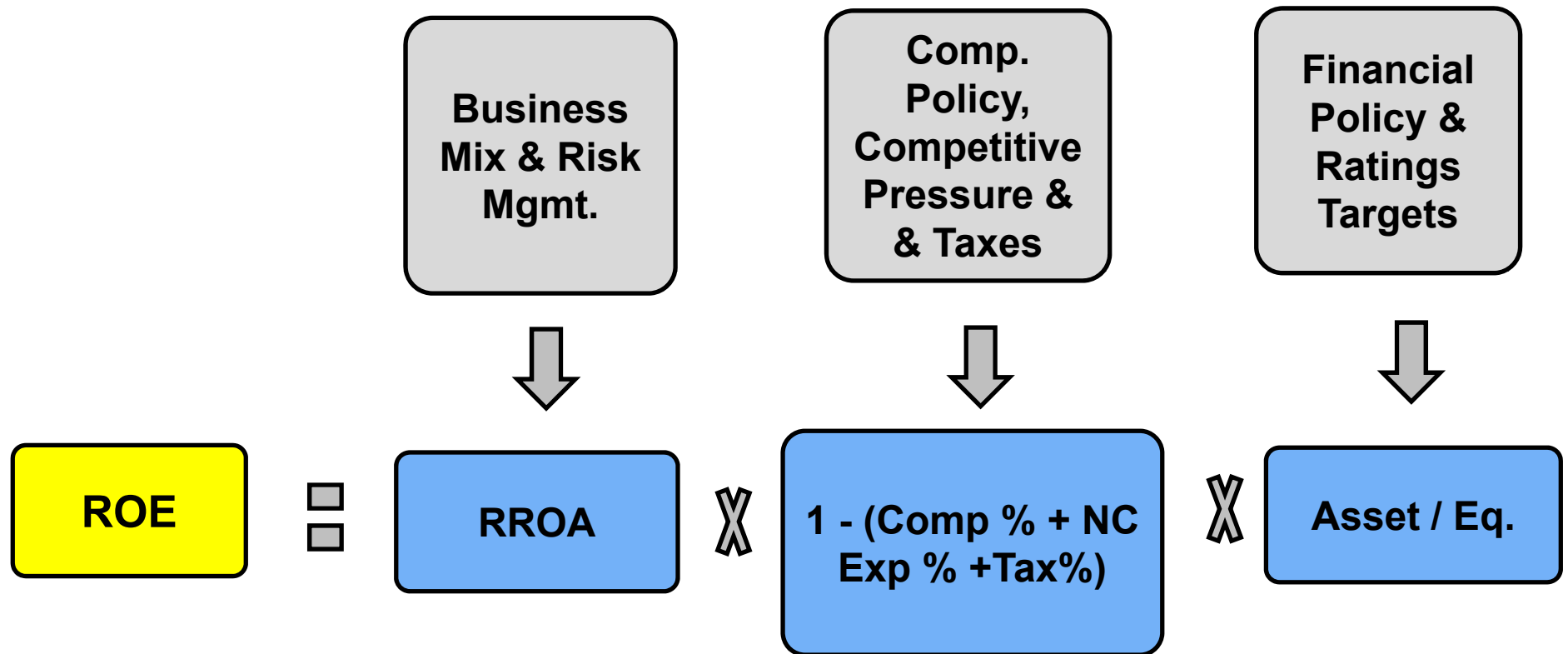
Mean = 2.67%       $\sigma$  = 0.65%

## ROE versus Return and Leverage

		RRONA				
		1.0%	2.0%	3.0%	4.0%	5.0%
Leverage	30	5.6%	11.2%	16.8%	22.3%	27.9%
	25	4.7%	9.3%	14.0%	18.6%	23.3%
	20	3.7%	7.4%	11.2%	14.9%	18.6%
	15	2.8%	5.6%	8.4%	11.2%	14.0%
	10	1.9%	3.7%	5.6%	7.4%	9.3%

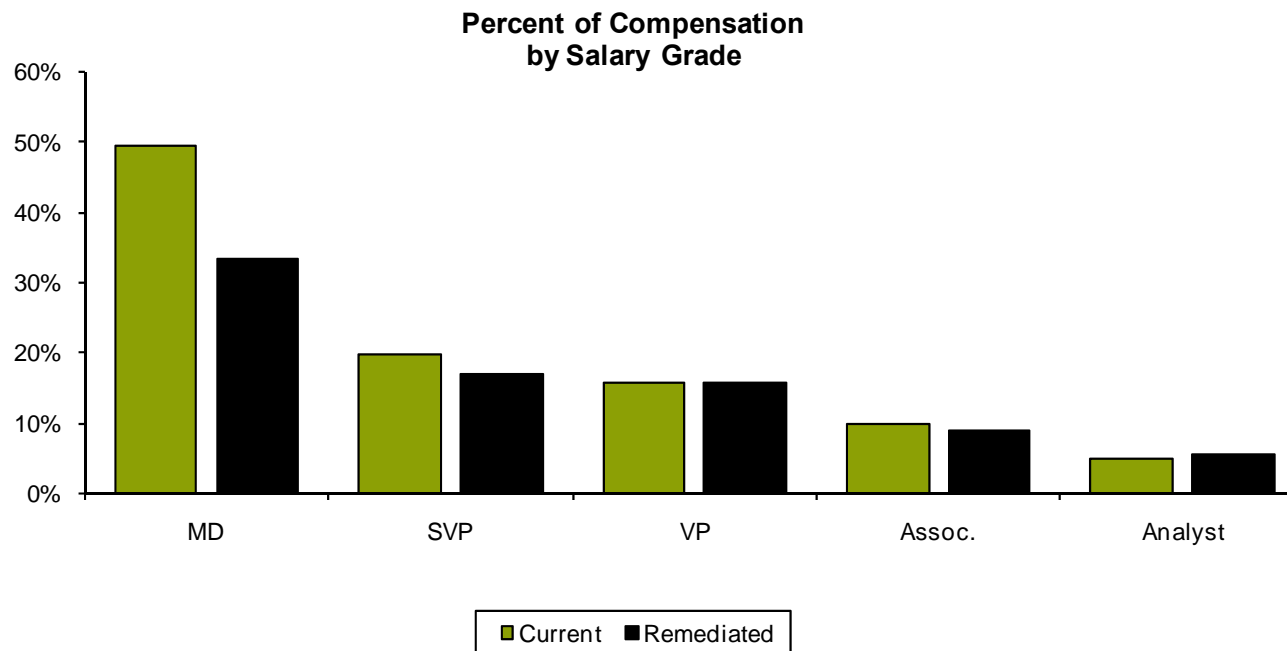
## The Choice; Smaller Positions , Less Compensation, Lower Growth

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## Grim Reality - Compensation

- Only alternatives Wall Street will have are to cut compensation, reengineer the business, limit capital in trading books and push for higher commissions in equities and wider bid offer spreads in fixed income.
- **Compensation.** Bernstein expects the average compensation of an MD in Sales and Trading to drop by 20% and the percent of MDs in a trading operation to decline from 15% of staff to 10%. SVP compensation will decline by 15%. This will reduce the compensation ratio to 40%



## Grim Realities – Balance Sheet Management

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- **Expect an intense re-evaluation of balance allocations. Low return businesses will find position taking authority limited and allocated inventories constrained.**
- **New capital allocation models will be established that use operation research techniques to drive dynamic balance sheet allocations based on real time market conditions.**
- **Linkages between businesses will be identified to ensure that balance sheet is used to maximize customer flow or support profitable trading strategies. Repo books and margin lending will be tightly limited to minimize the potential drag on performance.**
- **Inventory turnover discipline will be enforced and aged inventory will be tightly monitored. Retail flow will become an important non balance sheet source of liquidity to support equity execution.**

## Grim Realities – Reengineering

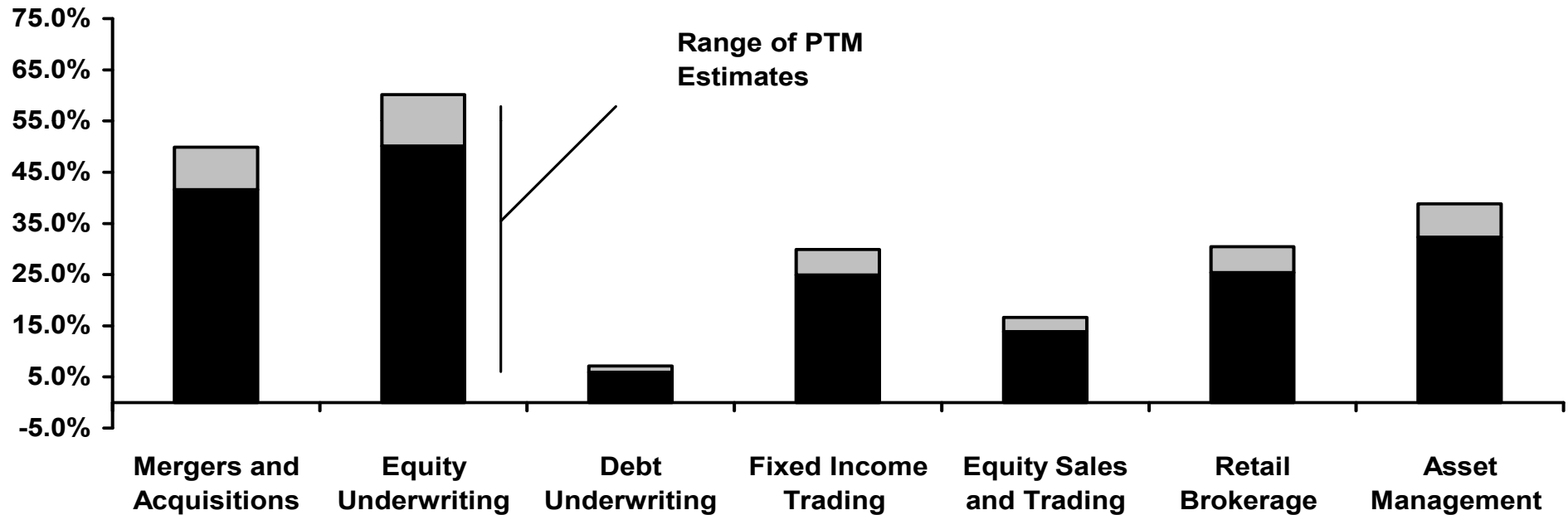
- FICC will implement a major re-engineering of its business model to support its staff reductions. Bernstein expects improved collateral management systems and straight through trading technology to be implemented to reduce middle office costs and drive operation costs down by  $\approx 2\%$ . Electronification of trading activities will facilitate direct client execution. High frequency trading technology will be transferred from equities to FICC to facilitate more automated desks in governments, money markets, medium term desks.
- Industrial engineer and process design experts as well as cost accountants will work to streamline trading floors and ensure that management reporting systems report the true economics of the individual desks and to properly allocate all capital and funding costs.

At 40% Compensation to Net Revenue

		RRONA				
		1.0%	2.0%	3.0%	4.0%	5.0%
Leveragee	30	6.3%	12.6%	18.9%	25.2%	31.5%
	25	5.3%	10.5%	15.8%	21.0%	26.3%
	20	4.2%	8.4%	12.6%	16.8%	21.0%
	15	3.2%	6.3%	9.5%	12.6%	15.8%
	10	2.1%	4.2%	6.3%	8.4%	10.5%

# The Capital Markets PTM – Mix Is Key to Success

Pre Tax Margins of Various  
Business Lines  
2000-2007



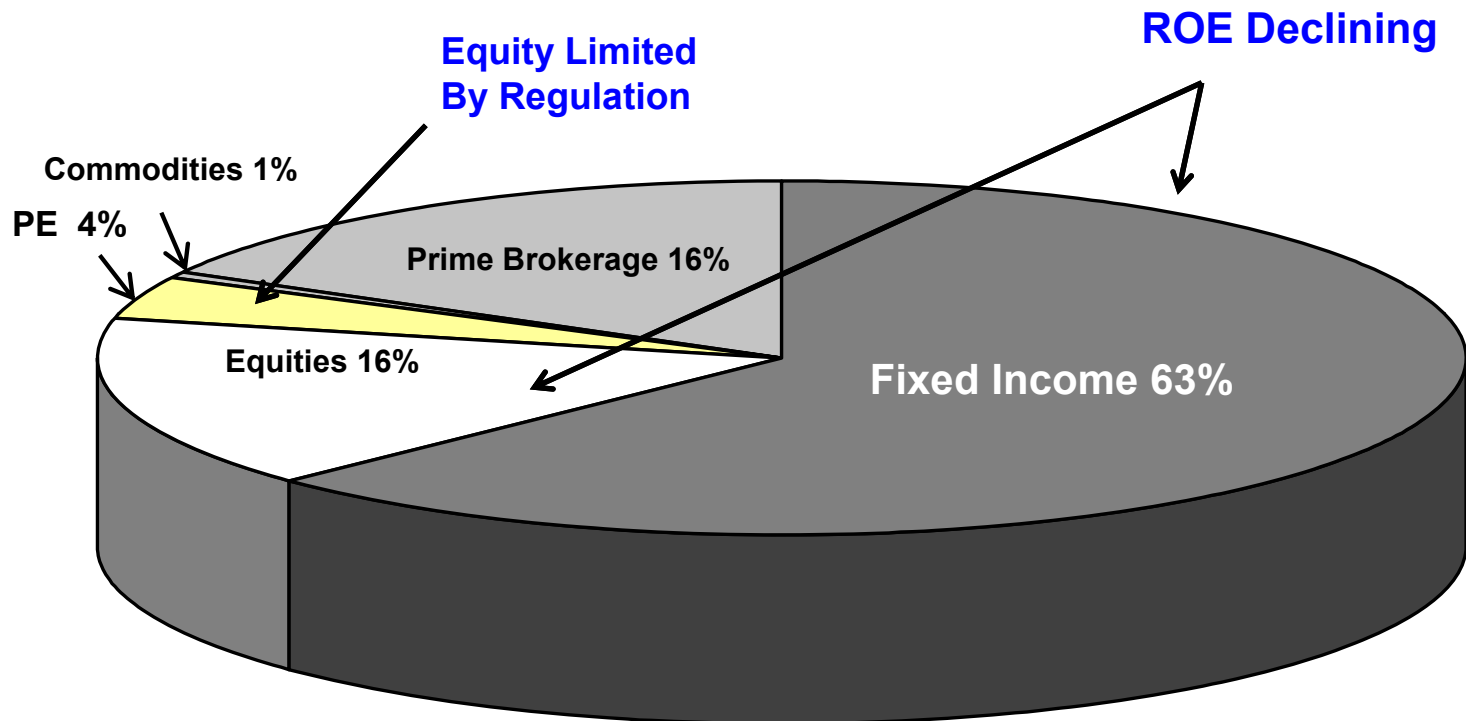
## Thinking About the Future - Shareholder Returns

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- **Expect reduced ROE of all balance sheet intensive businesses. But the firms with larger credit businesses and those with relatively larger FICC franchises will be impacted more seriously than those with larger FX and equity franchises.**
- **Despite restructuring, many low margin core trading businesses will no longer be able to achieve returns above their cost of capital. But client demand and linkages to other businesses will preclude shifting these businesses down. Capital markets firms will respond to this situation by reducing capital commitments to low return businesses and increasing pricing.**
- **At low leverage trading revenues will grow only with the global capital markets (7%-9% annually) free capital from trading as low return inventory positions are reduced. With less attractive investment opportunities, capital will be reallocated or returned through buybacks or dividends.**
- **Revenue growth rate falls, EVA falls, cost of equity falls, but ROE remains satisfactory.**

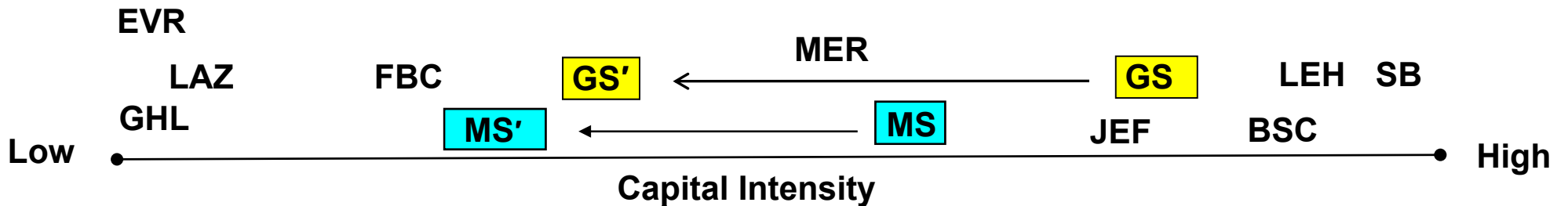
# Tangible Equity Employed in Capital Markets Businesses

What will the Street do with its Surplus Capital?

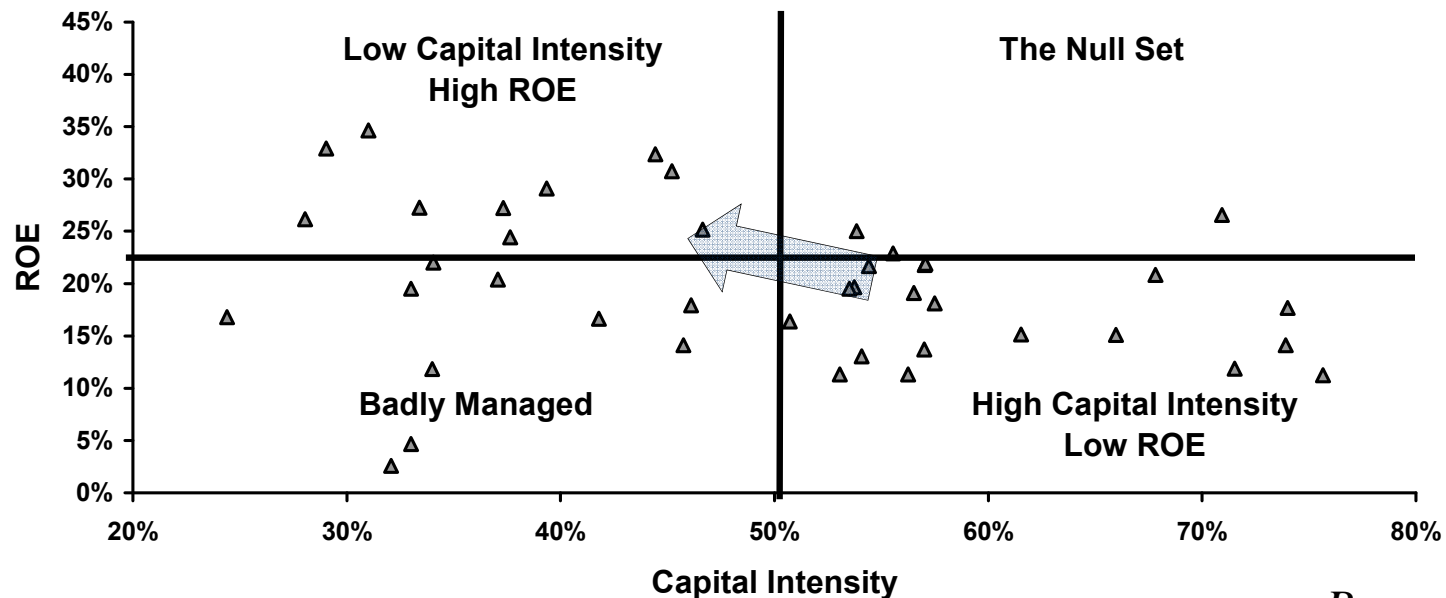


# Regulation Changes Business Mix

New Regulation Reduces Revenue Growth Rate and Forces Reallocation of Equity Capital.



ROE Versus Capital Intensity



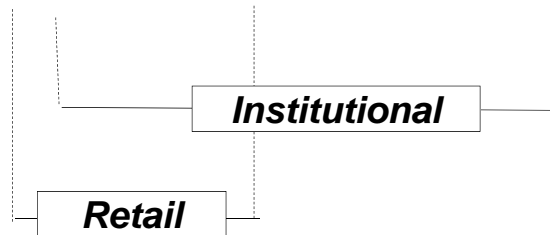
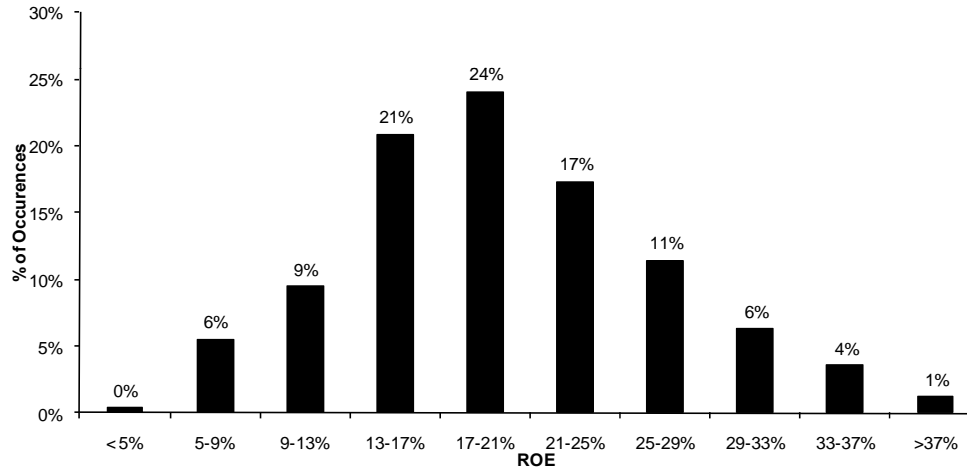
# Histogram of Investment Banks' ROEs (1990-'06)

**Historical Group Mean: 19.1%**

+1 Standard Deviation: 25.9%

-1 Standard Deviation: 12.3%

**Probability Histogram**



**Looking Forward;**

**Bernstein Estimates that the Retail Business Remains Largely Unchanged with a Mean ROE of 13%-14%.**

**The Institutional ROE declines to 15% due to Regulatory Changes**

# Disclosure Appendix

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