

Equities

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Beyond the Basics Financial Services Forum

Key Day 1 Conference Takeaways

■ Industry Overview

- **Conference kick-off** — The first day of our annual Beyond the Basics Forum included meetings with Goldman Sachs CFO David Viniar, JPMorgan Head of Equities Carlos Hernandez, SunTrust Head of Commercial Real Estate Walter Mercer and Fifth Third Treasurer Tayfun Tuzun and numerous industry & Citi experts on topics including Asset Liability Management, Basel 2.5/3, Commercial Real Estate, Housing Finance, OTC Derivative Clearing and Regulatory Affairs.
- **Overall conference sentiment neutral with modest near-term negative/cautious bias** — Despite the recent pull-back and underperformance of financials in recent weeks, among clients and speakers, we sensed a relatively neutral bias to large-cap bank/financial stocks couched with a healthy sense of skepticism regarding near-term risks particularly given rising correlations as Euro crisis concerns return to center stage.
- **Major Volcker Rule stiffening seems unlikely** — Despite the renewed Volcker concerns stemming from JPM's recent CIO office trading losses, several speakers at the conference do not expect material changes to the ongoing Volcker rule-writing process that would severely impair markets or market-making revenues – reinforcing our initial expectations – though the issue is negative at the margin and will certainly raise political rhetoric. Experts see Volcker sooner than later with a final rule highly likely sometime in the fall and no later than 12/31/12.
- **Numerous regulatory uncertainty remains, but no major new fears** — Like a sick patient learning to deal with a pre-existing condition, various speakers expressed continued industry progress preparing for various upcoming regulatory changes including Basel 3, OTC clearing, and Volcker.
- **Bottom in US home prices may be near helped by rental investors** — Several speakers and clients view that housing prices appear to be bottoming and significant amounts of institutional capital is coming in to purchase then rent single family homes.
- **Other key takes** — 1) The outlook for industrial CRE in the East is positive and is being driven by a manufacturing renaissance, and 2) a bubble may be emerging in the multi-family market given the combination of rosy assumptions by developers and high construction costs.

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Capital Markets

Goldman Sachs CFO David Viniar

- **Volcker is not necessarily going to be a worse final outcome than it was a week ago** – Goldman CFO Viniar expressed his view that the recent highly publicized trading losses at JPM, at the margin, are a negative for the industry, but seem unlikely to significantly change or toughen the final version of the Volcker rule. Viniar's view is based on expectations that regulators want to preserve functioning liquid markets, and his expectation that if hedges are prohibited on portfolio basis and required at a specific transaction level, that markets liquidity would be substantially impaired. The most likely outcome seems to be a significant reformulation of the proposed Volcker rule, but not a full re-proposal.
- **Risk mgmt & hedging at GS executed bottom-up at the trading desk level** – When asked whether the losses at JPM could occur at GS, Viniar noted that GS does not have any centralized trading/hedging function like JPM's CIO's office. All risk limits are managed at the trading desk level, so traders own the risk. Goldman also has a policy to run comparative analyses anytime a competitor suffers large losses (e.g. SocGen / UBS rogue traders) with controls such as back-office systems access limits and gross risk position reporting – to catch problems before they occur.
- **Moody's changes unlikely to significantly impact competitive landscape** – Viniar described the potential Moody's downgrade as essentially a down-shift of ratings for the whole industry. While a potential 3-notch downgrade may leave MS as an outlier, Viniar was skeptical that competitors would pick up significant share from Morgan, given clients that have chosen to trade with MS are well aware of its relative credit position given market spreads and have chosen MS based on their service/terms and product pricing – which should not materially change due to ratings outcomes. Viniar reiterated his disagreement with Moody's view, and noted that in the past clients with contractual mandates to only deal with counterparties above a given minimum rating (e.g. corporates or pensions) have changed their contracts multiple times as bank ratings have fallen.
- **Returns in FICC better in most liquid products, but GS still committed to structured solutions which are cyclically not structurally depressed** – Viniar noted that right now returns are higher in macro FX & Rates trading vs the more capital-intensive Credit, Mortgages and Commodities businesses. While near-term there has been less structured activity which likely has hurt Goldman's revenues more than peers, Viniar emphasized his view that the world is not likely to shifting to simpler products – and clients continue to have complex needs which will only grow overtime as more clients grow and more activity is conducted across borders

Equity Markets

JPM Head of Equities Carlos Hernandez

Returns in Equities are 12-13% today and could be 18% long term – Even in the current low volume environment, Hernandez views cash equities as a profitable standalone business (not a loss leader) and including high touch and low touch sees returns on favorable Basel 3 capital as in the 12-13% range today (dragged

down by tech spend and low volumes), excluding ECM origination which if included would boost JPM's ROEs to about 20%. As investments in electronic trading and prime brokerage bear fruit and volumes normalize, total Equities ROEs (ex ECM) should approach 18%. To deliver 18% firms must have scale and diversification. Marginal players who can't deliver scale and lack diversification (geographically, high touch and low touch) will be under pressure and some will exit taking capacity out of the industry – helping returns, though we remain skeptical this will occur in a big way. Hernandez estimated that the top 5 firms were probably profitable in equities.

Equities revenues reported on a net vs peers on gross basis, so JPM revenues are better than they appear – Hernandez also disputed that JPM's equities revenues were relatively middle-of-the-pack, citing the fact that revenues are reported in GAAP financials net of brokerage, clearing & exchange expenses vs many peers which report these figures on a gross basis. For example, Hernandez estimated that adjusted for this difference, JPM moves from #4 to tied with MS for #2 and is only behind GS by ~\$1 bil in equities revenues on an apples-to-apples net basis vs ~\$3 bil behind on a reported basis.

Emerging markets will be long-term payoff, but firms will become selective due to local capital demands – Hernandez noted that investments in emerging markets will pay off over the next decade, but that competitive pricing among new international players is depressing returns. This coupled with local regulators' desire for on-shore fully capitalized and funded local subsidiaries will force a re-examination among firms of their broad footprint ambitions. Firms will become more selective on which countries they seek to operate due to "trapped" capital demands. JPM is focused on being a "complete, not a comprehensive" franchise.

Key revenue opportunities for JPM will be international prime brokerage & electronic trading – 1) International growth of their prime finance platform that was acquired from Bear Stearns. JPM should also see benefits from the shift from one system to integrated platform with "one pipe" which makes internalization and order matching/routing much easier. 2) JPM was late to implementing an electronic equities trading capability but this is now complete and being rolled out to its existing customers, which should drive some incremental share gains. Low touch is roughly 60-70% of volumes but only 20% of profits so firms need both low and high touch capabilities. 3) Protected notes. 4) Emerging markets.

Low volumes/depressed revenues are impacted by secular & cyclical factors – Mr. Hernandez felt that today's weak volumes are driven by a combination of cyclical and secular forces. The secular forces are from clients that want lower execution costs and are pushing more toward low touch. The upside of greater low touch is it requires lower inventories and lower capital demands. Low risk taking and low portfolio turnover are the cyclical causes – but volumes should improve at some point along with economic growth.

Fixed Income Markets

Ryan Brist of Western Asset Management provided a Portfolio Manager's perspective on Fixed Income fund flows and the effects of reduced dealer bond inventories on liquidity.

- **Expectation that Fixed Income flows will continue to accelerate** – Ryan expects positive inflows for fixed income to continue and perhaps accelerate near term, despite the multi-year shift out of equities into bonds. Strong flows are also coming in from international markets such as Japan, Australia and Brazil.
- **Liquidity in the corporate bond market remains a key consideration for money managers and regulators.** Partly due to pending Volker rules, Wall Street dealers have sharply reduced trading inventory levels, which has driven bid / ask spreads wider and as a result raised trading costs for investors. Pre-credit crisis, dealers had carried ~\$245B of high grade inventory, which has now fallen to ~\$42B. The hope is that regulators / Washington realize the negative implications to liquidity when finalizing the Volker rules.
- **Reduced liquidity contrasts with 3x increase in outstanding corporate bonds.** The sharp decline in liquidity in corporate bonds stands in contrast to the threefold increase in growth of the overall corporate bond market outstanding. The reduced liquidity is illustrated by the much larger volume of trading in "on-the-run" bonds of the same issuer.

Housing Finance Reform

Our Housing Finance reform panel included Redwood Trust CEO Marty Hughes and Phillip Millman, Principal Capital Markets Specialist at the FHFA. Topics discussed included the role of private capital in helping the housing market bottom out and the interaction between the FHFA and CFPB in developing the new residential mortgage rules.

- **Redwood CEO believes housing market has bottomed out and is beginning to rebound** – Redwood CEO Marty Hughes believes the national housing market has bottomed out and is starting to rebound modestly. He cited reports of multiple bids for homes across many markets in California, Seattle, Dallas, Boston and NY. This follows his bearish outlook for home prices over the past several years at our Napa event. He attributes the bottoming to: 1) REO-to-lease programs as significant amounts of institutional capital are coming in to invest in single family homes, particularly in weaker markets like Phoenix, etc; and 2) psychology of prospective buyers has changed.
- **Mid-teen returns attracting Private Capital, boosting housing demand** – The influx of private capital coming in to buy and rent single family homes is helping to take out the overhang in the lower end of the markets where supply concerns from foreclosures have been more acute. Investors could make up to mid-teens returns.
- **Final QRM rule appearing unlikely pre-election** – The FHFA is working with other regulators (including the CFPB) to come up with QRM (qualified residential mortgage) rules post Dodd Frank. However, it seems unlikely the six regulators, which all need to agree to the rules, will come to conclusions before the Presidential elections.
- **Private Label securitization market still quiet, but regulators may allow new initiatives to help boost supply** – The agencies (Fannie, Freddie, FHA) are funding 95% of all new mortgages in the US as the private markets remain largely shut with only a handful of securitizations being done. This seems unlikely to change for quite some time (i.e. years) but there are some potential initiatives being considered by regulators to take steps towards more private market

funding. One idea that seems to be bridging the divergent camps and gaining momentum is a "re-insurance" concept where the agencies continue to purchase mortgages (TBA market remains unchanged) but private investors purchase the credit-sensitive tranches, effectively transferring the credit risk away from the agencies.

Commercial Estate Outlook

Our CRE panel included KC Conway of Colliers with Walter Mercer, Head of CRE at SunTrust and Brian Olasov of McKenna, Long & Aldridge.

- **Our speakers were more bullish on the outlook for the CRE market than they have been in a few years as they believe there are new opportunities.** More specifically, the outlook for industrial CRE is considerably more positive given the "manufacturing renaissance." Our speakers attributed the manufacturing renaissance to: (1) patent law protection, as more companies opt to manufacture in the U.S. in order to protect their intellectual property; (2) the weak U.S. dollar which makes domestic manufacturing more inexpensive; and (3) infrastructure, particularly rail and ports. With regards to infrastructure, our speakers pointed towards the East Coast as a growth area for industrial CRE as companies choose to build in states that: (1) have sound fiscal situations; and (2) are "right to work states."
- **On a somewhat less positive note, our speakers pointed towards \$300-\$500 bil of annual CRE debt maturities each year for the next few years.** The CRE loan market is ~\$3 trillion, ~45% of which is owned by banks with a large part of the remainder in CMBS. Less than 1/3 of the upcoming debt maturities can be refinanced without new equity as the majority of the maturities are what one speaker termed "the unfortunate intersection between easy lending terms and maturities." Also on a somewhat less positive note, our speakers are concerned about a possible bubble in multi-family building due to the combination of rosy assumptions made by developers coupled with rising construction costs.

Asset & Liability Management in a Low Rate Environment

Our ALM panel included Tayfun Tuzun, Treasurer of Fifth Third, Jim Tyler, Head of Asset Liability Management at Bank of the West, and Ethan Heisler, Bank Treasury Strategist for Fixed Income Trading at Citi.

- **Low rates push the focus to driving NII growth rather than being concerned about NIM** – Assuming the low rate environment continues, banks will be much more concerned with driving NII growth through asset growth as opposed to NIM growth. At this point, banks do not have much control over their NIM trajectories given how low deposit costs are and the flatness of the curve.
- **While NIM is difficult to control, confidence in near-term forecasts is strong** – With regards to how much visibility and confidence they had into their NIMs, our speakers said they were highly confident in their ability to accurately predict their NIMs over the next 12 months. The biggest source of uncertainty with regards to forecasting NIM in the near term is government policy (ie, HARP). Our speakers expect NIM declines in '13 to be at a slower rate than the declines in '12.

- **FDIC deposit guarantee expiry seen as a non-event** – Banks have been flooded with deposits and neither of our speakers are worried the expiration of the FDIC deposit guarantee at 12/31/12 will have a material impact on their deposit levels.

OTC Derivatives – Clearing

Christopher Perkins, Global Head of OTC Clearing for Prime Services

US central clearing should begin by Dec 2012/Jan 2013 – Perkins estimates that US clearing rules including key items such as legal definitions of a “swap,” a “standard swap” and a “security based swap” will be proposed by June or July 2012 followed by a 90-day comment period, then given 90-day implementation period putting effective date at late 2012, early 2013 for US firms. This will launch a three-phase implementation over the next 270 days with swap dealers and major swap market participants going first, followed by buy-side firms.

Client clearing driven by prudence & pricing – Recent industry client clearing volumes have been rising with the largest clearing members clearing several hundreds of billions of client notional today on a cumulative basis – largely consisting of interest rate swaps and some Index CDS. The largest 15 or so buy-side fixed-income firms have been moving to clear early to test the operational feasibility and due to fiduciary concerns, while others have moved because uncleared trades have started to see higher pricing.

Numerous complicating issues remain due to lack of a harmonized global rules – While Perkins was confident that clearing would move forward in the US by the end of the year, many challenges remain due to lack of a harmonized global regulatory framework including potential fragmentation of derivatives markets with required onshore clearing, challenges from increasing client demands for full segregation of initial margin collateral, and inconsistent bankruptcy laws around the world – as clearing is a global phenomenon, but laws regarding resolution in the event of a default are inherently local and not fully in synch.

Regulatory Update

Candi Wolff, Citi Head of Global Government Affairs

- **The political climate towards banks’ concerns toward regulatory reforms remains very challenged.** Regulators from various agencies are working to draft and implement so many regulations so quickly, they are not able to take a holistic view and consider how various regulations interact with one another. The Financial Stability Oversight Council is tasked to consider how the regulations collectively will impact the broader economy, but so far this process does not appear to have really moved forward.
- **Final Volker rule to be issued as early as September but more likely later in the fall and definitely before 12/31/12.** If the rule is finalized by 12/31/12 and Romney wins the Presidential election, it will be much more difficult for Republicans to change the rule than if the rule had not been finalized and the Republicans take control of the White House.

- **The likelihood of a re-proposal of the Volker rule which would allow for a new comment period seems extremely low.** Although Romney has stated that he would repeal Dodd-Frank, the chances of a full repeal appear very low as it appears to be an unlikely scenario that Republicans will have the necessary 60 votes in the Senate. However, the relatively unpopular swap “push-out” provision does appear to have a decent change of being repealed by year-end 2012 given is bipartisan support. Separately, one of the industry’s top concerns is the broad-reaching oversight of the CFPB and the uncertain impact it could have over the next several years.

Basel 2.5 & Basel 3

Evan Picoult from Citi Risk Architecture provided an update on the coming implementation of Basel 2.5 & Basel 3 and also highlighted a number of draft rules which could significantly impact the banking industry.

- **Possible EU exemptions for Sovereigns and Corporates from CVA charge could create uneven playing field.** European legislation equivalent to Basel 3, Capital Requirements Directive IV, could exempt banks from calculating RWA for CVA for sovereigns, SMEs and corporates. This raises the potential for an uneven playing field for both US banks and businesses, with the US seen as potentially unlikely to follow given CVA mark-to-market accounting.
- **Recent Basel trading book review is not a proposal but may drive a move away from VaR.** While the recent Basel Fundamental review of the Trading Book is a conceptual paper rather than a proposal, it does raise the prospect that Basel may require banks to use Expected Shortfall rather than VaR and Stressed VaR for reporting risk. The review also notes the potential for market illiquidity rules based on different time horizons, which although not necessarily increasing overall capital requirements may shift requirements from less liquid to more liquid assets.
- **Key unknown remains Single Counterparty Concentration Limits** – Current Federal Reserve proposals would create a maximum single counterparty limit of 25% of capital for small banks (<\$500 bil), and 10% for financial institutions with more than \$500 bil in assets. This could have a potential impact on derivatives exposures to other large banks (as well as CCPs) particularly given the methodology does not give credit for margin/netting.

Appendix A-1

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