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FS Insights

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2010: The Year Ahead for Financial Services

The American poet and philosopher Henry David Thoreau said "Never look back unless you are planning to go that way." This would be considered sound advice in many circumstances. After all, there is nothing we can do about events that have already happened – except, we hope, learn from our mistakes.

As the global financial crisis has unfolded, we have already learned a number of lessons, including:

- **If it sounds too good to be true, it probably is.** It was never realistic to believe that real estate prices in the United States could only go up or remain constant for an indeterminable period.
- **We live in a global economy.** If the largest economy in the world falters, the rest of the world will be affected.
- **Incentives influence behavior.** Because of improperly designed compensation incentives, financial institutions did not raise sufficient capital to withstand an economic downturn, did not develop effective risk management systems and did not pay attention when risk managers did signal warning signs. They rewarded management and employees for performance with little consideration to the risk their actions presented to the institutions.
- **Lack of transparency can fuel a crisis.** When the market cannot be certain of the exposures that exist among its counterparties, it may stop functioning altogether.
- **Liquidity can be as important as solvency.** If stakeholders lose confidence in a business, the seeming strength of the business's balance sheet may not matter.

The interesting thing about these lessons is that we already knew them to be true. The challenge is, therefore, determining what we can do now to make these lessons "stick."

So, as tempting as it is for the financial services industry to try to forget 2009, there is little doubt that many parties, including lawmakers, regulators, academics and the media, will continue to look back at the causes of the financial crisis and try to identify steps that can and should be taken to prevent a recurrence of the same magnitude. Individual financial institutions will also continue to consider what they might have done differently to weather the crisis better. But as the various parties seek these answers, financial institutions need to get on with managing their businesses. They will face a number of challenges as they attempt to recover from the continuing effects of the financial crisis.

To varying degrees, depending on their unique circumstances, most financial institutions will face the following challenges in 2010, many of which are interrelated:

- Managing regulatory changes
- Dealing with more intrusive regulators
- Addressing continuing credit problems
- Managing and optimizing capital
- Attracting and retaining talent
- Restructuring their businesses
- Improving risk management
- Upgrading technological infrastructure and data management capabilities
- Planning better for the future
- Not losing focus on their customers

The changing regulatory landscape will be a significant challenge for the financial services industry in 2010. Some institutions may find themselves supervised by new, different and/or more regulatory bodies, and most will need to deal with the implementation of a rash of new regulatory requirements covering topics ranging from consumer protection to liquidity management. Multinational financial institutions may find themselves especially tested as they attempt to address inconsistent requirements across the various markets in which they operate because – despite all of the official rhetoric on the need for uniform requirements on a global basis – the pace and nature of change in the major financial markets have not been in sync. Perhaps even more daunting than addressing new regulatory requirements, however, will be the need to deal with more intrusive regulators.

Perceptions regarding the capabilities and commitment of regulators across the globe have been tarnished by the financial crisis, and existing regulatory bodies are intent on proving that they are up to the challenge. As a result, we can expect to see more challenging of management decisions and swifter regulatory response at the individual institutional level.

Financial institution management, either because it is clearly the right thing to do or because regulators insist, will need to focus on improving risk management.

The financial crisis, which began with the collapse of the subprime mortgage market in the United States, quickly grew into an economic crisis that affected borrowers and counterparties of all types. Past due, nonperforming and foreclosed assets have continued to increase. As with unemployment, improvement in these areas will lag the economic recovery. Financial institutions, therefore, have a long way to go to work through their credit problems, and credit issues will continue to have an adverse impact on earnings and capital adequacy. The way financial institutions, with the concurrence of governments and regulatory bodies on issues such as valuation and write-offs, manage their problem assets may have a marked effect on the recovery timeline.

Beyond credit issues, capital will be affected by regulatory requirements for more capital, including buffers (e.g., convertible subordinated debt) that can be triggered in bad times. This will heighten the need for financial institutions to ensure that they are optimizing the capital they do have. For many institutions, this will require enhancing their methodologies for capital allocation, as well as their capabilities for measuring customer and product profitability.

Attracting and retaining talent has always been a mandate of the financial services industry. Many believe it will become even more difficult with the restrictions on incentive compensation being considered and imposed in many jurisdictions, particularly if these are not implemented uniformly across all types of financial services companies and across jurisdictions.

A significant restructuring is likely to occur in the financial services industry over the next several years. Capital and earnings needs – and perhaps regulatory pressure – will result in many companies choosing to divest of businesses, creating acquisition opportunities for stronger, better-positioned companies. On both sides of a transaction, there will be the need for effective change management that does not disrupt day-to-day business activities.

Financial institution management, either because it is clearly the right thing to do or because regulators insist, will need to focus on improving risk management. This will include, but will not be limited to, better risk identification, breaking down the management silos that exacerbated problems in many institutions, improving the use of predictive modeling, and better risk monitoring and reporting.

Integral to improving risk management will be upgrading technological infrastructure and data management capabilities. In fact, the Senior Supervisors Group in its October 2009 report titled *Risk Management Lessons from the Global Banking Crisis of 2008* highlighted “inadequate and often fragmented technological infrastructures that hindered risk identification and measurement” as a key industry weakness and said that improvement in IT infrastructure is “critical to the long-term sustainability of improvements in risk management.” The board of directors will most certainly weigh in when management considers these issues, as many jurisdictions are advancing debate around the appropriate level of risk oversight by boards.

Perceptions regarding the capabilities and commitment of regulators across the globe have been tarnished by the financial crisis, and existing regulatory bodies are intent on proving that they are up to the challenge.

Legislators and regulators in some major financial centers, the United States and the United Kingdom among them, are piloting or are considering imposing requirements that mandate that systemically important financial institutions develop “living wills” – comprehensive plans for unwinding operations in the event of trouble. Such plans will go far beyond the contingency planning in place at most large institutions. While such measures will present a daunting task for management, they at least will drive management to think about exit strategies when undertaking potentially significant risks.

Finally, while financial institutions are addressing all of the above, they can never lose sight of ensuring that they are delivering the products and services their customers want. For some institutions, there also will be a need to recapture customers lost during the crisis.

These and other challenges will continue to test the mettle of management and boards of directors of financial institutions. How well individual companies are able to respond to them will shape the industry landscape for years to come.

Key Lessons and Necessary Reforms: A Central Banker's View

In a speech in late November 2009,[1] European Central Bank President Jean-Claude Trichet said that the financial crisis "debilitated the real economy" and "deprived our citizens of confidence." At its center, the financial crisis disclosed a fundamental fragility in the international financial system that resulted in no market or category of player being spared from the effects of the crisis.

The ultimate goal of financial reform is, in Trichet's words, very clear – "the financial sector will have to return to its role of providing the best possible service to the real economy."

Addressing this fragility, Trichet believes, will require revisiting certain macroeconomic policies, particularly those that lack sustainability; refining and broadening the nexus between financial markets and the macro-economy; and, at the level of national economies, reinforcing measures to strengthen the structural engines of their economic systems.

For each of the three dimensions – the financial sphere, global governance, and the structural setup of local economies – Trichet outlines the reforms that he believes are necessary.

The ultimate goal of financial reform is, in Trichet's words, very clear – "the financial sector will have to return to its role of providing the best possible service to the real economy."

To accomplish this and make the financial system itself more resilient to future meltdowns, Trichet identifies three key steps that should be taken:

1. Improving the quality and quantity of bank capital and liquidity buffers in good times in order to mitigate the cyclicality of market economies
2. Enhancing the transparency of financial markets to allow for informed decision-making by market participants
3. Reforming executive compensation schemes and practices to discourage excessive risk-taking

Each of these three objectives is on the agenda of lawmakers and regulators in major financial markets. While certain jurisdictions, notably in the United States, have yet to establish how they will improve supervision to prevent or at least lessen the effects of future crises, Europe will follow a two-pronged approach: the formation of the European System of Financial Supervisors, a college of national supervisory authorities that will share information cross-border; and the establishment of a European Systemic Risk Board, which will provide early warnings and issue recommendations aimed at preventing undue risk buildup.

For the approach to reforms to be holistic, Trichet believes that there must be a rethinking of the links between financial behavior and macroeconomic policies, and proper alignment between the macroeconomic policies at the domestic level, with the objective of global financial and economic stability. Here, Trichet draws encouragement from what he describes as the "virtually universal consensus on global economic issues" that the G20 has been able to reach.

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At the structural level, Trichet acknowledges that reform ultimately must be the responsibility of local economies, but highlights the importance of addressing issues such as the following:

- Wage-setting practices
- Training and investing in a workforce
- Current account imbalances
- The need for restructuring the banking industry (particularly medium-sized institutions) to achieve tighter synergies and economies of scale

Trichet looks for these reforms, taken together, to help restore lost confidence and continue to promote economic stabilization.

[1] Speech by Jean-Claude Trichet, President of the European Central Bank, at the "Annual conference 2009," organized by the Asociación de Mercados Financieros, Madrid, November 23, 2009, available at http://www.bis.org/review/r091126a.pdf.

For More Information…

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Protiviti's dedicated Financial Services practice includes professionals with deep industry experience in banking, insurance, brokerage and investment companies. These financial services professionals can work with you to find approaches to help you improve and establish strategies for your business as changes in the industry and regulatory environment impact your organization.

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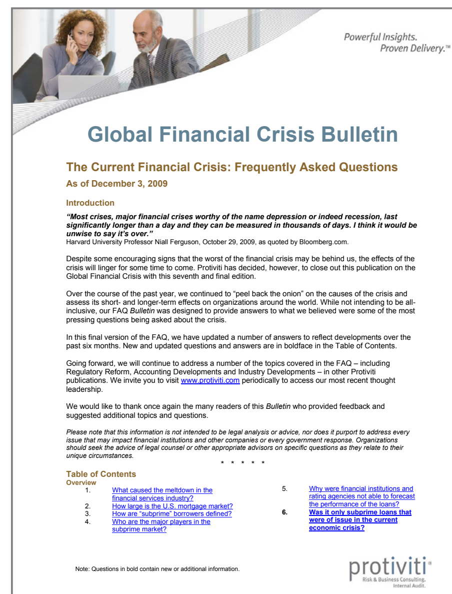
Read Protiviti's Latest Global Financial Crisis FAQs

While the effects of the financial crisis will be felt for some time, there are positive economic indicators suggesting that the worst may be behind us. With this seventh and final edition of our FAQ Bulletin, Protiviti shares insights on the most recent developments in this ever-changing business climate.

Over the course of the past year, we continued to "peel back the onion" on the causes of the crisis and assess its short- and longer-term effects on organizations around the world. In this edition of the FAQ, we have updated numerous questions and answers to reflect developments over the past six months in areas including new accounting rules and regulations, mortgage loan modification, and consumer credit. Going forward, we will continue to address a number of the topics covered in the FAQ – including regulatory reform, accounting developments and industry developments – in other Protiviti publications.

We invite you to visit **www.protiviti.com** periodically to access our most recent thought leadership.



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Global Financial Crisis Bulletin

The Current Financial Crisis: Frequently Asked Questions

As of December 3, 2009

Introduction

"Most crises, major financial crises worthy of the name depression or indeed recession, last significantly longer than a day and they can be measured in thousands of days. I think it would be unwise to say it's over."
Harvard University Professor Niall Ferguson, October 29, 2009, as quoted by Bloomberg.com.

Despite some encouraging signs that the worst of the financial crisis may be behind us, the effects of the crisis will linger for some time to come. Protiviti has decided, however, to close out this publication on the Global Financial Crisis with this seventh and final edition.

Over the course of the past year, we continued to "peel back the onion" on the causes of the crisis and assess its short- and longer-term effects on organizations around the world. While not intending to be all-inclusive, our FAQ *Bulletin* was designed to provide answers to what we believed were some of the most pressing questions being asked about the crisis.

In this final version of the FAQ, we have updated a number of answers to reflect developments over the past six months. New and updated questions and answers are in boldface in the Table of Contents.

Going forward, we will continue to address a number of the topics covered in the FAQ – including Regulatory Reform, Accounting Developments and Industry Developments – in other Protiviti publications. We invite you to visit www.protiviti.com periodically to access our most recent thought leadership.

We would like to thank once again the many readers of this *Bulletin* who provided feedback and suggested additional topics and questions.

Please note that this information is not intended to be legal analysis or advice, nor does it purport to address every issue that may impact financial institutions and other companies or every government response. Organizations should seek the advice of legal counsel or other appropriate advisors on specific questions as they relate to their unique circumstances.

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Note: Questions in bold contain new or additional information.

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