BSIC – Special Report
Corporate Finance Team

May 2015
www.bsic.it

The New Banking Business

The New Banking Business in the US and Europe

Together with flowers and good weather, spring brings about also first quarter results of a year where European QE plays the lion role. With surging volatility, stocks at their highest, and regulatory fines fading out, banks can eventually present to shareholders decent results. Indeed, the last years, which have been characterized by a sluggish economic growth, stable financial markets, and a heavy financial crisis legacy in terms of lawsuits and criticisms, have led to shrinkage in Wall Street's performance. Moreover, the great debates driven by regulators and politicians around banks' stability and health have strongly hit banks' way of doing business, also impacting on the way investors evaluate market players. For instance, Goldman Sachs' presentation of February 10, 2015 started with an overview of its financial soundness, comparing how the robustness of its balance sheet has changed between 2014 and 2007: banks' way of providing investors with returns has changed in less than a decade, let's find out how.

Methodology

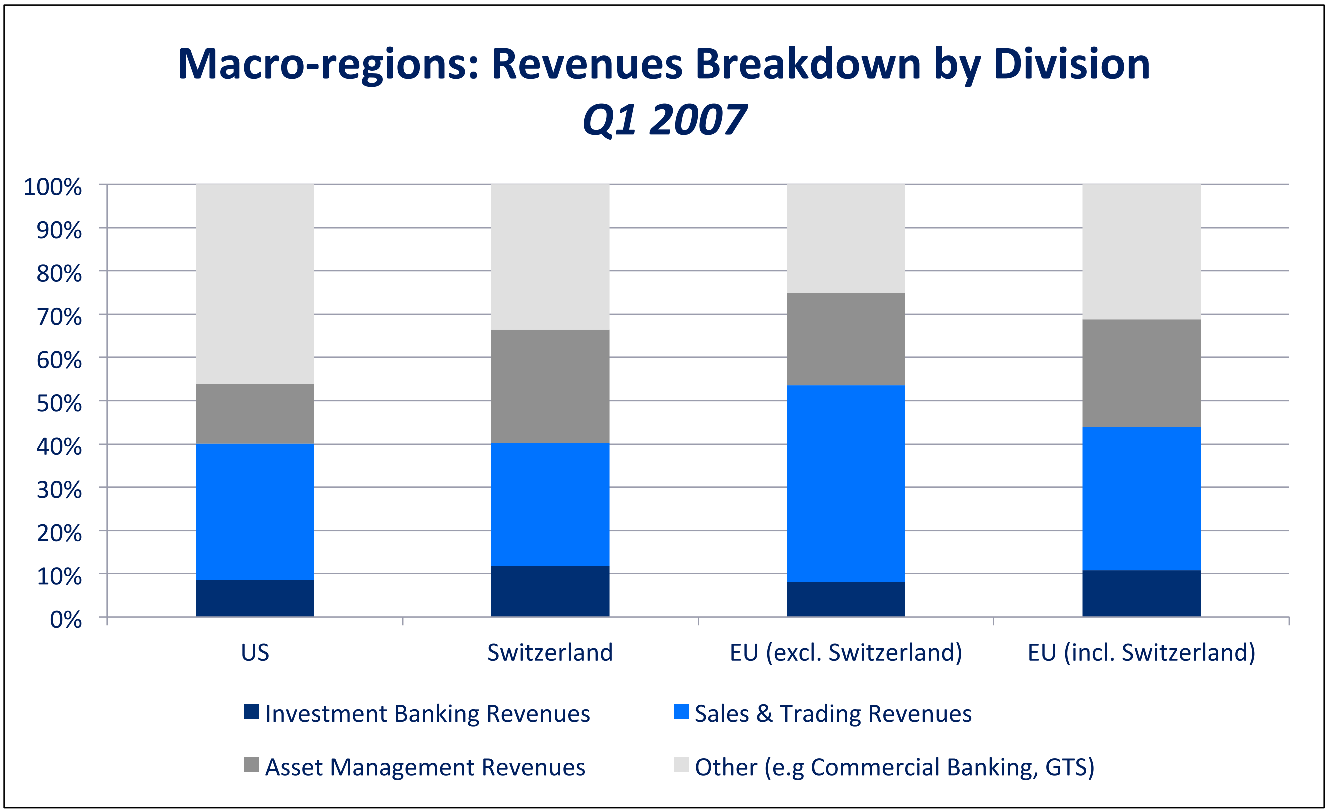
For this report we chose to analyse the most important investment banks in the world, taking into account both the US and Europe. With regards to the United States, Goldman Sachs (GS), Morgan Stanley (MS), J.P. Morgan (JPM), Citigroup (Citi), and Bank of America Merrill Lynch (BofAML) are included in the analysis. On the other side of the Atlantic, we decided to consider Barclays (Barclays), Deutsche Bank (DB), Credit Suisse (CS), and UBS (UBS) for Europe, where Barclays and DB form the EU (excl. Switzerland) subset, while CS and UBS form the Switzerland subset. Other entities currently relevant on the league tables, such as HSBC and RBS, are not considered in the sample since the former is characterised by a strong focus on Asian region while the latter is passing through a significant restructuring and downsizing process that, once completed, will not allow us to number RBS among the major investment banks.

In order to understand how banks' business has changed since 2007, we compared the results of the aforementioned banks in Q1 2007 with those just released in Q1 2015. In particular, we considered total revenues, total assets, (adjusted) ROE, main divisions' revenues as well as share price performance as key indicators for our analysis. For what concerns the divisions, we took into account the main internal divisions of investment banks, namely Investment Banking (formed by advisory and underwriting – ECM and DCM – activities), Sales & Trading, and Asset Management (broadly including also Wealth Management and Private Banking).

Finally, it is worth mentioning some methodology devices which were necessary to properly compare the results over time since both the acquisitions following the 2007 crisis and the differences in reporting periods have had an impact on banks' statistics over the last 8 years. In particular, JPM data in 2007 are on a pro-forma basis including Washington Mutual and Bear Stearns, both bought in 2008. Bank of America Merrill Lynch figures in 2007 are on a pro-forma basis including Merrill Lynch, acquired in 2008, while Barclays results in 2007 are on a pro-forma basis including the US arm of Lehman Brothers, bought in 2008. Moreover, for all the banks whose Q1 reporting dates are different from March 31, adjustment are applied in order to rescale data assuming constant monthly growth for stock measures and constant flows on a monthly basis for flow measures.

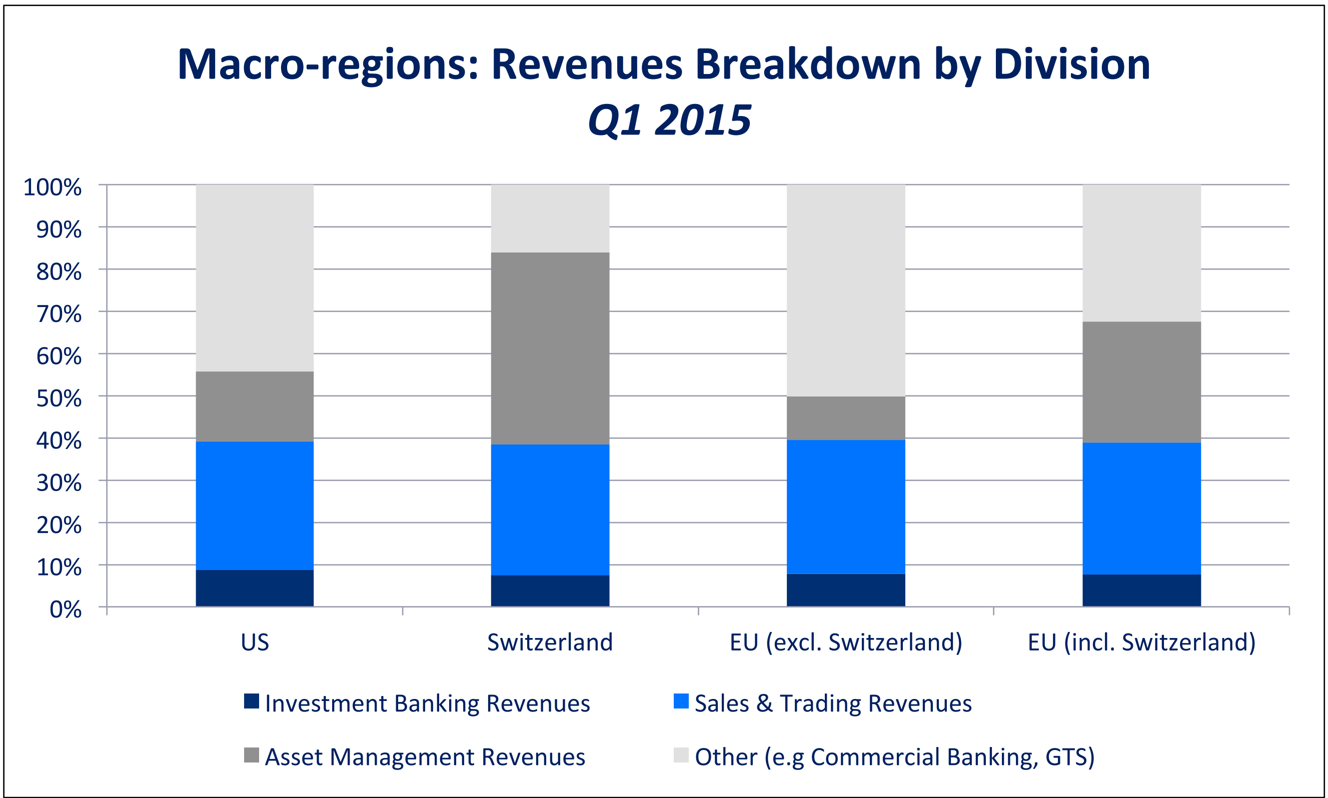
Global trends: analysis by macro geographic regions

On average, revenues generated by banks have decreased substantially across the board, recording an overall decline by 28.7% between Q1 2007 and Q1 2015. Indeed, in the US and in EU, the banks considered show a contraction of the top line by 16.60%, 58.3%, and 41.7% respectively.



Investment Banking (IB) business has neither gained nor lost relevant weight on the banks' top line over the last 8 years: among US banks, it has slightly increased its weight on total revenues (from 8.6% to 8.8%), while among European banks it has decreased (from 10.8% to 7.7%). Being a cyclical business and considering that both Q1 2007 and Q1 2015 have recorded a good degree of activity in both M&A and IPOs as well as in bond underwriting, there is no surprise in observing a fairly stable relative performance of this business line. However, in absolute terms, pre-crisis levels are yet to come since the total amount of revenues generated by IB in Q1 2015 is still 37.1% lower than Q1 2007.

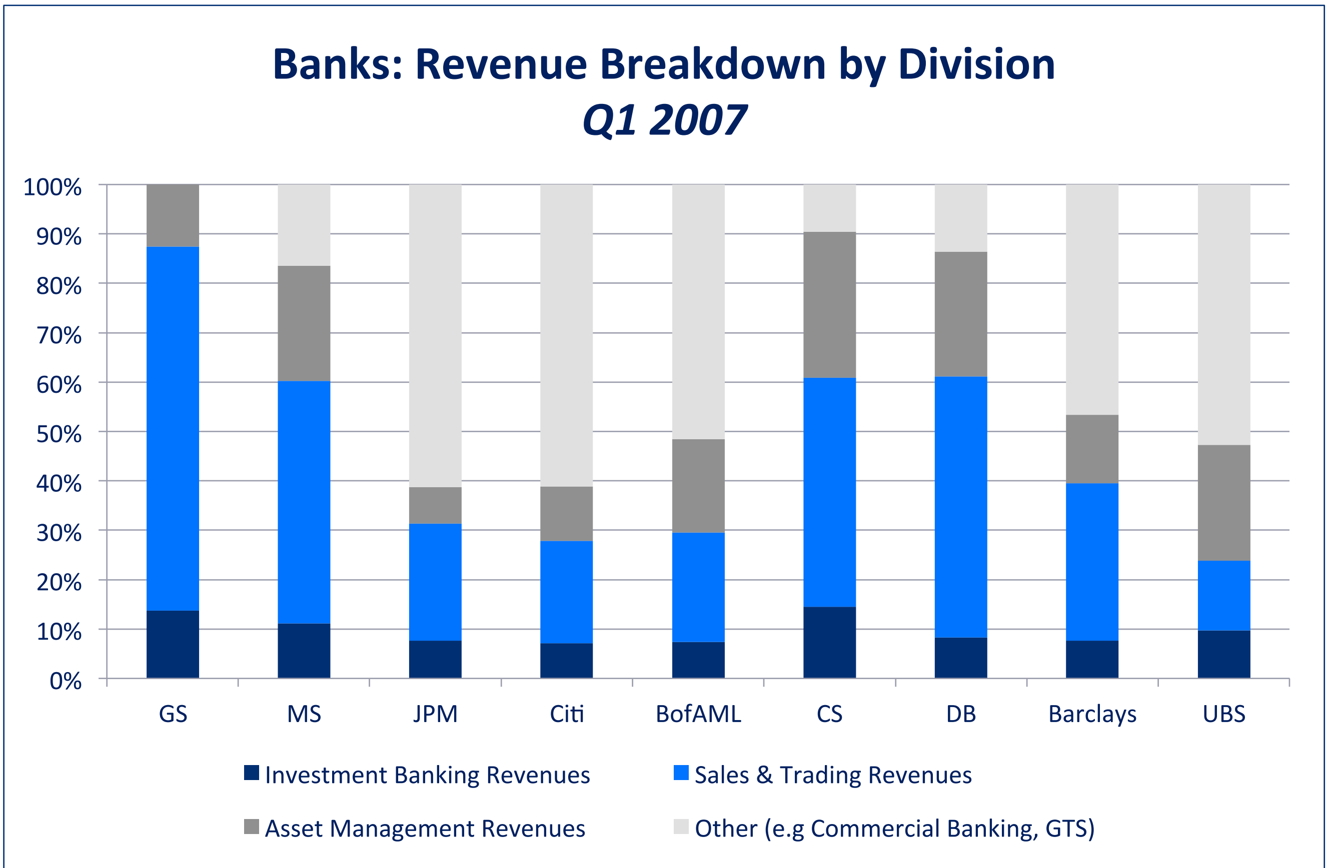
Sales & Trading (S&T) business has faced a downward trend over the years in almost all banks' income statement in both absolute and relative terms. Both EU (excl. Switzerland) and US registered a decrease, however with a significant difference in intensity. In fact, in EU (excl. Switzerland) S&T revenues sunk from 45.4% in Q1 2007 to 31.6% Q1 2015 of total revenues, whilst US from 31.6% to 30.4%. Swiss banks, on the other hand, recorded opposite results, showing an increase in their S&T revenues from 28.4% to 31.0%.



Asset management (AM) business has experienced a generalised increase in all the macro regions considered, with the exception of European banks (not including the Swiss ones). In particular, Swiss banks revenues generated by AM have almost doubled their weight, from the 26.2% of Q1 2007 to 45.4% of Q1 2015. On the contrary, the other European banks recorded a significant drop of their presence in this division, form 21.3% to 10.4%. Instead, US banks, following the same trend of UBS and CS, developed their AM businesses and the proportion of AM revenues on total revenues increased by 2.8% between 2007 and 2015. Such a diverging trend between Switzerland and the rest of Europe may be due to the return of the former to its vocation of wealth managers, whereas US dynamics may be explained by the huge amount of wealth accumulated in the last years by HNWIs.

Banks' performance: analysis by individual financial institutions

The results shown above derive from the choices that each banks' management has made in order to tackle the effects of the crisis, including the pressure from regulators and politicians, and to deliver value to shareholders. The following paragraphs, hence, aim at uncovering the strategies banks implemented for these purposes, showing the change in revenue generation at individual banks' level.



US banks

We can split the set of US banks in two different groups. On the one hand GS, MS, and BofAML, which have decreased their Total Assets (TA) in the last years, and, on the other hand JPM and Citi, which have significantly increased their TA. In the former group, in particular, BofAML shrank its assets from $2,503bn as of March 31, 2007 to $2,143bn as of March 31, 2015, whereas, in the latter group, JPM recorded an increase in its TA, augmenting them from $2,161bn in 2007 to $2,573bn in 2015.

The breakdown of revenues allows us to uncover the different business strategies implemented by the banks. GS is the only bank that seems to have maintained a similar relative incidence among its divisions, with the only exception of IB revenues that increased from 13.8% to 18.0% of total revenues in Q1 2015, thus acquiring more relevance with respect to S&T that decreased from 73.9% to 67.1% of total revenues.

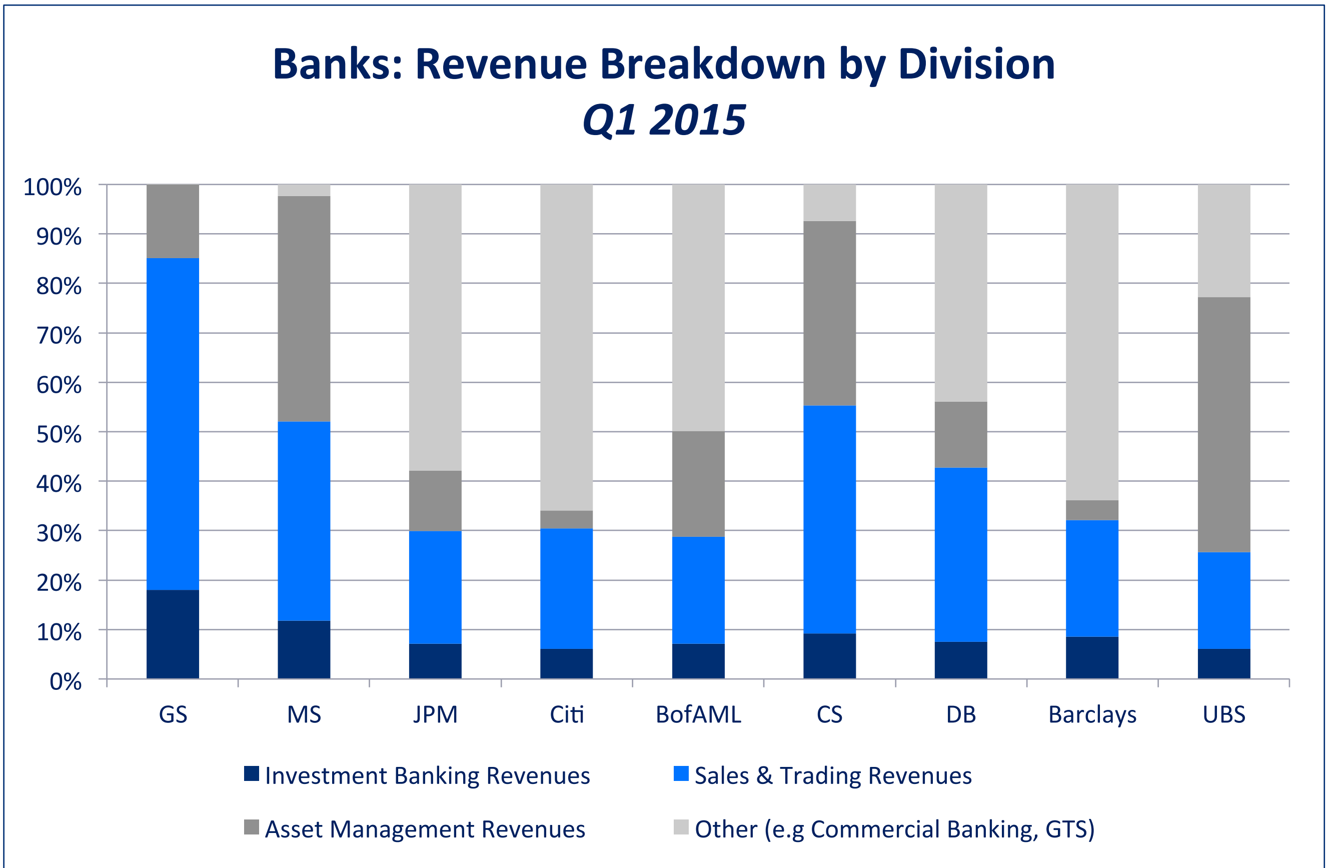
However, S&T business, even if reduced in absolute terms, remains the major source of revenues for this bank.

JPM and MS have adopted a different business strategy with respect to GS during the last years. In fact, both of them have decreased their S&T revenues and developed their AM presence. MS, in particular, has refocused its business in this last division (especially in Wealth Management after the acquisition of Smith Barney from Citi in 2009), almost doubling its weight on total revenues from $2.65bn in Q1 2007, accounting for 23.3% of total revenues, to $4.50bn in Q1 2015, representing 45.5% of total revenues.

JPM, besides having developed its AM division, recorded a strong relative weight of the other activities such as Corporate Lending, Commercial Banking, and GTS both in Q1 2007 and in Q1 2015. BofAML developed its AM business as well, which has increased its weight on total revenues from 18.9% to 21.3%, while the other businesses have remained fairly stable revenues contributors.

Finally, Citi recorded a different trend with respect to the other three US banks, drastically reducing its revenues generated by the AM division from 11.1% of total revenues in Q1 2007 ($2.82bn) to 3.6% of total revenues in Q1 2015 ($0.7bn) as a result of the above-mentioned sale of Smith Barney to MS.

In fact, the business model of some banks has significantly changed after the reshuffle subsequent to the financial crisis. JPM has taken over the IB firm Bear Stearns as well as the lender Washington Mutual, thus exponentially increasing its size in just one year while the US-focused commercial bank Bank of America has become a universal global bank following the acquisition of the IB firm Merrill Lynch. Also, Citi, as mentioned above, has sold its AM arm to MS, which, in turn, has become a hybrid between a wealth management company and a pure IB player.



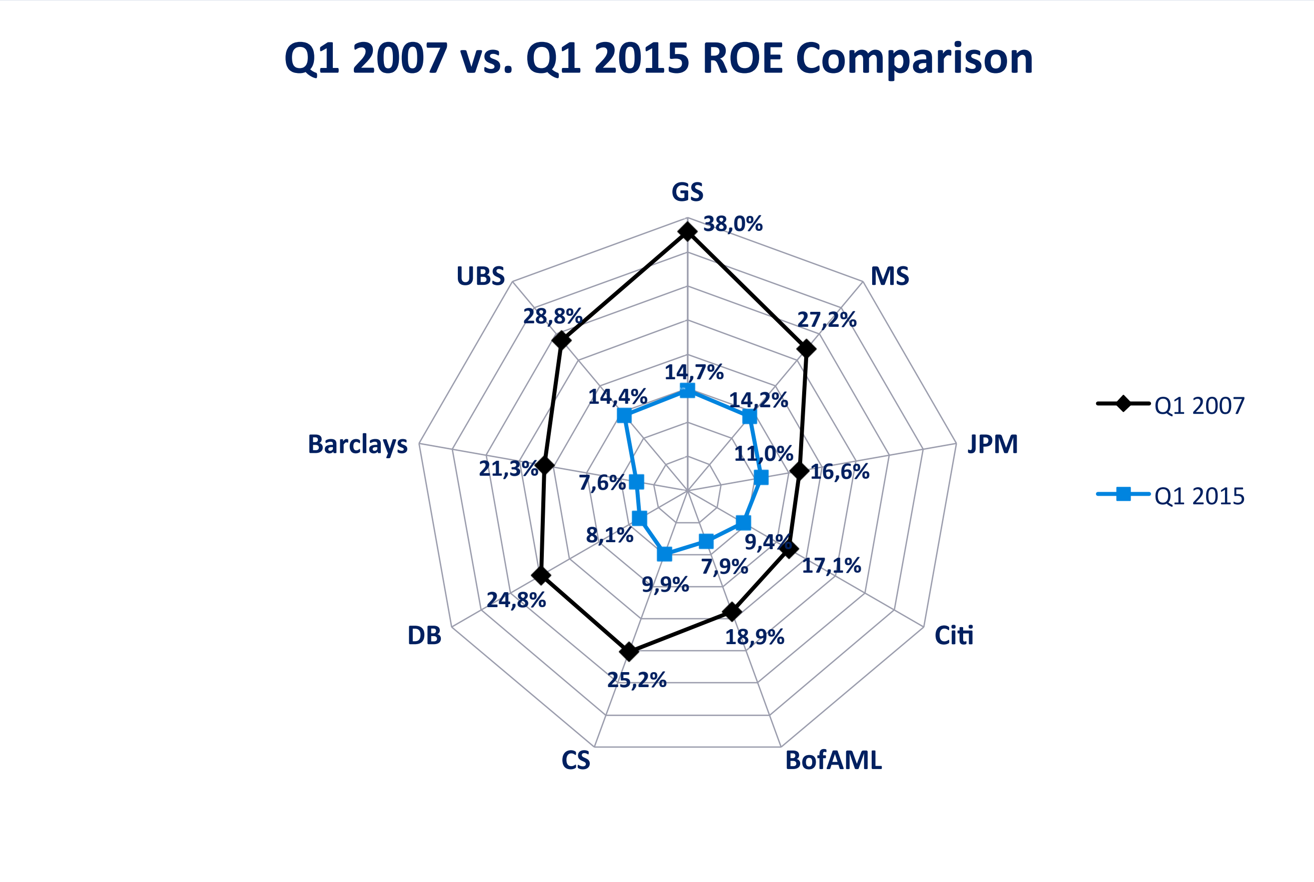
European banks

Alike the US, also the group of European banks has two internal clusters. On the one hand, Swiss banks sharply reduced their TA: CS decreased its balance sheet by 33% and UBS decreased it by almost 60% from CHF2,572bn as of March 31, 2007 to CHF1,048bn as of March 31, 2015. On the other hand, DB and Barclays present an opposite trend. They both experienced a relatively modest increase in their TA (€ 208bn for DB and £171 for Barclays), but it is worth noting that the German bank is the only bank in our sample that actually increased its revenues in absolute terms from €9.60bn in Q1 2007 to €10.38bn in Q1 2015.

Moving to the breakdown of revenues by division, CS and UBS have strongly increased their AM businesses (more evidently for UBS): the weight of the revenues generated by AM on the banks' top lines almost doubled. As regards IB business, both CS and UBS have reduced its weight on their top lines, while, for what concerns S&T, the weight of this division's revenues on UBS top line has increased whereas for CS it has remained fairly stable. Moreover, both of them have shrunk the other businesses such as commercial banking, as UBS, in particular, has significantly cut its commercial banking arm.

From our revenues analysis, it resulted that DB has shifted its focus from S&T and AM (weighting for 52.8% and 25.4% of Q1 2007 total revenues respectively) to other businesses such as commercial banking, corporate lending, and GTS, whose weight on the top line has increased from 13.5% to 43.9% over the last 8 years. IB, indeed, has remained fairly stable over time, accounting for 8.3% and 7.6% of total revenues in Q1 2007 and Q1 2015 respectively. Finally, for what regards Barclays the other business lines have significantly increased their relative weight on total revenues from 46.7% in Q1 2007 to 63.9% in Q1 2015, while IB revenues' weight has increased from 7.7% to 8.5% in the same period. Such a change occurred to the detriment of both S&T and AM which accounted for 31.8% and 13.8% in Q1 2007 against 23.6% and 4.0% in Q1 2015 respectively.

ROE analysis

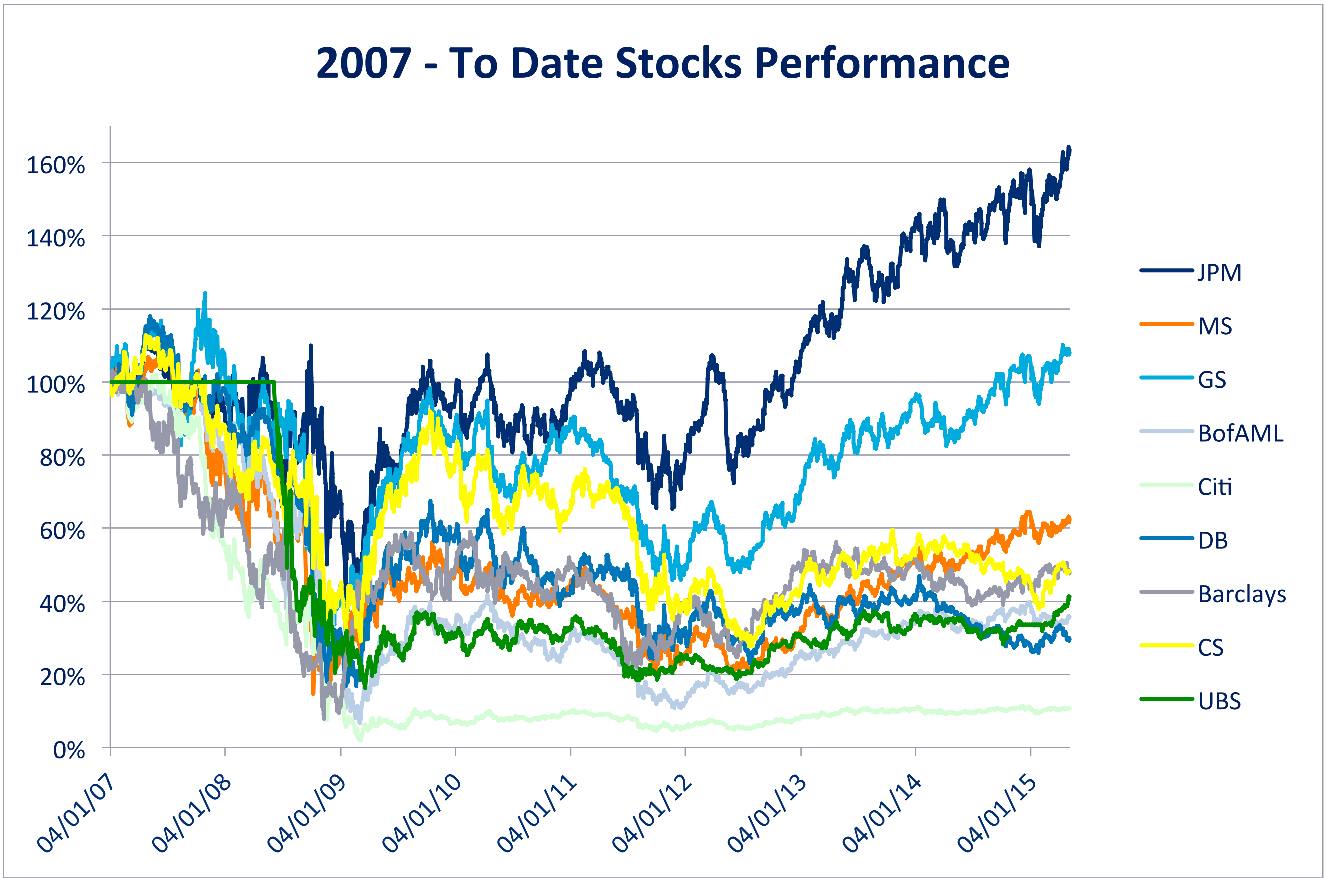


Over the last eight years banks' profitability measured as net income divided by equity has been heavily hit. Indeed, the ROE of the considered banks decreased on average by 13.4% in absolute terms, clearly identifying a structural decrease in bank profitability with respect to equity. Looking at this measure, which is an extremely important indicator of banks' performances from investors' point of view, the best performing player is GS, which was able to achieve a 14.7% ROE in Q1 2015 which compares with a 38.0% level in Q1 2007.

The other pure players like MS (14.2%) and CS (9.9%) outperformed universal banks like BofAML (7.9%) and Barclays (7.6%), even if the former financial institutions are far from reaching pre-crisis levels when they achieved a ROE of 27.2% and 25.2% respectively. However, the real outlier of the analysis is JPM: Jamie Dimon's bank is the best performing financial institution among universal banks, being able to achieve a ROE of 11.0% in Q1 2015, which, however, compares with the 16.6% figure achieved in Q1 2007. For all the other universal banks it seems that they have not been able to exploit the predicted (and expected) economies of scale and scope, significantly underperforming pure investment banking players.

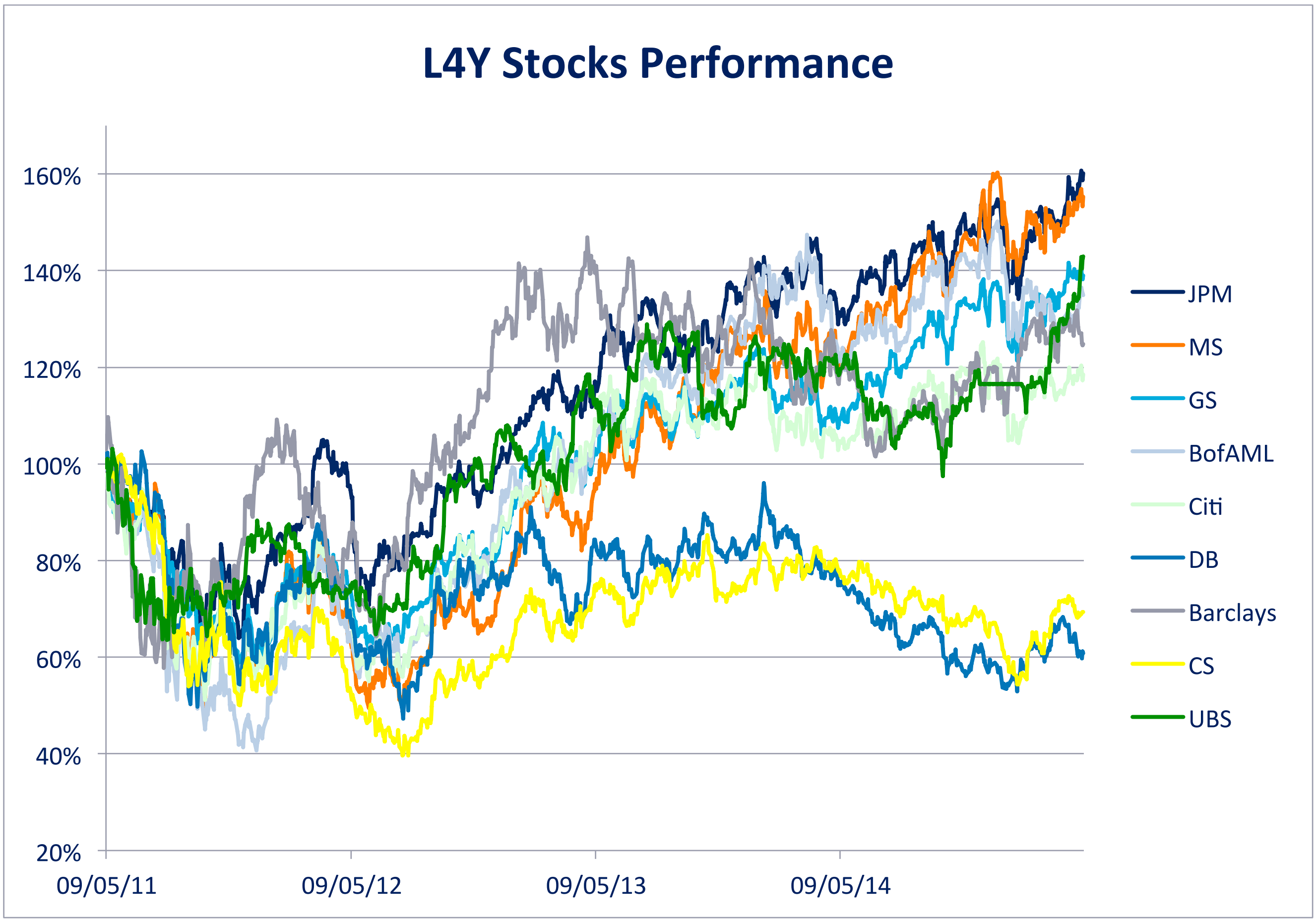
Stocks performance: the financial market test

What is better than the financial markets to evaluate the performance of a firm? When stripped of bubbles, speculations, and distortions financial markets should be (or "are" for those believing in market efficiency) able to perfectly gauge any firms' performance thanks to the "super-average" of interests and believes they are (or "should be" for those believing in the conspiracy theory) made of. As a consequence, we analysed the performance of banks' stocks from 2007 to date.



The impact of the economic slowdown and of the changing business environment after the financial crisis can be clearly deducted from the chart above. After the 2008 slump, only two players (GS and JPM) have regained their pre-crisis share level, with JPM rising well above it. All the other banks under analysis are still significantly below 2007 price levels.

It is clear, however, that, with the exception of JPM, all the pure investment banks (GS, MS) have outperformed both the universal banks (Barclays, DB, BofAML, and Citi) and Swiss banks (UBS, CS) strongly hit by stricter Swiss regulations. Nevertheless, as can be seen in the chart that follows, which considers only the last 4 years stocks' performance, the divergence between pure players and universal players has been relevant, but the main discriminatory variable seems to be the geographic location. Indeed, all the US banks have achieved better results than their European peers. A notable exception is UBS, which, after the crisis and the stricter Swiss regulations, shifted its focus away from investment banking and corporate lending to wealth management, a move that paid out well as the outstanding Q12015 results proved.



This geographical divergence may be explained by two factors. Firstly, the recovery of US economy, to which US banks obviously present a greater exposure with respect to the European banks, has begun earlier than in Europe, thus better supporting US banks results and, in turn, stocks' prices. The second factor is the emergence of a stricter regulatory framework in both the EU and Switzerland.

Conclusions

The analysis shows that the way of doing business of banks has significantly changed since the global financial crisis hit. In particular, after a period of consolidation in the sector following the crisis, each player has sought ways to generate profitability in an utterly different economic and financial context, characterised by thinner margins and extremely lower ROEs. The strong shift towards high margins businesses such as asset management and wealth management, where ROE can hit 30% or more, represents the most notable trend, together with the numerous cost-cutting policies implemented by all the banks.

The days when internship candidates flew to London for interviews in business class are, indeed, well part of the past. Nowadays, on one side, banks have to deal with stringent capital rules imposed by both Basel III and ECB in Europe and by the FED in the US, which limit the use of leverage and S&T activities, and, hence, directly affect ROE. On the other side, interest rates at record lows shrink net interest margins, converting the once cash cow retail business into a sluggish and RWAs-consuming burden so that the "scissors" focus is now moving from IB business to retail.

In this context the conundrum "pure player versus one-stop bank" is still unresolved. On one hand, pure players such as GS, MS and recently USB seem on track to deliver decent returns to shareholders, while, on the other hand, the giants BofAML, Citi, DB, Barclays and to a lesser extent CS, are facing mounting pressure to split up the business and become pure players as the one-stop bank does not seem to have brought in the hoped results. JPM remains the only highly performing "giant". Indeed, even if according to JPM and BofAML CEOs (J. Dimon and B. Moynihan), the universal bank model unlocks relevant cost and revenue synergies as well as provides earning diversification, the returns provided so far have been disappointing, together with the serious (legal) issues around the management of incredibly large and complex institutions.

However, *les jeux ne sont pas faits*: as long as global and diversified markets require global and diversified financial institutions the universal bank model is not going to be completely abandoned, also in light of the fact that the economies of scale achievable on a increasingly demanding IT infrastructure are probably going to increase. The flexibility and the governability of pure players are pivotal, but size keeps having its weight.

Sources

- Banks' Financial Statements
- SEC filings
- Bankscope data
- Yahoo! Finance
- Bloomberg

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