

Financial Services

The day after tomorrow

A PricewaterhouseCoopers perspective on the global financial crisis



‘The basic rule of storms is that they continue until the imbalance that created them is corrected.’

The Day After Tomorrow (2004)

Themes and imperatives for a new world

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one

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A new financial services model for a new world

Systemic problems require systemic solutions. The financial crisis started in one corner of the US mortgage market, but the fallout from the collapse of the sub-prime lending bubble has spread across the globe via the disintermediation of the originate-to-distribute banking model. What began as a crisis for individual markets and institutions has now undermined the foundations of the entire global financial system.

Credit markets were the first to be engulfed, but the contagion has subsequently reached all asset classes that were reliant on a combination of cheap money and high leverage, bringing the demise of the independent US investment banking model and sending countries from Iceland to Hungary cap-in-hand to the IMF. The full extent of the interconnected nature of the world's financial markets has been revealed, as has the need to address the underlying global imbalances that underpinned investment flows before the crisis.

Unlike in the wake of earlier crises in the post-war period, the world economy and its financial markets will not resume their former pattern. The balance of economic and political power will shift towards the East as part of a trend towards a less US-

centric world economy. Emerging market countries will increasingly influence patterns of trade and investment to reflect their own natural resource requirements and the banking system will follow these flows.

The nature of the banking system, too, will change. Unsustainable, overleveraged structures will be replaced with simpler and more transparent forms of banking, and some activities may be subject to limitations in a new model that represents a renaissance of 'classic banking'.

The emergence of this model will be driven both by increased regulatory pressure and the need for banks to adapt their businesses to new capital constraints. A massive deleveraging process is under way on the part of both financial institutions and debt-addicted Western consumers, who recognise that their previous levels of

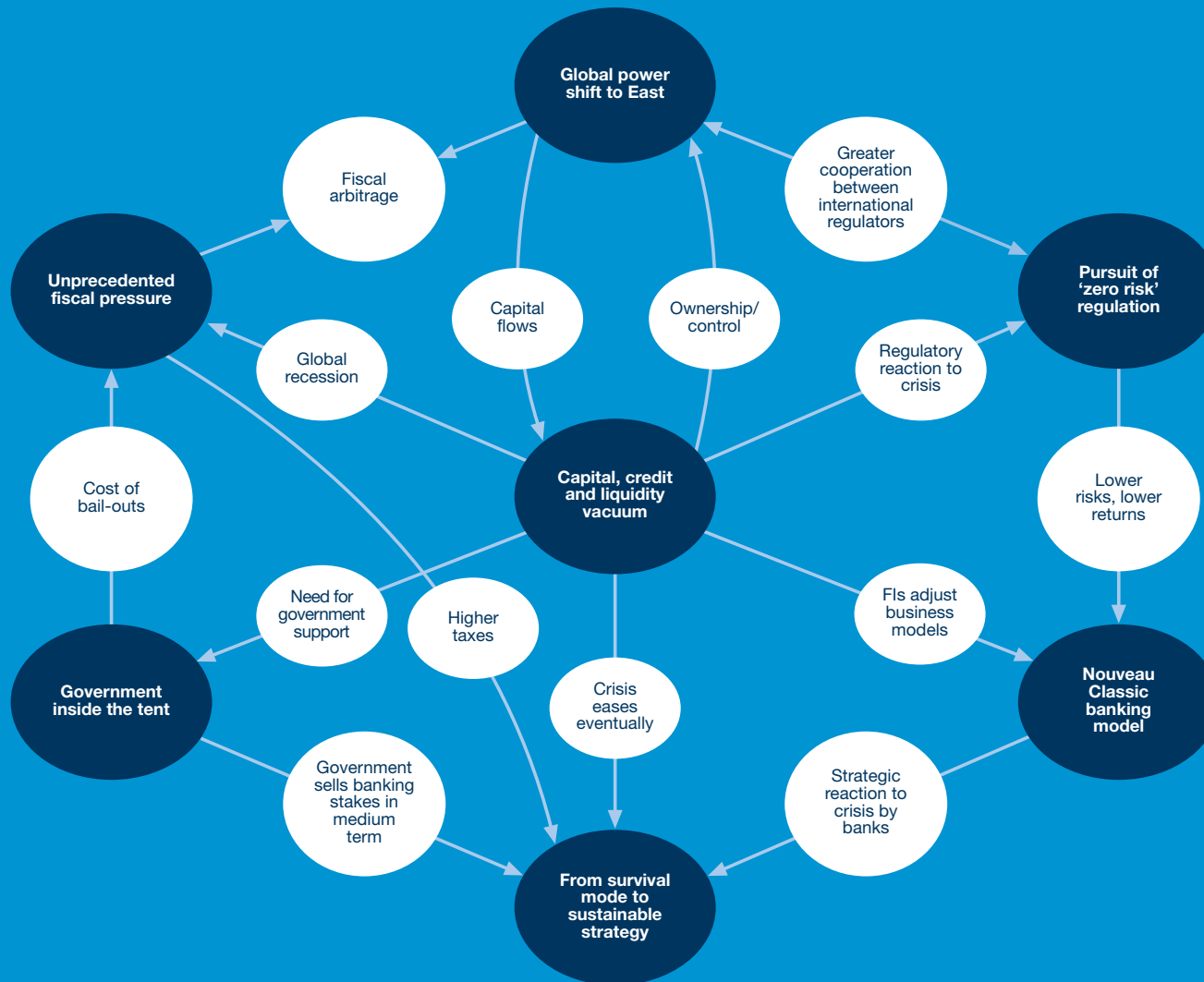
consumption are now unsustainable. In this more capital-constrained world, the banking system will be smaller, more transparent and subject to stricter governance.

The contraction in capital, credit and liquidity has created a 'monetary vacuum' at the centre of the banking system. Financial institutions and governments have attempted to fill that vacuum with fresh capital from state coffers and sovereign wealth fund investors. With governments now 'inside the tent', providing liquidity and financial guarantees and in some cases holding major or controlling stakes in banks, the long-term implications of this crisis management are profound. Hoping to ensure that a crisis on this scale is never repeated, governments and regulators will pursue 'zero risk' regulation. Their influence

in the financial system will be far-reaching, long-term and will raise significant conflicts of interest.

The result will be a banking system under a new stricter governance model, in which risks and returns will be lower, operating in a global economy that will look very different from the pre-crisis world order.

John Maynard Keynes said, 'When the facts change, I change my mind.' Financial institutions must look beyond mere survival mode, accept that the facts have changed and focus on achieving a sustainable competitive strategy in this new environment. They must deal with government stakeholders who face unprecedented fiscal pressures as well as the urgent need to restore confidence in the financial system, which is vital to worldwide economic recovery.



The seven themes have a complicated set of political, economic and social interactions

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The shift in global power towards the East

The long-term shift in financial power from the West to the East has been accelerated by the financial crisis, as the credibility and strength of Western financial institutions has been severely damaged.

A good financial system enjoys trust, is reliable, stable and well regulated. Some Western financial centres have displayed few of these attributes over the last two years. Banks, regulators, governments and other financial institutions have to find a way to restore trust because they will need to tap into the liquidity available around the world. If the major Western financial centres cannot rebuild trust quickly it will undermine their aspirations to maintain their pre-eminent position in the financial system. It is as fundamental as that.

As well as destroying trust in the abilities of Western financiers, the crisis burst an asset bubble predicated on the investment flows generated by the macroeconomic imbalances in a US-centric global economy.

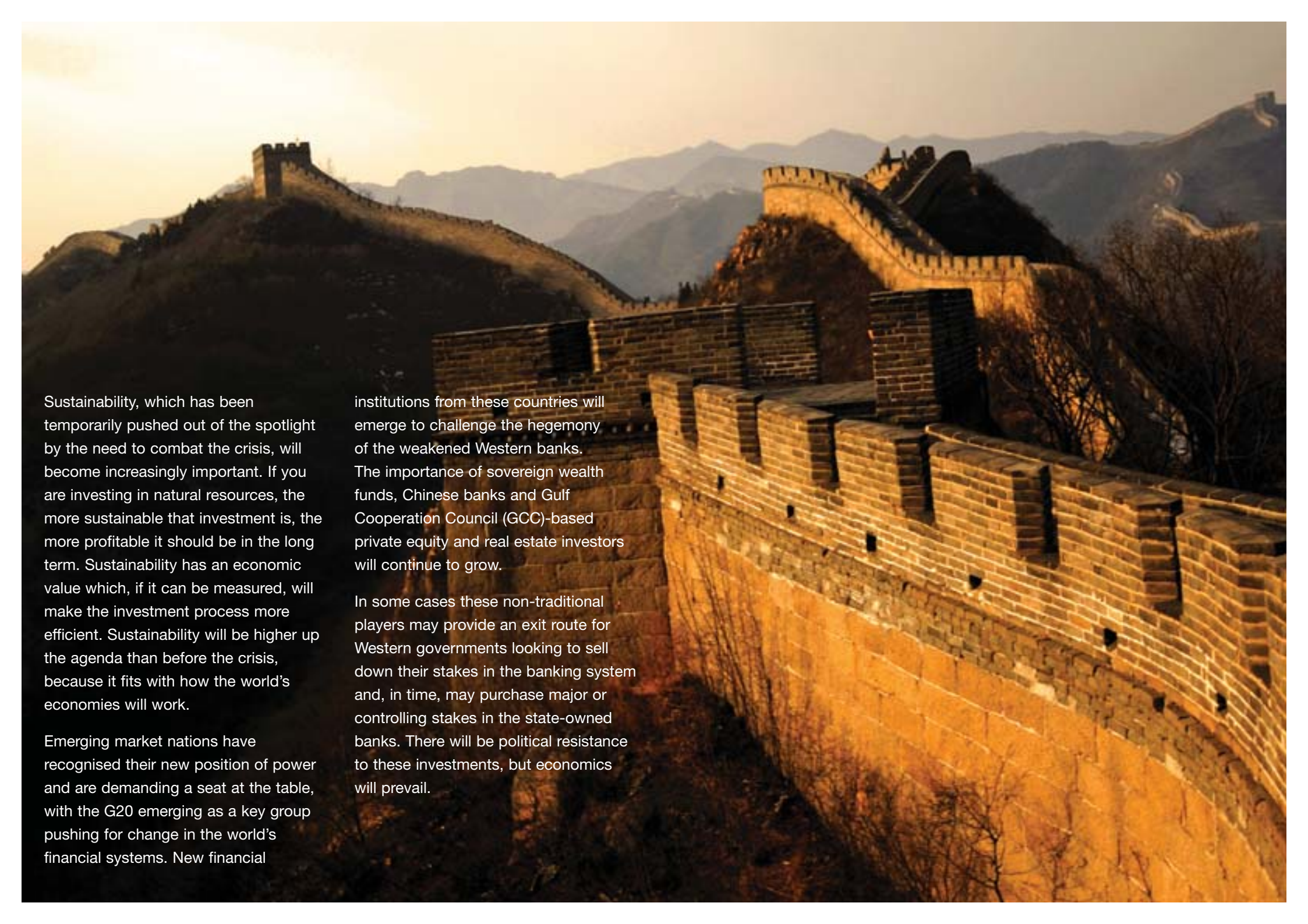
Fundamental imbalances are a destabilising feature of the system. When you have countries with an imbalance of trade it is the deficit countries that tend to be criticised, but you should also criticise the surplus countries.

The patterns of consumption and saving in both the West and the emerging markets must be adjusted. The West needs to consume less and save more, while the East must consume more and save less. More realistic market-based exchange rates should also be part of the economic landscape in the future.

The new patterns of world trade and investment that emerge from this fundamental rebalancing will look very different from the old US-centred system. Successful globalisation has always followed its customers and banks

will follow natural trade routes. We are moving to a multi-polar world where the Western financial centres could be bypassed. China, for example, will invest where it needs to, to build its economy. This will include more regional investment and direct investments in natural resources around the globe.

Financial institutions will have to adapt to meet this new reality. Global banking will shift towards a system based on facilitating investment flows linked to trade routes and natural resources. Banks are conduits for moving money around: they facilitate flows of capital. In future money will follow natural resources. There will be a greater focus on what you have in terms of resources, rather than what you can create through financial innovation.



Sustainability, which has been temporarily pushed out of the spotlight by the need to combat the crisis, will become increasingly important. If you are investing in natural resources, the more sustainable that investment is, the more profitable it should be in the long term. Sustainability has an economic value which, if it can be measured, will make the investment process more efficient. Sustainability will be higher up the agenda than before the crisis, because it fits with how the world's economies will work.

Emerging market nations have recognised their new position of power and are demanding a seat at the table, with the G20 emerging as a key group pushing for change in the world's financial systems. New financial

institutions from these countries will emerge to challenge the hegemony of the weakened Western banks. The importance of sovereign wealth funds, Chinese banks and Gulf Cooperation Council (GCC)-based private equity and real estate investors will continue to grow.

In some cases these non-traditional players may provide an exit route for Western governments looking to sell down their stakes in the banking system and, in time, may purchase major or controlling stakes in the state-owned banks. There will be political resistance to these investments, but economics will prevail.

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The renaissance of classic banking

In this new world order the banking system will be smaller and more tightly regulated. Large parts of the shadow banking system will be dismantled and there will be a movement back towards universal banks. Most of the banks that relied heavily on the capital markets for their liquidity and were specialist rather than universal have disappeared.

The full extent of deleveraging is, as yet, unclear, but could easily outweigh the stimulus packages currently being deployed. The growth of derivatives during the boom years decoupled from the growth of the real economy.

There will now be a reduction in that decoupling effect. Derivatives will not disappear, but their volumes may shrink and become more aligned with the size of real economies.

The inappropriate use of financially innovative structured products has led to tremendous wealth destruction. Financial institutions need to be ruthless in measuring risk-adjusted returns in their different businesses and consider exiting from products and markets where they have little sustainable competitive advantage. Capital should be redeployed

to core institutional capabilities and to anticipated gaps in the market. Where there is little chance of becoming a market leader in their chosen markets in terms of scale and meeting risk-adjusted returns in the next three to five years, banks are likely to exit the business.

In future, this 'Nouveau Classic' banking model will be simpler, more risk averse and more transparent. Profits will be lower, but risk-adjusted returns will not drop by as much, because the risk profile of the business mix will also decline. Banks will retain a larger part of their own origination and will take more responsibility for the due diligence necessary to ensure credit quality.

After the high-profile banking failures of 2008 brought short-term funding problems into sharp focus, liquidity will no longer be regarded as an 'always available' given. The pre-crisis expansion of debt did not create liquidity; in fact it did the opposite. Disintermediation in the banking process reduced transparency and investors did not realise that the liquidity shown in the system was not real – in the sense of being available over the longer term. It was not a case of liquidity being there one day and gone the next.

When trust and confidence disappeared and investors asked for their money back, it became apparent that real liquidity had not been created in the first place. This issue of the availability of liquidity is key to the workings of the

global economy and one that governments and their central banks must address as a major policy problem.

A two-tier financial services system is likely to develop. It is a natural outcome of increased regulatory pressure to end up with a more polarised financial system. On one side will be banks and investment banks operating under a tight regulatory regime and on the other a less heavily regulated sector comprising the hedge fund, private equity and real estate industries – albeit still facing greater scrutiny than in the past.

The crisis has highlighted shortcomings in banks' pricing, monitoring and managing of risk. Too much reliance has been placed on quantitative models, based on historical data, to make assessments of current and future risk

exposures. In future, risk management culture must be strengthened by designing organisational structures with risk at the centre and aligning compensation structures accordingly.

The key point on compensation is that problems arise when you try to recognise performance at a level below that at which you can measure risk.

Bonus pools should not be struck below the level at which cost and risk can be allocated, and performance-based incentive payments must reflect the risk taken in producing profits. Because of the potential competitive disadvantage for first-movers, compensation can only be effectively reformed on an industry level.



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The pursuit of 'zero risk' regulation

Compensation is just one area of focus as governments and societies bearing the cost of the financial crisis act with one overriding objective: 'never again'. While Western financial institutions have shouldered much of the blame, regulators, too, must bear some of the responsibility for not acting sooner. The fundamental weaknesses in the regulatory regime have been exposed. There will be material, substantive change to the regulatory environment under which banks and other financial institutions operate.

Recognition of the interconnections within the financial system has produced a consensus that these regulatory shortcomings cannot be dealt with solely on a national basis. Establishing one global regulatory body, however, would be fraught with conflicts of interest. Regulation is still a nationalistic issue partly because of different traditions and stages of developments of local markets. It is also influenced by the politics of the day and the pursuit of local agendas.

But cross-border regulation under strong leadership is an essential prerequisite for a healthier financial system. Regulators do collaborate and the European Union is pushing to formalise an approach based on a more empowered college of supervisors. Reflecting the shift in economic and political power towards

emerging market nations, the G20 has also outlined an Action Plan for Regulatory Reform. The concept of regulatory colleges is not new, but giving more authority to the lead supervisor would strengthen the concept. At the very minimum the idea of a college of supervisors must be pushed to the limit, with a strong lead supervisor with the mandate to direct local regulators.

The prospects, however, for more direct regulation and supervision of the hedge fund sector are less clear. There are countries out there that will always wish to attract investment management businesses. The bottom line is that it will be very hard for the authorities to actively regulate the sector.

In the onshore sector there will be more regulation in more areas. Overall financial stability will be the primary concern; anything that can affect it will be regulated in one form or another and the shadow banking system will shrink dramatically. Governments will have greater influence over state-supported banks' strategies and regulators will scrutinise more closely the adequacy of risk management frameworks and processes and compensation policies.

Shortcomings in capital adequacy regulations must also be addressed. The crisis has revealed that, on its own, without a strong liquidity pillar, Basel II is impotent. The Basel regime, which was always meant to be an evolutionary process, will change. The trend – apparent before the crisis – towards

loosening the definition of regulatory capital will be reversed. Definitions of capital will tighten and regulatory capital requirements will increase.

Capital must no longer be looked at in isolation. The regulations must recognise the interplay between liquidity and capital and the ability of liquidity problems to become capital problems. They must act faster in the future. In addition to developing a more prescriptive regime for liquidity risk, future capital rules should make excessive leveraging incrementally more expensive and address procyclicality, potentially by requiring banks to maintain larger capital buffers over the cycle.

Governments will also need to consider what role they should play in regard to the stabilisation or support of asset prices in the event of a future global dislocation of similar proportions.

Inevitably the authorities will make misjudgments, resulting in unintended consequences as they grapple with extremely complex system issues that are not yet fully understood. As well as inaction, instances of inappropriate intervention are also highly probable. Some regulatory interventions have not been fully thought through and reflect a lack of complete understanding of how the system works. For example, intervening to underpin housing markets

in a manner that is advantageous to financial institutions does not take account of the fact that banks will not want to repossess properties in a declining property market. Governments have lost confidence in financial markets working, but on the whole they still work. The banks will figure out solutions for reasons of self-preservation.

Part of the problem is that despite improvements in the technical skills of regulators in recent years, there is still a lack of capacity and a lack of capability within many regulatory bodies. Talent and capital have outmanoeuvred the regulator.

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Government 'inside the tent'

Governments must resolve the conflicts of interest between the need to ensure the continued operation and ultimate return to profitability of the banking system and the need to deal with unprecedented fiscal pressure, while simultaneously balancing wider social and political issues.

Governments will be in financial services for some time to come. Although governments may wish to unwind their holdings, in the foreseeable future the problem will be a lack of willing investors with sufficient capital. It is the 21st-century equivalent of the New Deal: government is providing the capital infrastructure for the financial system.

A significant difference from the New Deal era is the increased importance of the financial system for developed countries' economies. As GDP per capita rises, growth in the value of financial products as a proportion of GDP accelerates. It is absolutely critical for the survival of developed economies that the financial system is trusted so that the citizens, businesses and investors that use it are happy to place their wealth in it.

It seemed to take Western governments a long time to wake up to the overriding need for trust and the systemic nature of the risks coming from a lack of trust. Even two years ago, it would have been unthinkable that iconic FS groups would become so widely distrusted. Regaining this trust is key to worldwide economic recovery.

Governments are expected to intervene more heavily in the way the financial system operates, in order to stimulate their economies. This intervention is already evident in the US and the UK, with pressure being applied to state-supported banks with respect to repossessions and foreclosures and SME lending. More conflict should be expected as governments reflect society's wishes and exert influence

on banks' governance, tax, dividend policy and compensation. After such a massive bailout society expects, understandably, that the banks will adjust their behaviour to reflect the wider public interest and not, necessarily, shareholder interests.

Non-state-supported banks, that is, those without significant government influence, will face pressure to alter their behaviour too, despite not receiving government funds. Public opinion will play a key role, as the public believes that it has bailed out the entire banking system, not just the new state-supported banks.

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Unprecedented fiscal pressure

Governments must address the impact of the bailout on their finances as well as public opinion. Western governments face intense fiscal pressure as the recession and the decline in asset prices reduce tax revenues. Governments will tell the banks that in return for being saved from disaster they must now pay their fair share. The countries under greatest pressure will be those where financial institutions play the largest role in the economy, where consumer debts are highest and house prices are falling most – the US, the UK, Spain and Ireland. The UK and the US face additional pressure because they are entering the recession with large structural deficits.

Tax rates may go down and spending may rise in the short-term to mitigate the effects of the recession, but in the longer-term, taxes in the US, the UK and elsewhere will have to go up. Given the importance of financial services to the economies of the developed world, it is natural that governments will seek to tax the sector more heavily.

Governments will increasingly expect financial institutions not to engage in 'unacceptable' tax planning and will rely on them to maintain compliance on the part of their customers. This will include pressure on some activities undertaken in offshore financial centres perceived as tax havens by the authorities.

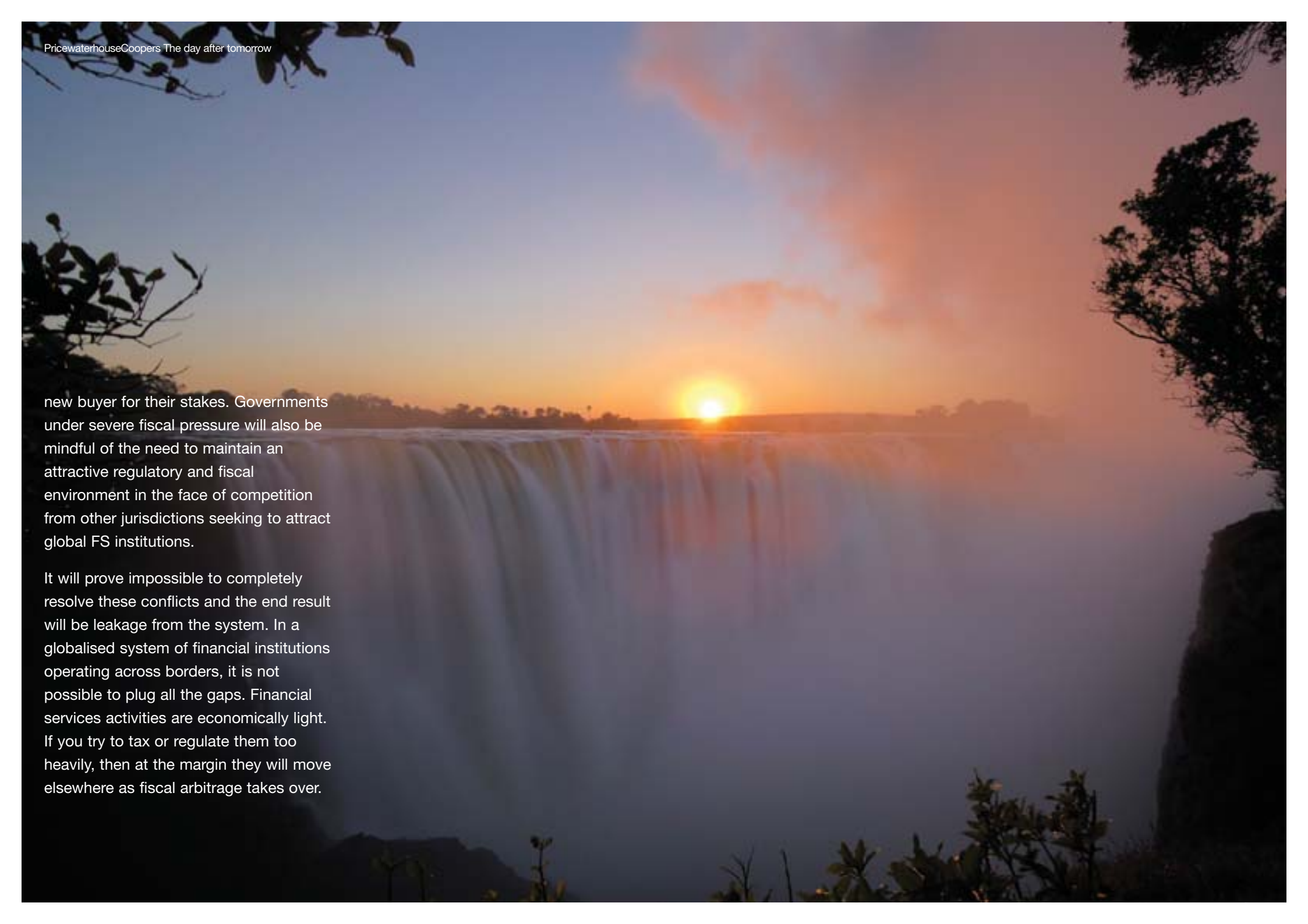
Deleveraging is also a key point of tension between governments and financial institutions. Governments want the banks to keep lending to mitigate the effects of the recession, while the banks need to shrink their balance sheets and restore profitability.

Tension between banks and government is not new. Governments have attempted to legislate against tax minimisation schemes for years. The difference now will be the extent of the pressure that governments apply for banks to toe the line, using their position of power as a major or controlling stakeholder. A key issue for FS institutions will be where they position themselves in the tax arena, not only for their own organisation, but also for their clients.

This decision on tax positioning will have to be taken at board level because of the high profile of the issue.

Tax issues are a subset of the wider debate over increased regulation of the financial services sector. Just as banks must attempt to ensure that the regulatory backlash does not stifle sound innovation, they will have to negotiate with government to steer a course between rebuilding their profitability and acting as responsible citizens who have been the recipients of a costly bailout.

The two issues are interrelated since, while wishing to raise revenue, it is in governments' interest for banks to be profitable, since they need to earn a return on their investments in the banking system and ultimately find a



new buyer for their stakes. Governments under severe fiscal pressure will also be mindful of the need to maintain an attractive regulatory and fiscal environment in the face of competition from other jurisdictions seeking to attract global FS institutions.

It will prove impossible to completely resolve these conflicts and the end result will be leakage from the system. In a globalised system of financial institutions operating across borders, it is not possible to plug all the gaps. Financial services activities are economically light. If you try to tax or regulate them too heavily, then at the margin they will move elsewhere as fiscal arbitrage takes over.


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From survival mode to sustainable strategy

‘The Chinese use two brush strokes to write the word crisis. One brush stroke stands for danger; the other for opportunity. In a crisis, be aware of the danger, but recognise the opportunity.’

John F. Kennedy



The winners from this crisis will be those that do what is required for survival, but also adapt to the realities of a new world. Financial institutions must resist the tremendous urge to become completely reactive at the expense of longer-term considerations. At the same time, financial institutions must adjust to the realities of doing business in a world where the interest of multiple stakeholders – governments and society in general – have become more important.

To get financial institutions working, a sustainable business model is needed. Most institutions are stuck in survival mode, when their executives need to be taking decisions now on where the business will be in two or three years'

time. It is difficult for chief executives to focus on the longer-term and there is a risk that many organisations will not address the problem now, which will put them at a competitive disadvantage in the future.

Financial institutions must recognise that the future will not be like the past. The shift in economic and political power from the West to the East is a long-term shift and will bring with it a completely different pattern of investment, consumption and global trade.

While it is easy to lose sight of longer term trends during a crisis, the underlying forces shaping the future of financial services have not changed. Alongside the global power shift and the

changing patterns of trade and globalisation are three further forces driving the industry: ageing populations in developed markets; the faster growth in E7 economies relative to the G7 economies; and the continuing impact of technological advances on financial services.

To remain competitive, financial institutions must incorporate these powerful long-term trends into their sustainable business strategies, and they must do it sooner rather than later.

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