

Capital Markets & Banking | Talent Trends into 2012

A CTPartners Perspective

Introduction

The myriad regulations that are impacting the capital markets and investment banking sector have led to significant and far-reaching strategic reviews by all market participants. While banks are not required to be legally compliant with some measures for a number of years, and indeed industry lobbying may well affect the final impact of proposed regulations, shareholders and other stakeholders are seeking clarity of intent now. This is stalling the development of business plans and therefore talent planning for 2012. Not surprisingly, the current issues in the Eurozone are proving to be additional distractions.

This short paper synthesizes some of the current market variables that are feeding into the strategic planning process and includes a section on 2011 compensation trends. It concludes with a summary of roles that will see investment in 2012 and beyond.

Eurozone impact on Asia and other emerging markets

In a report published by the IMF, 'October 2011 Regional Economic Outlook for Asia and the Pacific,' three key risks are noted: (a) the liquidation of foreign investor positions; (b) the repatriation of liquidity from Asia by foreign-banks; and (c) a loss of market liquidity in key derivatives markets.

Indeed, the *Financial Times* reported on 8th November, 2011 that Mark Carney, Chairman of the Financial Stability Board (FSB), was concerned that turbulence in Eurozone credit markets would hit emerging markets. This was echoed by the CEO of HSBC, Stuart Gulliver, who noted that, as liquidity is withdrawn by European banks, Asia faces a slowdown in growth. Continental European banks are responsible for 25% of the US\$ 2,520 billion of international bank loans outstanding in ex Japan Asia; according to data from Dealogic, foreign banks provide Indonesia with 75% of total bank funding, South Korea with 52%, and Australia with just over 50%.

According to research by the Royal Bank of Scotland, published on the 16th November 2011, the share of European Union (EU) banks in foreign bank lending in Asia-Pacific has declined from around 25% in 2009 to 19% in March 2011.

The impact of sovereign risk on bank funding

A Bank for International Settlements (BIS) report published in July 2011 noted that higher sovereign risk since late 2009 has pushed up the cost, and adversely affected the composition, of some euro area banks' funding, with the extent of the impact broadly in line with the deterioration in the creditworthiness of the home sovereign.

The adverse change to bank funding costs caused by a rise in sovereign risk occurs through several channels: (a) the losses on bank holdings of government debt weaken their balance sheets; (b) a fall in value of government debt reduces the collateral value of the asset when used for wholesale funding and central bank liquidity; (c) sovereign downgrades generally flow through to lower ratings for the domestic banks; and (d) a weakening of the sovereign reduces the funding benefits that banks derive from implicit and explicit central bank guarantees.

A recent article by Peter Lee in *Euromoney* warned that, 'Whatever confidence trick banks and regulators come up with next, investors are no longer paying attention. They are taking a much closer look at the long-term sustainability of bank business models after allowing for reduced access to wholesale funding at higher cost. And they are making binary choices. For banks with unsustainable models, funding won't be available from the private market at any price.'

Profitability

Return on Equity (ROE) for European and US banking was less than 10% in 2010, with their cost of equity standing at about 12%, and this is before the impact of Basel III and equity surcharges on Systemically

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Important Financial Institutions (SIFIs). In its report entitled 'The state of global banking – in search of a sustainable model, September 2011,' McKinsey states that US banks will have to grow their net profits from US\$ 121 billion in 2010 to US\$ 312 billion in 2015 to achieve 12% ROE; and European banks will need to move from US\$ 168 billion to US\$ 328 billion to achieve the same result in the same time period. Notwithstanding the withdrawal of liquidity discussed earlier, emerging markets such as Asia are noted by McKinsey to have higher growth potential over the next decade than developed economies.

Despite the issues concerning profitability noted above, Eurozone countries were debating a 'Tobin Tax' in October 2011 (named after Nobel Laureate economist James Tobin) as a method for raising funds that would be used for aid projects and for investment in the 'real economy.' The Tobin Tax is a charge which could be applied to financial markets transactions in the Eurozone although, according to the European Commission's own estimates, roughly 62% of the revenues generated by an EU tax would come from London. The proposal is opposed by sell-side and buy-side market participants based in London on the basis that it would raise transaction costs and make the City uncompetitive, which would lead to yet further job losses.

In addition, a report by the UK's Independent Commission on Banking (ICB), otherwise referred to as the Vicker's Report (after its author, Sir John Vickers), recommended that, by 2019, Britain's banks should have to insulate, through ring-fencing assets, their retail operations from the risks of their wholesale and investment banking activities.

Banks asked for, and received, some flexibility in the ring-fencing arrangements because of their different funding structures. For instance, Barclays uses corporate deposits to fund investment banking, while HSBC uses its large volume of retail and small business deposits to fund corporate banking. Assets that qualify do not require the ring-fenced bank to hold regulatory

capital against market risk. Broadly, this principle would mean that the majority of the retail and commercial banking divisions of current UK banks could be placed in ring-fenced banks, however, the wholesale/investment banking divisions could not.

Britain's banks will be able to place between £1.1 trillion and £2.3 trillion of assets in ring-fenced divisions. Another £4 trillion of assets, roughly, would sit outside the ring -fence. Assets within a ring-fence must be backed with 10% core capital and apply a 4% leverage ratio.

While the ultimate resolution of these debates is as yet unknown, banks are being forced to consider the likely future impact as they plan for 2012 and beyond.

With declining revenues and increased capital requirements McKinsey has estimated that US and European banks will need to reduce their costs by an average of 6% annually between 2011 and 2015; with higher base salaries in wholesale/investment banking, this will mean more redundancies as banks shrink client portfolios and deliver a reduced product range more efficiently and effectively.

In 2009, the wholesale and investment banking divisions of major international banks increased salary grids as incentive compensation became subject to intense scrutiny by regulators. This increase, while welcome by some at the time, is now widely, but not exclusively, criticized by both business line managers and human resource professionals for reducing management leverage over engagement/productivity, and reducing the flexibility to retain staff during down cycles.

While the impact on productivity can be debated, it is clear that the current crises will force banks to exit more staff. In certain instances most especially in emerging market environments, staff will be difficult and costly to replace as the market finds its new level and the gaps in coverage become visible. For staff that remain, only the top players, such as talented leaders

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and game changers are likely to receive a bonuses for 2011; therefore the market will see more zero bonuses than ever before. Compensation trends are examined in more detail, below.

In mature markets, successive years of forced ranking have already purged the market of average bankers. In emerging markets talent is tight and expensive to replace, however managers in Asia are still having to reduce headcount across the board.

As the nature of the industry changes, with regulation increasing and revenue upside (and therefore reward) decreasing, some will choose to exit banking of their own accord. It may not be as easy to attract the same profile of professional in the future. Indeed, given the changing profitability of certain areas of banking it may also not be necessary.

Summary of compensation trends

The New York-based, independent financial services compensation firm, Johnson Associates, reported on 7th November, 2011, that a difficult trading environment in 2011 has produced narrower spreads and reduced capital usage; this, in turn, has led to a significant and unexpected broad decline in incentive compensation by sector and area, since capital markets and investment banking were positioned for bigger volumes. Affected areas include

- Major Investment and Commercial Banks, with declines in the range of 20% to 40%, driven by: Fixed-income and Equities (in which the results ranged from -20% to -50%), Commercial Banking (-5%), Investment Banking (-10% to -20%), and Wealth/Asset Management (+5% to -15%).
- Market-based business, which reported mixed results over 2010: Asset/Wealth Management (with a range of +5% to -5%), Hedge Funds (0% to -10%), and Private Equity (0% to -5%).
- It should be noted that the above assumes no

further economic shocks in the near term.

Overall, total compensation and benefit costs in Corporate and Investment Banking are expected to average 45% of net revenue, up from about 42% in 2010, amounting to about 66% of pre-tax net income, up from about 63% in 2010.

Johnson Associates also reported that this has been a challenging environment in which to manage expectations, decipher market trends, and recognize performance, compounded by the ongoing impact of regulation and public sentiment. There has been limited hiring in Q4 2011 and only moderate retention concerns for early-to-mid 2012.

Primary market activity

Basel III capital regulations mean that banks are being forced to de-leverage, and this means less lending to clients. Long-term financing of infrastructure projects and shipping and aircraft acquisition through loans will become especially difficult. The financing of commodity trade also has been impacted. Since the summer of 2011, this has become an increasing problem for French banks and their customers, such as Switzerland-based commodity-trading houses and their Asian operations. French banks especially have unsustainable headcount in their financing businesses: not just in terms of origination, but also in credit approvals and loan servicing.

Not only will banks need to set aside more capital against transactions, but capital has become increasingly expensive. Indeed, the sovereign crises will lead to disadvantageous funding costs for the domestic banks of those countries most under pressure, which in turn could lead to domestic and cross-border consolidation.

As noted above, liquidity is being withdrawn from Asia, and so loan origination will reduce while loan trading and sales will increase. The reduction in private debt is in turn predicted to drive the growth of domestic

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and international bond issuance in Europe and Asia. In Q4 2011, issuance was difficult due to market volatility; and while issuance in the long-term may increase, banks will seek ways to make this process more efficient and therefore, the talent pool is unlikely to grow significantly.

The inability to refinance, combined with a slowdown in trade, will increase the level of non-performing loans and loan workouts by banks and specialist advisory firms, in addition to an increase in distressed and special-situations investing by funds. These players are mostly already well staffed and have been waiting patiently for the right time to invest.

The need to raise equity finance will continue and cross-border M&A will increase, as Asian corporates expand into overseas markets while some seek to secure access to raw materials. This will lead to continued demand for bankers in certain sectors, such as Energy and Natural Resources and Industrials.

In Asia, banks that can leverage Transaction Banking, FICC product delivery, and Investment Banking competencies through corporate coverage will gain market share of State-Owned Enterprise (SOE), Privately Owned Enterprise (POE), and Multinational Companies (MNC) business across the board. Although efficiencies in coverage are being sought, net hiring is occurring where banks have become product, rather than client, focused. For instance, JPMorgan is investing globally in its transaction banking and corporate banking platforms and Deutsche Bank has changed its corporate coverage model.

New providers of loans, such as the London-based, Intermediate Capital Group (ICG), are entering the debt markets to provide financing to private equity groups. ICG is also looking to raise additional senior debt funds to target mid-cap companies. Bluebay Asset Management also recently announced that it would raise billions of Euros for lending to European small and mid-cap companies.

Secondary market activity

Significant headcount has already been shed from the FICC divisions of most banks, as regulations combine to reduce the profitability of some lines of business.

Capital charges are going to restrict activity in illiquid assets, such as highly structured, emerging market, and high yield products. Capital efficient products such as FX, and to a lesser extent Rates, will attract investment in technology to increase dealing, processing, and settlement efficiency and thereby reduce costs. The problem with electronic delivery and straight-through processing, however, is that these also decrease top-line revenue, so additional volume needs to be captured.

Most major players now trade 90%-plus of flow FX electronically (by volume of deals), but perhaps less than 50% of Rates transactions. There is clearly room for improvement in Rates, but the range of product is greater and net margins will decrease. Profitable FICC and Equity business will require excellence in technology for networks, execution, algorithmic capability, and desktop delivery to clients.

The positioning of ecommerce platforms is being reviewed by all players. Some banks are further ahead than others, however, there will be pressures on the talent pool in this space as major players seek to accelerate their electronic delivery.

Banks currently are making decisions regarding the asset classes in which they major, or emphasize, or withdraw from all together. These decisions will have global or regionally specific impact.

FX is the most efficient asset class from a capital perspective, with short tenors and high volume, Rates products are less efficient from a tenor and sovereign-risk perspective while Credit is one of the most capital-expensive asset classes. Some banks may choose to focus on liquid, high-grade, flow product and withdraw from more illiquid, emerging market and high-yield business. Banks that do not have a strong

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debt-capital-markets business may retreat and become clients of the Street, whereas even active players will provide less liquidity for their clients unless margins increase to pay for it.

With regard to Commodities, due to the Dodd-Frank legislation in the US (see below), there will be an ongoing shift to a client-focused model, and banks will look to grow Asia as regulations increase in Europe. There will be a continuing rise in the demand for industrial and agricultural commodities, with contracts increasingly tailored for the Asian market and a gradual movement of liquidity to Asian exchanges for certain products.

Proprietary trading and investing

The Volcker Rule, named after Paul Volcker, the former Chairman of the Federal Reserve who advised on the US Dodd-Frank legislation, severely restricts proprietary position taking and principal investing by banks as well as their ability to invest in hedge funds and private equity funds.

The Dodd-Frank legislation is "An Act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.'

The Act's definition of proprietary trading is problematic in terms of consistent application, and although the ease and practicality of identifying client facilitation vs. proprietary business is the subject of debate, banks already have started to reduce the most obvious examples of this activity. For instance, Goldman Sachs has closed its Equity Principal Strategies and Macro Proprietary Trading desks.

This legislation applies to all US banks and non-US banks with branches in the US, while residents of the US are restricted from any involvement in proprietary

trading regardless of the country in which they are located. This could give European banks a business advantage through geographical jurisdictional arbitrage.

It has been argued that there are enough hedge funds and private traders to provide the liquidity and market efficiency that the proprietary desks once fulfilled. It is also argued, however, that this simply moves risk into the alternative asset management sector, which is harder to regulate and monitor.

Some of the larger banks have more than 20% of Tier 1 core capital invested in hedge funds and private equity funds, which will need to be reduced to 3%. Analysts have estimated that implementation of the Volcker Rule will reduce the annual profits of investment banking divisions by 25%; the US Office of the Comptroller of the Currency has estimated that it will cost banks US\$ 917 million to raise more capital plus an additional US\$ 50 million in compliance and legal expenses.

Despite the predicted negative impact on revenues, a paper published on 13th July, 2011 by the US Government Accountability Office (GAO) reported that stand-alone proprietary trading desks at six bank holding companies (Bank of America Corp., JPMorgan, Citigroup Inc., Wells Fargo & Co, Goldman Sachs, and Morgan Stanley) had a net loss of about US\$ 221 million for the period from June 2006 to the end of 2010. Trading for the banks' own accounts produced positive net revenue in 13 out of the 18 quarters examined, totaling US\$ 16.6 billion; such trading generated total losses of US\$ 15.8 billion over the other five quarters. This study therefore suggests that maybe the long-term effect on revenues will be negligible.

A report published by Oliver Wyman in October 2011, 'The Volcker rule ban on prop trading: A step closer to reality,' summarized four areas of strategic impact: (a) *reduced revenues and profitability* (assessing that proprietary trading contributed 10% of industry

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revenues in 2009, this would lead to a change in client pricing and service models); (b) *longer-term changes to operating models* (through the redesign of hedging and risk-management practices, and reorganization of trading units where complex retained basis risks will be impacted most significantly); (c) *bank withdrawals from trading businesses* (from which they derive marginal direct and indirect benefits); and (d) *a benefit for traders in non-bank institutions* (since, although it is the case that systemically important non-banks may be subject to similar provisions in the future, they would need to grow significantly before this becomes a real threat).

Exchange-based activity and clearing houses

As OTC activity is traded electronically and centrally cleared, some of the staff that lose jobs at banks may be able to transfer their skillset into various parts of market infrastructure.

Oliver Wyman and Morgan Stanley published a report in on 17th February 2011, 'The Future of Capital Markets Infrastructure,' which notes that the financial crises propelled regulators worldwide to improve market transparency, reduce systemic risk, and drive down cost through a greater use of centralized clearing and electronic trading platforms.

The report points to a number of key changes that include the following:

- US and European cash equities exchanges remain under significant pressure from the continued rise of Alternative Trading venues (ATVs) and a loss or erosion of both volume share and pricing power;
- Derivatives exchanges retain their current 'defensible' revenue streams, but are increasingly challenged to defend open-interest against migration to other venues replicating on-exchange structures;
- In the execution layer of OTC, the multi-dealer

request for proposal (RFP) model emerges, shifting some of the control from dealers to Inter-Dealer Brokers (IDBs), trading platforms, and exchanges. However, a two-tiered pricing structure remains in place;

- A large share of OTC derivatives is centrally cleared as of 2012, with eligibility driven mainly by the level of product standardization. A two-layered, asset class-driven Central Counter-Party (CCP) model emerges, initially separating on-exchange and OTC clearing; and
- Global custodians are exploring additional revenue pools in custody+ and hedge fund+ for OTC derivatives.

Derivative trading platforms, such as Tradeweb, Bloomberg, and MarketAxess, and IDB platforms, such as BGC and ICAP with electronic cash markets, will have an advantage as Swap Execution Facilities (SEFs) facilitate electronic trading of OTC contracts.

However, the benefits of this migration are not universally agreed. For instance, the International Swaps and Derivatives Association (ISDA) published a paper in November entitled 'Costs and benefits of mandatory electronic execution requirements for interest rate products.' The Chief Executive, Connie Volstad, is quoted as saying "Our research and analysis indicate that the electronic execution mandate will result in higher bid-offer spreads and significant costs, most of which will be borne by end users. There is little to suggest that it may benefit market participants. There is, to the contrary, much to suggest that it will take away users' choice, create inefficiencies and discourage innovation."

The clearing of swaps is already rising, with more trades being placed with CCPs. While the business is largely bank-to-bank and dominated by LCH for interest rate swaps and Ice Trust for credit derivatives, the CME clearing volume is increasing.

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In the commodity markets, natural gas and oil swaps have been cleared by dealers on the CMA and ICE after the 2001 collapse of Enron and credit downgrades of energy companies.

In Asia, there is less pressure on incumbent exchanges as: (a) the markets are driven by issuance; (b) the lack of serious electronic platforms will support execution pricing margins in the near term; and (c) there is growing local investor demand, while protectionist measures remain.

In addition to the growth of roles in the market infrastructure space for non-bank players, the banks themselves will need to employ more technology, operations, risk, and finance professionals to help connect the banks with the execution and post trade players, data providers, and trade repositories.

Private Banking

Investment banks such as UBS and Credit Suisse are cutting staff from their investment banking divisions, while investing further in their private client businesses.

Although they are reducing the risk-weighted assets (RWA) used by their wholesale banking activity, it is felt that retaining a reasonably significant investment banking platform is important in order to service their private banking clients.

Indeed, banks are seeking to increase the product sophistication within their private wealth divisions and to achieve more crossover business between their private banking and investment banking divisions.

Resulting hiring trends

Investment:

- Senior managers and leaders who embrace and drive required changes;
- Foreign exchange;
- Debt capital markets – China, although the market slowed in H2 2011;
- Loan distribution specialists;

- Equity capital markets – China, although the market slowed in H2 2011
- Cross-border M&A in FIG, Industrials, TMT, and Energy and Natural Resources;
- Event-driven and regulation-related structurers;
- Sophisticated, 'product savvy' corporate bankers-China, Indonesia;
- Transaction banking – Custody, Cash management, Trade Finance;
- Private banking – product specialists to cover Ultra High Net Worth (UHNW)/Family offices;
- Sovereign Wealth Funds (SWF) – front-office and finance and risk infrastructure
- Fund managers – corporate credit risk professionals
- eCommerce professionals;
- Technology and operations professionals;
- Finance, legal, and compliance professionals;
- Risk management professionals;
- Business managers;
- Exchange professionals in emerging markets;
- Global custody professionals.

Divestment:

- Less technical corporate bankers;
- Loan origination professionals, especially those specialising in the long-term financing of assets such as Infrastructure, Shipping and Aircraft;
- Corporate credit approval specialists;
- Cash equity sales and trading;
- Credit trading and sales, especially in less liquid markets;
- Structurers focused on developing complex products for single or multiple asset classes;
- Proprietary traders that can't find a seat at a hedge fund.

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