

# The New Financial Services Marketplace

## Restoring broken markets





# Foreword



The global financial system is undergoing a dramatic transformation. A period marked by high leverage and ever more complex financial products has come to an end. In its place, a new financial services marketplace that is now emerging will require different strategies and different business models.

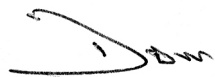
I am pleased to present the first in a series of papers by the Deloitte Center for Banking Solutions on the new financial services marketplace and its implications. The present paper examines the trends driving the new marketplace and how they will affect financial institutions. The next two papers will address the implications for government regulation and for financial business models.

Although the new financial landscape is still taking shape, many of its main features are becoming clear. Institutions and individuals are seeking to reduce risk, which will mean an increased demand for simpler, more transparent financial products. Investors are seeking financial institutions with stronger capital positions. And, with securitization markets effectively closed, the traditional banking model of taking deposits and originating loans is reclaiming its former importance. These trends have important implications.

In response, financial institutions are seeking to strengthen their balance sheets by boosting capital and reducing leverage for high-risk activities. The increasing importance of lower-risk products is placing pressure on margins, making a commitment to continuous efficiency improvement even more important. Finally, deepening customer knowledge and building long-term relationships is assuming greater importance.

We hope this report on these trends and their implications stimulates your thinking as your company fashions its response to the new financial services marketplace.

Sincerely,



**Don Ogilvie**  
*Independent Chairman*  
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# Executive summary

The integration of global financial markets has created significant benefits in terms of financing and investment options, but it has also created additional systemic risks, as evidenced by the current financial crisis. This integration was facilitated by the growth of risk transfer products that contributed enormously to the prosperity of recent years by allowing risk to be measured, hedged, and distributed to liquid wholesale markets through multiple intermediaries. As we witnessed from the events in the last few decades, financial engineering took markets to new levels and transformed the financial system, creating more credit and investment options than ever before.

The credit crisis changed this. A financial system based on confidence suddenly stalled. In its stead, a new financial services marketplace is emerging — one that invests in simplicity rather than complexity and seeks safety and soundness above all else. After a long period of disintermediation by wholesale markets, banks are once again the primary providers of credit that is grounded in the strength of their own balance sheets.

Governments are investing heavily in restoring confidence in the system as a whole, exploring fresh and potentially more effective approaches to the regulation and assurance of both traditional and alternative sectors. How this will be accomplished and to what lengths they will need to go remains a work in progress.

In this paper, we explore the emerging trends shaping this new financial services marketplace and the implications for financial institutions. In two subsequent papers, we will explore steps to secure a safer and sounder marketplace and the financial business models that are likely to thrive now and in the future.

As this new marketplace takes form, its ultimate structure remains elusive, but the trends shaping it are becoming clear. Already, it is characterized by simplicity over complexity, capital over leverage, transparency over opaqueness, reintermediation over fragmentation, and the growing influence of cash investments over structured ones. Most dramatically, the government has become a significant investor in institutions and markets. Nearly 500 institutions have received capital infusions under the administration's Troubled Assets Relief Program (TARP) program.

The implications for financial institutions are a return to fundamentals — strengthening customer franchises and retail deposit bases; building more robust risk and liquidity management systems; clarifying the role of rating agencies; and a consistent focus on developing leaner, more efficient operating environments. The new marketplace may also seek a greater focus on stronger markets, settlement systems, and institutions. Financial institutions will need to respond accordingly.



# A new marketplace emerges

A new marketplace is emerging from the credit crisis. The crisis appears to be creating a simpler financial marketplace and spurring a return to basics for many financial institutions. The new marketplace can be characterized by six key trends that will likely have significant implications for financial institutions in the months and years to come.

- **Banks reintermediate.** Stalling wholesale markets and the collapse of securitization restored banks' position of primary credit providers based on the strength of their own balance sheets. Since the 1970s, the development of wholesale markets has altered banks' traditional deposit-lending model in favor of non bank financial institutions. Ultimately, this alternative system provided nearly half of the economy's credit needs, with banks relegated to the role of originator and warehousing agent. Today, the traditional holding company model has been validated, and banks find themselves with a significant opportunity to play a defining role in the recovery process, under the spotlight of enhanced accountability and a need to restore public trust in financial management.
- **Governments become temporary owners.** The U.S. Treasury has injected capital into banks in an effort to strengthen their balance sheets, taking preferred stock in return. Governments in some other countries have taken similar actions. However, government investments create new complications pertaining to issues of control and exit strategies. To date, newly involved governments have influenced executive compensation and dividends. The Financial Stability Plan,<sup>1</sup> recently announced by the U.S. Treasury, requires banks to be more transparent about their exposures and the extent to which they will use government capital to support new lending. The potential influence of regulators on strategic planning and operations is also becoming apparent.<sup>2</sup> The auto industry has found the price of government support to include decisions about management structure. As a result, banks may need to become much closer to their regulators.

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Still, government support is only temporary, and institutions must prepare for its eventual withdrawal. The particulars of the government's exit strategy — especially timeframe and legacy issues — remain unclear.

- **Markets consolidate.** The U.S. banking market has been consolidating for decades, and the current crisis is accelerating that process. Between the end of 2007 and the third quarter of 2008, the top five U.S. banks' share of total banking assets increased from just over half to nearly two-thirds. This trend is occurring across the financial services industry as larger, more diversified institutions emerge from the crisis. These financial institutions will face the task of managing larger enterprises that combine very different cultures. This may pose challenges that affect talent management, compensation, business models and operations for acquirers and their targets. It may also lead some customers to move to other institutions, diminishing the value of the acquisition. Conversely, acquired customers may not fit the business model of the new enterprise, or they could introduce additional, unanticipated risks. Allowing stronger institutions to acquire weaker ones may prevent liquidations and smooth the process of recovery, but it may also lead to the creation of ever larger and more complex entities.
- **Markets and products shift to lower-risk businesses.** The pre-crisis marketplace was characterized by a search for exceptional (alpha) returns that usually involved more risk and leverage. Many alpha businesses,

such as hedge funds, investment banks, and private equity firms, that flourished before the crisis now face declining revenues and negative returns. As a result, the emerging marketplace suggests that financial institutions might become more dependent on their safer and more predictable (beta) businesses, such as cash management, asset management, custody, trust and settlement services, for revenues and margins. Extreme consolidation in the alpha sector could lie ahead until a new form of alpha emerges.

- **Institutions emphasize capital and liquidity.**

Deleveraging is the hallmark of the new marketplace. A flight to quality has battered the credit markets. Despite government support, concerns about the adequacy of bank capital and liquidity persist, and possible higher future requirements for capital ratios may reduce returns on assets and equity. Institutions may need to reconsider the impact of funding strategies that create dependence on volatile, short-term markets, coupled with deposits that can be moved with mere mouse clicks.

- **Consumer protection has intensified.**

The administration has signaled its intention to regulate the provision of all financial services. Government guarantees on bank deposits have increased to \$250,000 and extended to money market mutual funds. Compensation has been paid to investors in auction rate securities and collateralized debt obligations. Banks even offered loan modifications to mortgagees to forestall foreclosure. New rules have been adopted for the credit card industry that shield borrowers from increased interest rates on existing balances. These point to the need for a new contract between the customer and the financial institution — one based on a deeper understanding of needs and the restoration of trust, which will ultimately drive a closer relationship for the longer term.



# Unintended consequences

Government initiatives to restore the health of the financial system have been aggressive, although many of the details of recent announcements remain unresolved. Despite this, the economy continues to deteriorate. The recently announced U.S. Financial Stability Plan suggests that government involvement will expand before any retraction occurs. Current proposals recommend requiring banks to retain exposures in securitizations, and for government to increase regulatory oversight of hedge funds and the Over-the-Counter (OTC) market. Governments, in fact, seem to be going beyond investing in institutions and markets to addressing many of the fundamental weaknesses in the financial system. As a result, new chapters in the history of central banking are being written.

Yet, government support may have unintended consequences. First, in rescuing institutions, government cannot avoid making decisions about winners and losers, which could perpetuate business models that are no longer viable. Furthermore, a regulatory response that is too intrusive may impede innovation, which could then find an outlet through less controlled channels and create additional risk. In a recent survey by the Deloitte Center for Banking Solutions, over 50% of bank executives favored more effective regulations while only half that number supported an increase in the amount of regulation.<sup>3</sup>

Secondly, by deeming institutions “too big to fail,” government could make them less rather than more sensitive to the importance of increased governance and improved risk management. If government eliminates risk, how will the market learn to manage it more effectively? Other concerns abound. At some stage, investors could become anxious about the debt required to pay for the bailout packages and economic stimulus plans and become reluctant to finance increasing levels of public debt. Recent increases in credit default swap premiums for the United States and the United Kingdom reflect this concern.

The recovery process has involved larger institutions acquiring financially challenged ones. This has avoided bankruptcies in the short term, but it has created larger, more complex institutions in the longer term. New cultures and customers must be absorbed and businesses integrated if mergers and acquisitions are to be successful. Linger questions from the previous marketplace — how to better integrate governance, risk and compliance into the organization and instill an enduring culture of accountability — will likely remain for these new mega-firms to answer.

Another possible unintended consequence has to do with consolidation of the global financial system. Today the top ten banks in market capitalization represent a much greater share of the global financial system than in previous years. This concentrates risk in fewer but larger institutions. The larger these institutions become, the harder it may be to rescue them. As a result, countries — especially smaller ones — may find it more difficult to provide sovereign support in the event of difficulties. We have seen this most recently in the failure of Iceland’s commercial banks. While Iceland has been the most visible example of bank assets surpassing its country resources, other sovereign nations also face this risk. As regulators extend their oversight across all parts of the financial system to include the alternative sector, the cost of providing longer term support increases.

# Implications

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The ability to manage risk has become a competitive differentiator and a key driver in reshaping the industry ...the new marketplace will require cooperation rather than competition to create safer, more transparent markets and stronger settlement systems for OTC derivatives.

To reverse the current downturn and maximize the investment opportunities created by government support, institutions will likely need to embrace fundamental reform in some core areas:

- **Fortress balance sheets emphasizing strong capital and liquidity positions.** Current capital ratios are increasing; in the United States, these levels are now equivalent to their highs during the 1930s and 1940s — a period of extreme insecurity brought about by recession and war. These levels may be necessary to restore confidence in financial institutions until markets recover. The issue is not limited to banks, because hedge funds are facing unprecedented pressure for withdrawals and have significantly increased their cash holdings. Private equity firms are no longer able to access leveraged loan markets, resorting instead to smaller investments or the purchase of distressed assets. With the closing of securitized markets, finance and credit card companies also increasingly need to access retail deposits, and they may need to revisit business models to restore profitability.
- **Closer alignment of capital with risk.** Many institutions are revisiting economic capital models that adjust for risk and alternative returns. In a tougher capital environment, this makes discretionary investments less attractive and reinforces the importance of focusing on the enterprise's mission and core business. The logic of the pre-crisis marketplace suggested that higher-risk

businesses needed less leverage than lower-risk ones, because investment banks were more highly leveraged than commercial ones. The new marketplace reverses this logic and creates much greater deleveraging in the alternative banking sector.

- **Greater importance of risk management.** The ability to manage risk has become a competitive differentiator and a key driver in reshaping the industry. In this case, risk embraces liquidity in addition to the traditional pillars of Basel II — credit, market, and operational risks. There is a natural tension in bank and non bank sectors to fund long-term assets with short-term deposits. For several decades, the ratio of bank deposits to liabilities has been declining. A number of institutions in the alternative banking sector combined very short-term funding with historically high leverage ratios. When credit markets became tighter, short-term funding became difficult to renew, increasing systemic risk and the likelihood of insolvency. The new marketplace will require cooperation rather than competition to create safer, more transparent markets and stronger settlement systems for OTC derivatives.
- **Continuous efficiency and performance improvement.** A focus on cost management can no longer depend on the phase of the business cycle. Instead, it should be embedded in the culture of the enterprise. Research by the Deloitte Center for Banking Solutions suggests that more efficient institutions generally enjoy higher returns, faster growth, and superior stock-price performance.<sup>4</sup> The importance of efficiency is reinforced by the additional challenges to profitability and balance sheets that less efficient institutions endure when absorbing the shock of higher credit costs. This also reinforces the risks of creating larger, more complex institutions, where scale may decrease costs but organizational complexity amplifies the difficulties of achieving continuous efficiency improvements.

# Strategies for the new marketplace

The crisis has created a new marketplace that is radically different from its predecessor. The leveraged business models that defined the pre-crisis global markets are dead or at least temporarily in abeyance. Instead, financial business models now appear to be focusing on the importance of bank deposits and savings. Consumers and commercial customers alike are deleveraging. Although the full extent of this change remains unclear, business models that relied on securitization or the leverage of proprietary trading and structured investing face obsolescence. Almost all financial institutions relied on this to some degree.

If anything, the current crisis has validated the viability of the traditional banking business model that is funded by customer deposits. This is evident in the current pursuit of deposits by numerous institutions as well as in the rising number of credit card companies, insurers, and securities firms now seeking holding-company status. Still, with a weak economy and ailing consumers, banks will have to restore themselves internally to financial health. This will likely involve three key steps:

- **Rebuild the customer relationship.** Larger, more complex financial institutions that have emerged from the crisis are providing customers with a wide range of financial products, from checking accounts to alternative investments. However, banks are retaining product-focused business models and siloed organizational structure. Many of these institutions have not built enduring customer relationships based on an understanding of financial needs or longer term value. This has made it difficult for both consumers and businesses to create a holistic relationship with institutions that are designed to operate as a collection of individual parts. As a result, many consumers — particularly affluent ones — have relationships with a variety of banks to address their myriad needs.

As capital markets become less accessible, banks find themselves again in a position to choose the relationships that best support their business as the primary providers of credit. This is an opportunity to engage with customers, develop a deeper understanding of their needs, build longer term relationships, and achieve a greater share of wallet by providing a much broader range of products.

- **Strengthen risk management and compliance.** Although risk management is a competitive issue for many institutions, the industry may continue to lack a consensus around a “best practices” approach. Research by the Deloitte Center for Banking Solutions suggests that governance charters and risk

management approaches vary from one institution to the next. Compliance structures in some firms have also struggled to keep pace with a more complex environment.

Many new and enhanced regulatory requirements and standards have been adopted or proposed since the onset of the credit crisis. The Financial Stability Forum made recommendations on five main areas: stronger oversight of capital, liquidity, and risk management; enhanced transparency and valuation of assets; changes in the role of credit ratings; strengthening the responsiveness to regulatory risks; and more robust arrangements for dealing with stress in the financial system.

The Institute of International Finance<sup>5</sup> and the Counterparty Risk Management Policy Group III<sup>6</sup> made over 200 recommendations, the latter calling for a “private initiative” to complement official oversight and reduce systemic risk in the financial marketplace. All of these recommendations focus on the need to address the modern financial system’s risks, including three levels of response: one from institutions themselves; one from industry associations where institutions put competitive issues aside to cooperatively develop a safer and sounder marketplace; and one where regulators play a key oversight role.

- **Develop a culture of continuous efficiency improvement.** Financial institutions tend to favor cyclical rather than sustained efficiency improvements. Some favor short-term cost reduction initiatives with limited impact over longer term efficiency programs. As a result, financial cycles have often been intensified by strong hiring programs during upswings and significant layoffs during downturns. The efficiency ratios of many larger institutions have deteriorated during the current crisis. With the return to beta businesses, lower margins will require leaner, more tightly managed operations and a sustained approach to efficiency improvement. Although this may be new to many financial institutions, the goals and methods of quality and process improvement have been adopted by dozens of other industries, often with excellent operational and financial results.

Conserving key operating skills will be important as financial institutions reduce costs. To achieve this, management should focus on longer term strategies and avoid the temptation to embrace short-term results. The current crisis reveals an important lesson: Banks with a consistent track record for improving efficiency have generally weathered the crisis most effectively. This endowed them with a stronger equity cushion in terms of market capitalization and margins to absorb increased credit costs.

# Survival 2.0

Most faltering industries suffer a slow decline. For financial institutions, this decline can be immediate and economically devastating. Until the onset of the current crisis, many believed that major financial dislocations were a thing of the past, and that markets could be controlled by models and managed by the laws of probability. The new financial services marketplace will address some of the shortfalls of its predecessor, but the economic turbulence that has characterized financial services since its inception is not likely to disappear.

Governments and institutions are trying to restore broken markets through partnerships between private and public capital and addressing the fundamental issues that led to the market's downturn. Funding alone will not restore confidence in fragile markets and institutions. Regulators will likely expand their scope to include both traditional and alternative sectors in an attempt to restore systemic safety and soundness. An extended regulatory charter brings the prospect of a broader safety net to contain future market freefalls. The question remains: Is an ample safety net sustainable on a long-term basis at a price that markets can absorb and government can support?

Financial institutions will be constantly challenged to navigate shifting or broken markets. To this end, they will need to develop business models that are sensitive to industry cycles rather than overly dependent on them. They will also need to maintain strong customer franchises, more robust risk management systems, and consistently leaner operations. Institutions that can make these fundamental adjustments in response to changing market structures may be the ones that survive and thrive through the marketplace's many iterations.

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## About the Center

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The Deloitte Center for Banking Solutions provides insight and strategies to solve complex issues that affect the competitiveness of banks operating in the United States. These issues are often not resolved in day-to-day commercial transactions. They require multidimensional solutions from a combination of business disciplines to provide actionable strategies that will dramatically alter business performance. The Center focuses on three core themes: public policy, operational excellence, and growth.

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## Endnotes

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<sup>1</sup> U.S. Treasury Web site - <http://www.treas.gov>.

<sup>2</sup> "U.S. Ratchets up its Citigroup Oversight," Wall Street Journal, December 17, 2008.

<sup>3</sup> Based on a sample of 1,500 financial services executives, the results may not be representative of all financial executives.

<sup>4</sup> "Improving Efficiency — The new high ground for banks", Deloitte Center for Banking Solutions, 2009.

<sup>5</sup> "Final Report on the IIF Committee on Market Best Practices," IIF, April, 2008.

<sup>6</sup> "Containing Systemic Risk - The Road to Reform", Counterparty Risk Management Policy Group, August 2008.

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