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# Fight or Flight: The New Face of Banking and Its Impact on Spending

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PERSPECTIVE #

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## IN THIS PERSPECTIVE

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George Soros states that we are at the end of the accepted paradigm that financial markets tend towards equilibrium and that active involvement from government is required to avoid the boom and bust cycles that have characterized first the dot-com and now the housing bubbles. As governments around the world find themselves forced to adopt this view and intervene in unprecedented ways to avoid a financial disaster, the way out of this situation is far from clear.

This Financial Insights Perspective provides the FinSights Advisor's weekly perspective on the financial services industry. It provides financial institutions with timely guidance about maximizing one's technology and business investments. This week's issue looks at the impact of global efforts to stabilize the state of the industry through unprecedented bail out plans and talks of major regulation and intervention into the financial markets.

As each week brings another momentous surprise and the end of the darkest hour before dawn seems still far away, we ask what the new order will look like and its impact on consumers, technology and future business models. How long will the world live with the consequences of the mother of all bailouts?

### Background

Events that have transpired over the past ten days on Wall Street are nothing short of historic in nature and have the ingredients to reshape the future of the financial services landscape for decades to come as did the watershed events some 80 years ago during the Great Depression. The wave is now a global tsunami extending to all financial markets.

Some of the major headlines, since the announcement of Merrill Lynch's proposed acquisition by Bank of America and Lehman's chapter 11 filing have been:

- Insurance giant American International Group Inc. (AIG) comes under government control in an $85bn bailout

- Short selling temporarily banned on over 800 companies by the SEC, as well as similar conditions imposed by other regulators globally

- The Treasury brings the $700bn Troubled Asset Relief Act (TARA) bailout plan to Congress, with the final structure still uncertain as of this writing

- Goldman Sachs and Morgan Stanley become bank holding companies

- Morgan Stanley sells 20% to Mitsubishi UFJ Financial Group (MUFG) in order to raise capital

- The Federal Reserve lifts rules limiting buyout and private equity firms from taking large stake in banks, such that they can own up to 30% (and 15% of controlling shares) of banks

- Warren Buffet invests $5bn in Goldman Sachs

- LloydsTSB and HBOS merge in the UK, creating the a megabank for the retail domestic business

Of these headlines, the Treasury's latest bailout plan and Goldman Sachs/Morgan Stanley bank structure change stand to have the most long-term implications. The Treasury is pushing Congress to pass a $700bn bailout plan (TARA – Troubled Asset Relief Act) in order to stem further financial firm failures, bolster liquidity and reduce the possibilities of a recession. This bill, which Federal Reserve Chairman Ben Bernanke and U.S. Treasury Secretary Henry Paulson are urging Congress to pass in short order, is being met with resistance and criticism from Capitol Hill, in turn keeping the markets hanging in the balance. The larger questions that are stalling approval are around the bill's vagueness and perceived impunity and broad new powers that the Treasury would gain. The ultimate decision Congress makes will change the speed at which the U.S goes into or avoids recession. First reactions to any decision will be seen in the stock market, followed by financial services firms further clamping down, which inevitably leads to IT spend considerations.

## A Tale of Two Crises

### *The Sub-Prime*

The steps currently being taken in the US are designed to remove illiquid assets from the balance sheets of financial institutions, in order to re-inject some confidence and stability into the markets. Part of the reason why the current discussions are tense is that ultimately all roads lead back to the consumer, who is both a contributor to the problem and a victim of the eventual outcome.

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Since 2002, US consumer debt has risen, in the aggregate, from just over $6 trillion to its present level of just over $11 trillion. Looking across categories of consumer debt, i.e. credit cards, auto, consumer finance, home equity and mortgage; the greatest increase has come with mortgages, which now stand at $8 trillion, or almost 78% of the total consumer debt. A significant portion of this increased debt, $1 trillion, has been issued to “sub-prime” consumers. On any given day, several thousand new consumers are landing in a default and foreclosure scenario. With the current proposals in U.S. Congress to set up a $700bn bad debt mortgage authority for the U.S. Treasury, one might ask the question, "Is it enough?" Will the ultimate tally approach $1.5 trillion or more? Given that these toxic assets have been securitized by global banks, international banks will need to be part of this plan.

Assuming a recessive economy in 2009, Financial Insights believes a bailout of $1.5 to $2 trillion would not be shocking. In the future, the ultimate cost of this bailout will come down significantly, when and if, the government is able to sell troubled assets back into the financial markets. Experts estimate net costs to taxpayers (the difference between government investment and re-sold mortgages) to be at or below $500bn. Whether in the case of the US or other government-led bailouts, the current financial crisis may lead to substantial regulatory adjustments to under-pin the long-term stability of the public finances. Protecting the consumer short-term will leave the US and many other economies dealing with a new challenge: that of government debt.

### *The Credit Crunch*

Globally the markets need to deal with the continued issues surrounding institutional liquidity. Although the industry by nature has had to deal with peaks and lows of the business, the most surprising part of this crisis is its unexpected length. It highlights the vulnerabilities of a global banking system.

Major financial institutions worldwide, both commercial banks and investment banks, are intertwined by a high volume of reciprocal short-term deposits. In calmer times, the ubiquity of such deposits on institutional balance sheets serves a valuable purpose, allowing each firm to optimize the utilization of liquid funds at the best rates available. The availability of such deposits is a significant benefit to financial institutions, both as lenders and as borrowers, in managing the mix of sources and uses of funds on their balance sheets. However, in unstable or nervous times, a firm's exposure to the deposit and redeposit market increases risk. Because such deposits are short term, near term maturities need to be constantly replenished by net borrowers, and in a crisis of confidence, replacement deposits become difficult to find. Initial uncertainties might be reflected only in a slight interest premium, but continuing uncertainty rapidly causes the providers of funds to avoid a suspect name entirely, preferring to place their funds elsewhere.

Recent financial history includes numerous instances in which a single financial institution became the target of a crisis of confidence,

whether due to the exposure of internal fraud, or a major strategic or tactical miscalculation. The markets have responded predictably, with many participants reducing short term exposures to weakened institutions by withholding new deposits. The system has coped with these crises, and the relevant authorities have either provided support to bridge a short-term liquidity gap at the affected institution or shepherding it, if necessary, into a new structure. The Federal Reserve, and Central Banks globally, has long provided such a bridge to US commercial banks via its "discount window," allowing the banks to pledge illiquid assets as collateral against short-term borrowings. The discount window has been used successfully as a safety valve, and without stigmatism, by numerous commercial banks.

What is different this time? In the current case, the Federal Reserve attempted to fill a short term liquidity gap in recent months, by its actions earlier this year when it opened its "discount window" to US investment banks (which had previously been ineligible to borrow from the Fed). As rumors continued to swirl, and typical interbank liquidity dried up, several investment banks as well as several commercial banks made regular and growing use of the discount window. It hasn't been enough, however, because of the depth of the underlying home mortgage crisis, compounded by the lack of transparency into the extent of associated weaknesses in multiple types of mortgage-backed securities. Without some extraordinary new initiatives on the part of the regulators, there is simply not enough liquidity in the "stop gap" measures of the discount window to bridge this particular gap. Worryingly, as bank ratings are lowered it is more difficult for these banks to get cheap loans on the wholesale lending market.

This has had unprecedented global effects, as we continue to "guesstimate" the exposure to first the sub-prime and now Lehman Brothers. The European Central Bank, Bank of England, Bank of Canada and other central banks in Asia responded to the events of last week by injecting more emergency funds into the system. For example, the Bank of England introduced a special liquidity scheme, which allows banks to swap untradeable mortgages for gilts for up to three years. More than £100bn have already been swapped, twice the original expectations. These emergency funds are also now being extended well beyond initial planned time frames.

These are exceptional measures for exceptional times. In the process they are also redefining the banking landscape and business models for years to come.

## The Regional Outlook

Although the US is bearing the brunt of the storm for now, a regional round up shows the extent of the exposure, each linked to specific regional issues. Countries most vulnerable remain those where high levels of debt result in consumers and companies being more exposed to eventual economic downturns.

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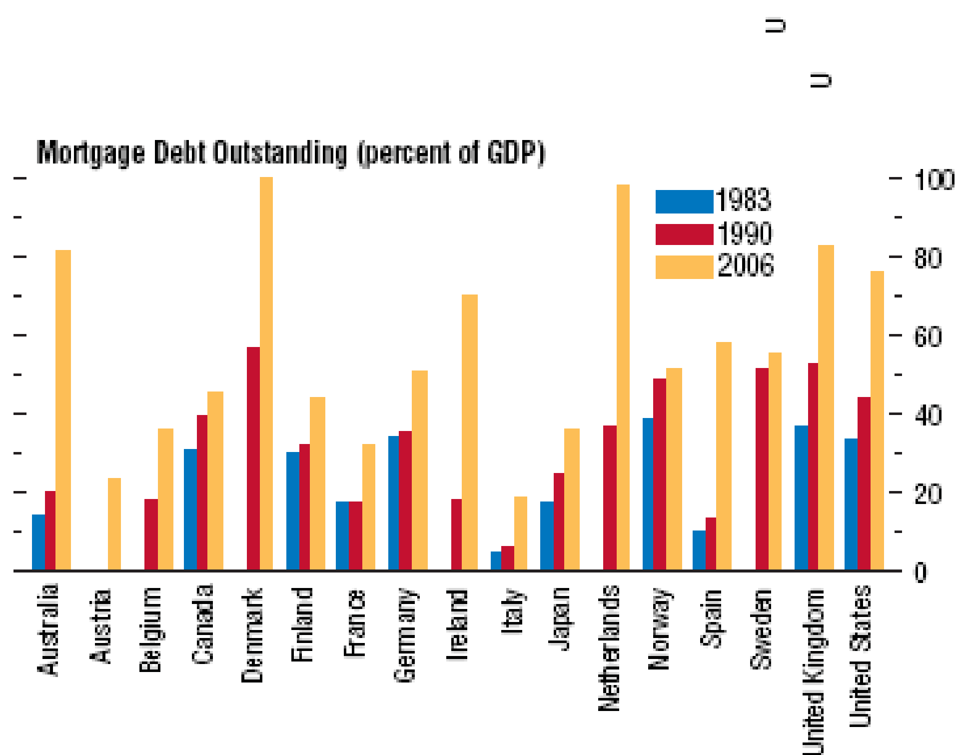
## FIGURE 1

Debt Outstanding Evolution




Source: National accounts; European Mortgage Federation, Hypostat Statistical Tables; Federal Reserve; OECD Analytical Database; Statistics Canada; and IMF staff calculations.

### *European Exposure*

Until now the somewhat unexpected consolidation of the financial services market was predominantly a US led phenomena. In Europe, only a few banks, Northern Rock in the UK (the first run on a bank in a 150 years) and Roskilde Bank in Denmark (along with a few smaller German banks) had to face the ignominy of bail out. The true extent of exposure to the sub-prime issues is still becoming apparent, but there are still banks walking wounded who are having to make drastic restructuring of their business. Unlike the US model, an integrated approach to investment banking was favored in Europe, but with an increasing blurring of the business lines. This is the case of UBS, a model that was a foundation to its success. In a complete reversal of strategy, UBS has now separated the four components of its business (whereby the investment arm had access to cheaper funding via its wealth management business) in order to stem the flow of its sub-prime exposure.

The sudden Lehman bankruptcy filing, followed by the LloydsTSB "rescue" of HBOS from another bank run, may change the balance. In this volatile market, there will be more speculations on which banks are future proof. The immediate possibilities for further consolidation are endless, especially if we add local issues such as in Spain where a number of smaller banks may yet face their own local crisis linked to

failing property development business. In addition many countries are still over-banked in Western Europe (Germany, France, Italy) and further consolidation is inevitable.

### *Asia Pacific Exposure*

Statistics and figures relating to sub-prime exposure in Asian financial markets have proven to be speculative and inaccurate. For example, in late 2007, the Korean Financial Supervisory Service (FSS) stated that the country's sub-prime exposure was limited to approximately $350m. However, in recent days the exposure to the collapse of Lehman Brothers and the takeover of Merrill Lynch (events directly linked to the sub-prime crisis) have been stated at $1.44bn. Clearly, the true scope of the impact of the sub-prime crisis in Asia is difficult to gauge with local and regional institutions unsure as to how far their liabilities extend.

The Asian economy, previously thought to be rather immune to the financial crisis in the U.S, is seeing the impact on countries heavily reliant on exports to the U.S and Europe. In addition, inflation concerns in countries like China, Australia, South Korea and especially Vietnam have many of the market players worried.

The next crisis for the region may lie in the bond markets. ING recently released data on maturing debt in emerging markets. A $111bn backlog of bonds that need to be refinanced over the next year has built up in the emerging market economies, while investors are taking money out as worries over global economic slowdown hit. This will have an impact on China, which may trickle through the region.

## ASSESSING THE IMPACT

Once liquidity is restored and stabilized for money movements between global banks and institutions they will then be able to offload non-performing mortgage assets to a national or international holding trust. Two key questions come to mind. The first question is whether ratings agencies will reverse their tsunami of company and bond issue specific downgrades handed out over the past year? Downgraded credit ratings due to increased default rates within asset-backed pools of many financial firms have impeded or destroyed many business models. The assumption can be made that firms and tranches will not be upgraded quickly or materially due to a federal bailout program.

The second question is more macroeconomic in nature. With consumers providing two thirds of the thrust to the U.S. economy, with a stabilized global financial services market, will consumer demand for goods and services begin to recover in the next 2 to 3 years? Macroeconomic growth in the U.S., but also in other countries such as the UK, has with the last expansion come from consumer demand for durable goods and services and has been financed to a material degree. This financed economic expansion placed consumers at the debt service breaking point. Consumers are saturated with debt and are going to be living with lower confidence and borrowing

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capacity for the next 2 to 3 years. Along with stabilization of liquidity among global banks and purchasing defaulted mortgage assets, policymakers will need to work out how to keep consumers in their homes and out of foreclosure. A massive U.S. federal or global program to refinance or re-work mortgage terms for consumers is advised, with the objective of spreading out the economic damage so that it does not hit the market all at once.

## A New Banking Industry

Economics aside, the most fundamental change will be in the fiber and structure of our banking industry. The U.S. banking model is evolving to look more like the Canadian or European one, where the large banking groups all have investment bank or capital markets arms. There are clear benefits, but also issues and further silos within the business. Across the Atlantic, the UK is seeing the merger of two banks, LloydsTSB and the largest mortgage lender, HBOS that would simply not have been allowed only 12 months earlier. Now the tripartite powers regulating the industry, the government, the Bank of England and the Financial Services Authority are taking measures to ensure that each bank in the country has a plan B or exit strategy. This is particularly the case for banks that have used the wholesale financing market as the main source of funding (as in the case of one of the last of the UK's large independent building societies Bradford & Bingley). What will the final picture look like?

### *Changing Rules*

In an effort to ride out the crisis Goldman Sachs and Morgan Stanley converted into bank holding companies. Both are seeking to gain access to the Fed window and a safer source of funding found in deposits. Goldman Sachs and Morgan Stanley already have deposits, but they are a very low percentage of overall liabilities compared to a traditional bank. Don't expect to see Goldman Sachs ATMs and branches popping up anytime soon, but rather expect to see deposits bolstered by making purchases of deposits in the wholesale market, deposits of failed banks and expansion through existing wealth management and brokerage clients. While not all stand-alone investment banks are dead, the remaining lot is more focused on M&A and underwriting, rather the prime brokerage and proprietary trading activities of their larger counterparts. Many are writing that Wall Street is dead, but in reality it is going through a major overhaul that should benefit the Street long-term through increased regulatory scrutiny, greater transparency into operations for investors and deleveraging of risky investments. The prime brokerage units will continue to operate and proprietary trading will tail back but not disappear.

### *Internationalization*

All is not bleak. Some banks are in a position to take considerable advantage of the current crisis. One of the fundamental changes we are witnessing is the internationalization of U.S. and Western European banking. In Europe, many banks saw welcome relief from Sovereign

Wealth Funds (in particular United Arab Emirates, Qatar and China). These are minority stakes, but likely to be a continued trend. In the US the situation is very different. Barclays now owns the US business of Lehman Brothers. Mitsubishi UFJ will acquire 20% of Morgan Stanley, resulting in almost one-third of the bank's stock being held by Far Eastern investors, Santander is rumored to be looking at troubled Washington Mutual, Canadian banks are likely to extend their significant US business operations. When the storm has passed, will this have a significant impact on decisions being made within the US banking system? In particular, will the foreign ownership lead to US banks investing into greater levels of core system renewal and consolidation as pressures are felt to become more operationally efficient?

### *Regulation Raises Its Head*

The US authorities are discussing the ramifications of a possible buy-out of illiquid mortgage-backed securities. Increasingly the discussion is around the lack of visibility into institutions' risk portfolio, or what constitutes the true value of these assets. Some critics point the finger to existing regulation, which no longer applied proper oversight to the financial markets. Others blame Basel II for the resulting liquidity issues in Europe, while institutional investors are blamed for accelerating the bubble through their weight in the market. In desperate measures to curb dwindling share prices, limits on short selling have been introduced by the SEC, the FSA and across the EU, and Australia. Responsibility with regards to risk is also discussed, as well as incentives and bonus scheme structures for the financial services industry.

There will be a backlash on banks and the new order will be one much more regulated with increased oversight. Already some discuss Basel III, adding new risk categories as the next step, while a review as to disclosure of financial banking results seems to be the next big step.

### *Business Models: Back to Basics?*

At the moment the business model favors a stable cushion of cash, and retail deposits are king. While Goldman Sachs felt they were on sound financial footing, it was clear that it was not Goldman who was in charge of their own destiny, but the organizations ensured their continued liquidity.

It is hard to determine if the banks that are now snapping up assets in the largest fire sale in history had a better business model or are hapless benefactors of the fact that they have made less fatal mistakes. Notwithstanding this determination it is banks that are now in the driver's seat for the foreseeable future. These banks are taking advantage of once-in-a-lifetime opportunities and creating a new financial services landscape. Large international universal banks are an emerging operational model that has been accelerated by recent events. This diversity of funding and lower concentration of business risk will re-shape the industry. Banks that most closely match this new model will prosper.

## The Ripple Effect on IT Spend

With the global turmoil in financial services, what will be the impact on IT spending? It remains important to look beyond the headlines and examine individual markets. Current reports from Asia indicate that vendors and financial institutions are proactively renegotiating existing contracts in light of substantial changes to market conditions. Further, Indian banks as recently as last week remain confident that IT spending will increase at a 25% year-over-year growth rate. Clearly there are impacts globally, but it is dangerous to generalize based on top-line assessments. Financial Insights has examined the afflicted institutions and predicts that IT budgets for those firms will be reduced $2.7bn for 2009. This reduction is the net effect of specific bank spending changes dating from the Bear Stearns acquisition through to the latest turmoil of this week. Some institutions, such as Bank of America and JPMorgan Chase, are increasing spend to quickly integrate the acquired entities. Firms such as Wachovia and Washington Mutual are staying the course for now, but holding the line on new projects.

Specifically, Financial Insights expects overall budgets at the former five Wall Street investment banks will see pullback, but in varying ways.

- The Survivors: For example Goldman, whose first half 2008 IT spending actually rose 20% from 2007, will need to spend more to diversify its business and meet new Federal Reserve regulatory requirements, while still maintaining the support of its prime brokerage activities and trading units. Spending will likely need to be maintained on infrastructure and telecommunications but expect softening from front-end desk level applications and a freeze on many planned new projects.

- The Merged: Merrill Lynch brings units to Bank of America that have little overlap, so there will need to be a due diligence effort to leverage Merrill's best of breed technology and move what it can onto Bank of America's existing infrastructure, which will likely mean reductions seen in the form of IT staff reductions.

- The Fallen: Lehman Brothers will likely see overlapping IT staff reductions and IT spending cuts from business units that might be closed if Barclays/ Nomura deems them unnecessary.

Financial Insights estimates that firms hardest hit by the market swings and turmoil are reducing IT investment by postponing all discretionary spend, which our surveys show amounts to 22% on average for the industry. For institutions in bankruptcy, the impact is very similar, as spending is placed under a microscope by the receivers running the firm. Those benefiting from government bail-out are harder to evaluate, so for now, spending estimates remain unchanged.

However, there is a more nuanced story that will play out over the next five years. In 2009, future spending reductions expected through

merger activities will not yet be realized. Integration spend will first spike immediately post-acquisition, with cost savings realized beginning in year two. Looking at historical data, when RBS acquired Natwest, then the largest integration project in the history of UK banking, expenditure attributed to the cost of integration rose to £520 million in the first 12 months.

That is not to say that there are not immediate impacts to technology spending. Any discretional spend is being examined, with banks such as Wachovia reporting publicly that they are preserving capital by delaying or canceling $350m in planned capital expenditures for 2009. There will also be immediate impacts from the overlapping vendor relationships acquired institutions have with acquiring institutions. Technology vendors are reporting difficult contract renegotiations as details of contracts are reviewed and the acquiring institutions exercises its new strength by negotiating discounts.

There will be a shift in spending in sell-side capital markets technologies that will be more far-reaching. This is the segment of the financial services industry most willing to adopt innovative technologies and take a chance on small firms. With commercial banks now making decisions for Merrill Lynch and Bear Stearns, there will be less willingness to take risks for the sake of competitive advantage, and a more measured approach to tech investing. Spending will instead be funneled into bigger services, outsourcing, and infrastructure deals, led by the likes of Accenture, CSC, HP, IBM, and TCS. A shift to software as a service, which was already progressing throughout banking and capital markets, will accelerate. With capital investing under pressure, software as a service allows institutions to introduce new capabilities faster, and with limited impact on capital expenses.

## GUIDANCE

### Advice For Banks

It appears that the financial community is split into two factions, those who are weathering the economic storm and those who seek to profit from it. The effectiveness of the strategies of both these groups will depend on further market and regulatory developments. We can divide actions into three key groups:

**The Consolidators**: Those banks that either through luck, more risk averse mentalities, or greater oversight into their growth strategies have come out of the storm unscathed and are now focusing on cherry picking the best opportunities. These also include banks that have the infrastructures that enable them to make acquisition both because of low cost and ability to streamline systems rapidly. This is the case of Santander for example. These banks will need to ensure that they create short-term return on investments from their acquisitions. They will have to identify opportunities for integration and consolidation of applications, focus on leveraging existing enterprise systems. As they grow in business or geographic scope the biggest danger is to lose

visibility. There are no direct correlations between size of a business, return on assets or size of IT spend.

**The Survivors**: Many banks will be in a situation where the crisis will have been a costly experience, battling for existence. Many will now be looking at taking cost out. Banks that have stood still, focused on good old banking practices and kept existing systems and processes in place may have been saved because they had kept away from more complex securitized products, perhaps because of the limitations of their legacy systems. However, looking forward the time will be ripe for reviewing their strategy and making difficult decisions with regards to their existing systems. This is not changing business strategies, but catching up with industrialization principals for their IT infrastructures. In particular in the U.S. as consolidators revamp systems in the U.S. market, pressures to remain cost competitive will accelerate.

**The Differentiators**: Across regions, a large number of smaller banks will survive despite consolidation in the market. However these institutions will need to focus on their value proposition, which is servicing the customer. These banks will need to center their efforts on owning the customer, quality of service delivery and understanding of their local market requirements (especially where small and medium businesses are concerned). If they have not done so already, these banks will need to take difficult sourcing decisions. Areas, which do not sit in their core value proposition, need to be outsourced whether this is to another bank, service provider or technology partner. Care must be taken not to outsource solely based on cost, but based on whether it is core to the business.

For all these groups a review of current and planned projects will be required. However banks need to be careful not to stifle their competitive drive. The increased consolidation will make it a harder market to play in.

## Advice for Vendors

Historically vendors have been behind the curve in preparing for potential market downturn. Although the exact quantification of the decrease is still difficult to assess long term, banks are postponing decisions as to hardware and software upgrades and sales cycles are likely to lengthen.

**Cost cutting**: Vendors need to prepare for a potential downturn by focusing on cost optimization. For those that have not yet done this, the focus should be on cheaper production in particular in the area of software. Streamlining development and testing, insuring synergies in upgrades of product portfolios will be key. They will also need to concentrate on projects that maximize value. Many larger vendors will need to take overhead costs out rather than impact customer and implementation focused resources and activities.

**Maximize order books**: Vendors need to learn from past mistakes by not making overhead cuts that will impact on the quality of their service delivery. They are likely to see a reduction in their order books. Now is the time to guarantee revenues from every project. Deliverables need to be met in a timely fashion, meeting high quality standards that will increase the likelihood of the bank keeping the project live. In the past, delays on implementations drastically reduced ROI for the banks and led to projects being terminated. This will be critical in weathering the storm and gain advantage in a market that will invariably refocus back to ROI.

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- *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)
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