

NEWSFLASH

The 2008 U.S. Elections and Impact on the Financial Services Industry: What To Watch

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NEWS UPDATE

Following Barack Obama's election to the U.S. presidency and the retention of control of Congress by the Democrats (with substantially greater majorities) Financial Insights expects more legislation to protect consumers, incentives to reduce off-shoring, federal regulation of the insurance industry, more bank failures, and streamlining of banking regulatory agencies. Some of these events, such as the bank failures, would have occurred regardless of the outcome of the election; the differences will largely be of emphasis and severity. One of the big unknowns, and what is most important to the industry, is selection of the incoming Treasury Secretary. The Treasury Secretary will play the lead role in reshaping the industry and laying the stage for the long-term future of the industry.

OUR VIEW

The Bottom Line

Whether Obama or McCain had won the presidency, the financial crisis would have inevitably led us to increased regulation, and the economy will continue to languish in an economic recession. However, the direction of the response will now be determined by Democratically-controlled executive and legislative branches. Following are some of the impacts Financial Insights expects based on campaign platforms, Secretary Paulson's actions, and past experience.

Regulatory Change

The lame duck Congress will likely return to session and begin hearings on the financial crisis. Expect regulators, banking executives, and consumers to testify before Congress as the government seeks retribution for the failure of the housing and banking industries. Although economic stabilization is the underlying need, there is a pressing need to assign blame which will play out in the hearings – leading to embarrassing admissions from regulators, mortgage originators, appraisers, investment advisors, and financial services executives. One danger is that the blame game may negatively impact consumer trust in the whole banking system – contributing to the more volatility. Changes that will result likely include reform of mortgage origination practices, limitations on exotic investment instruments, the absorption of the Office of Thrift Supervision by the FDIC, federal regulation of the insurance industry, and increased capital adequacy requirements for all financial service segments (i.e., banking, insurance and capital markets). Admissions of guilt by these various participants will assist the plaintiff's bar in their class action lawsuits they bring against the failed and bailed companies which in turn will increase the losses that Property & Casualty insurers will have to incur from Directors & Officers (D&O) or Errors & Omissions (E&O) policies.

What will remain unresolved is the disconnect between nationally-regulated financial institutions competing in a global environment. On Nov. 15 the first of a series of global financial services summits will be held in Washington. The Bush administration announced that input from the President-Elect will be included. Financial Insights view is that as part of Obama's plan to improve the global opinion of the U.S. he will take as large a role as the current administration permits in the process. It is unlikely that these global summits will lead to any additional global oversight, even though inconsistent national regulations have fueled the cascading crises. With national institutions competing on uneven footing in a global market, any regulatory requirements that are applied unevenly across the globe will result in capital flows toward the most attractive markets. Now, attractiveness equals safe return of capital. Once financial stability is achieved, attractiveness will again equal better returns. Shoring up the U.S. financial services industry requires that U.S. institutions can compete effectively regardless of investor goals. It will be critical for financial institutions to actively involve themselves in regulatory efforts in a positive way. For example, instead of ignoring concerns about executive pay, financial institutions should make serious reforms, including institution of "clawback" provisions for compensation based on results which are later shown to be false, and election of directors based on a true majority of votes casts, rather than a plurality. If the industry is seen to be reforming itself, it will take much of the wind out of government-led efforts. This will also work to the advantage of

well-run institutions, who in the past faced unfair competition from institutions that were willing to engage in risky lending practices.

Off-shoring

As jobs continue to be lost in the U.S., financial institutions will find it more difficult to increasing off-shoring – either through outsourcing or off-shore captives. President-Elect Obama's campaign platform included ending tax breaks for firms that move jobs outside the U.S. Instead, tax credits will be awarded to those firms that increase the ratio of U.S. to non-U.S. employees. Countering this potential government policy will be the necessary cost containment that beleaguered banks can attain with labor arbitrage. Given the national prerogative to strengthen the financial health of the banking industry, any government policy will need to balance two competing goals – increasing employment in the U.S. and stabilizing the industry. We agree with the majority of tax experts that there is little the government can do, since taxes are not the primary driver of offshoring and outsourcing. Indeed, the recession will increase cost pressures, and this, combined with industry consolidation and increased foreign ownership of banks, will probably lead to an increase in offshoring and outsourcing.

The Emergency Economic Stabilization Act of 2008 (EESA)

So far nine of the top U.S. financial institutions have received a capital infusion of \$125B as a result of this Act. These institutions were compelled to accept funds, and the strings which were attached. Encumbrances with the infusion include limits on stock dividends, stock repurchases, and executive pay. This government loan has increased oversight of these institutions to a greater extent than ever before seen in this country. Whether because they are compelled, for the good of the economy, or for good business, financial institutions are working much more with borrowers to work-out loans and avoid foreclosure. JP Morgan Chase took the exceptional step of freezing foreclosures on October 31. Treasury Secretary Paulson has taken control with a very firm hand, the new administration will likely stay the course, perhaps by keeping Paulson in his position. Even if he is replaced, Paulson has dramatically increased the modern-day power of this cabinet position, and the next incumbent will not easily loosen the reins. The government and Treasury Secretary are now partnered with the industry and individual institutions as each moves through this uncharted territory. Criteria for picking winners and losers through this program have been opaque under the current administration, more transparency may come to pass under the Obama administration.

Bank Failures

With EESA, the current administration was very clear about the institutions which are "too big to fail". Beyond the largest, there will

not be intervention to prop up failing institutions. The acquisition of National City by PNC is illustrative of the government's desired outcome for those institutions with weak balance sheets. With real estate prices still declining, credit tight, and a weak dollar, it is in the best interest of the country and the economy to allow weak financial institutions to fail and be acquired by stronger competitors. Through 2009 Financial Insights is forecasting a reduction in the number of FDIC-insured institutions from the 8,400 now in existence to less than 8,000. This is a needed culling of the herd to ensure that it is those institutions with skilled management, strong risk management cultures, and good business practices that lead the industry from the brink of disaster. One on-going issue moving forward is whether the acquisition of weak assets will be restricted to strong domestic franchises or will include foreign-based competitors – including the Canadian banks with strong US presence.

Stimulus Package

Through government spending, the Obama administration and Congress will seek to soften the impact of the recession. Rather than the taxpayer checks favored by the Bush administration, expect more investment in infrastructure and public works. In a recent letter to Congress, the nation's governors have already requested a broad array of infrastructure projects including airports, highways, transit systems, clean water, sewers and broadband as part of any stimulus package. With consumer confidence at a low, there is little reason to expect that a cash infusion to consumers would not be used to pay down debt or increasing savings – blunting the impact of the stimulus. Direct stimulus is also not the traditional path taken by Democratic administrations. Rather, the administration will launch new spending projects to improve failing infrastructure and create jobs throughout Congressional districts.

Essential Guidance

The U.S. financial services industry and the country are at a watershed moment. The incoming president will preside over an industry on the verge of breakdown and an economy in recession. Safety and soundness must be returned, and the new government is likely to tread lightly, but persuasively, as it seeks to right the ship. However, regulatory change will be slow in coming as legislators and the industry seek to find balance. Financial Insights expects significant regulation will not be enacted until late-2009 or 2010, with financial institutions feeling the impact thereafter. Overly constrictive new regulation could hamper the largest U.S. institutions from competing in a global market, and legislators will need to recognize the need to retain balance. Individual culprits will however be identified and pilloried to assuage the pain of homeowners and investors (also known

as voters). Retribution will likely be paid by these individuals, rather than the financial industry or particular institutions.

In the immediate aftermath of the election, markets and global leaders will look to President-Elect Obama to provide more detail and take steps toward building a team to manage the financial crisis as soon as he comes into office. There will need to be a plan for the first days in office so that uncertainty does not lead to further shock waves.

LEARN MORE

Related Research

- *Financial Services Crisis – Transitioning from Crisis of Confidence and Liquidity to Longer Term Credit and Economic Issues* (Financial Insights #TBD, November, 2008)
- *Worldwide Credit Crisis: The Contagion Spreads to Europe and Asia/Pacific* (Financial Insights #FIN214654), October, 2008)
- *Fight or Flight: The New Face of Banking and Its Impact on Spending* (Financial Insights # [FIBA55Q](#) , October 2008)
- *Irrational Exuberance Turns to Irrational Despair: Merrill Lynch and Lehman Brothers* (Financial Insights # [FIN214345](#) , September 2008)
- *Fannie Mae and Freddie Mac Takeover: A Short-Term Solution in an Industry with Longer-Term Issues* (Financial Insights # [FIN214221](#) , September 2008)
- *Fannie Mae, Freddie Mac, and the Feds: What's Next for Mortgage Market Players?* (Financial Insights # [FIN213521](#) , July 2008)
- *The Bear Stearns Collapse and Implications in the U.S. Financial Services Industry* (Financial Insights # [FIN211487](#) , March 2008)
- *The Subprime Lending Debacle: The Mistakes Were in Market Risk Analysis Involving CDOs, not the Credit Risk Analysis of Those Applying for Mortgages* (Financial Insights # [FIN206063](#) , March 2007)
- *Combating Fraud in Home Equity Lending: The Enemy of My Enemy Is My Friend* (Financial Insights # [FIN204930](#) , December 2006)

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