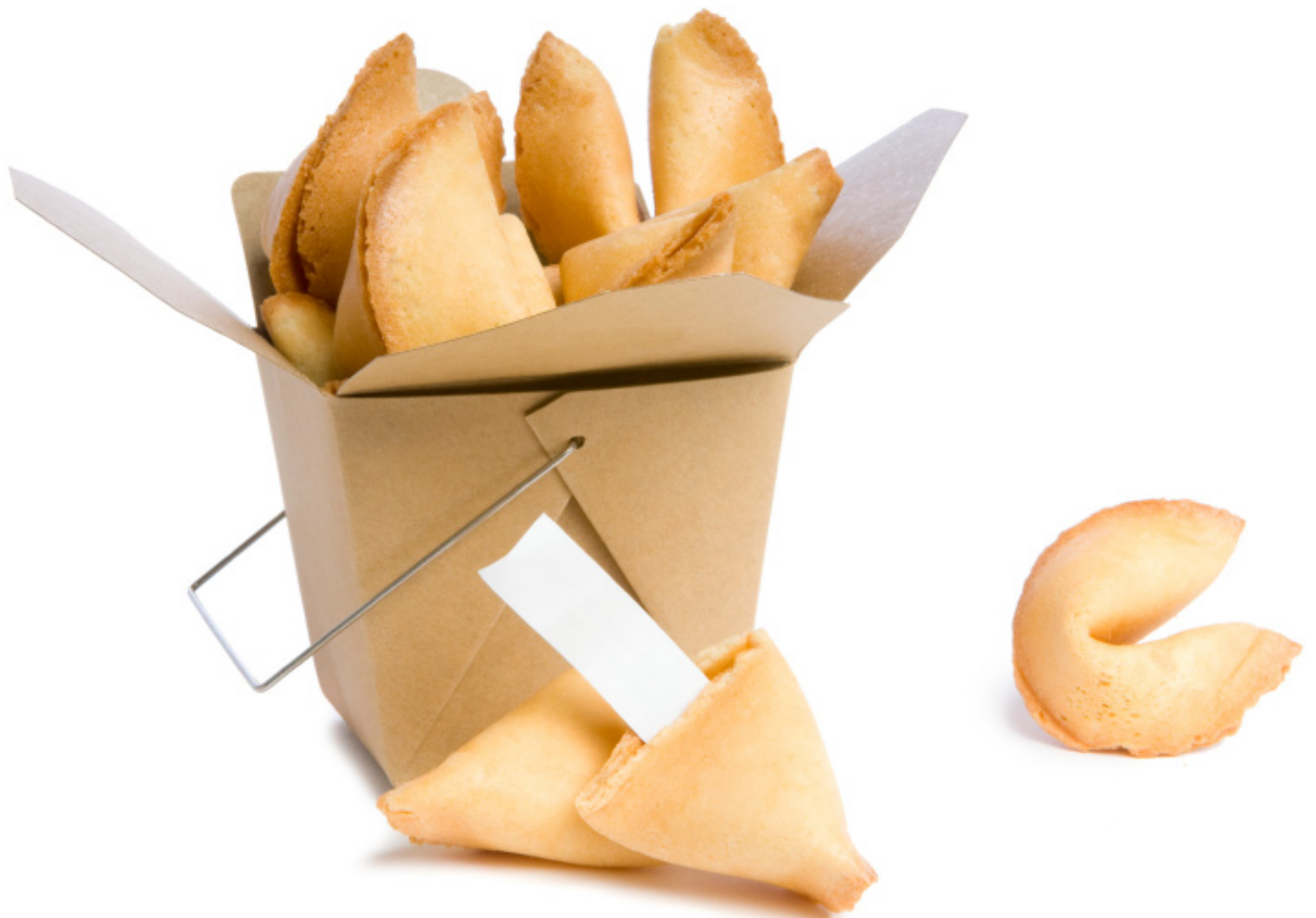




2009 Industry Outlook:  
Banking & Securities  
Challenging Times,  
Emerging Opportunities





# Banking and Securities



The banking and securities industry enters 2009 in an unprecedented state of turmoil and dislocation. What started as a credit issue in the subprime niche of the mortgage market has extended to all corners of the financial services industry, and all corners of the globe. What was a financial crisis is now a full-blown economic crisis with global impact.

By the end of September 2008, the large independent investment banks, Goldman Sachs and Morgan Stanley, became bank holding companies and began to be regulated on a consolidated basis by the Federal Reserve. Throughout the entire banking system, the price of risk has increased. Through mid-December 2008, financial institutions saw \$752 billion in write-downs globally; total write-downs are forecast to go higher. By the end of 2008, unprecedented actions had been taken by the U.S. government to address the crisis, including federal take-over of financial institutions and the expanded role of the Federal Reserve and government in providing credit to the private sector, and in some cases acting as the “investor of last resort” in addition to their role as lender of last resort. These actions have caused the Federal Reserve’s balance sheet to increase dramatically, with as yet unknown long-term policy and structural implications.

This crisis will continue to unfold in 2009 and the end of its storyline has yet to be written.

## Emerging trends signal a paradigm shift

As the industry continues its crisis-related evolution in 2009, five emerging trends indicate a paradigm shift that would affect not only financial institutions but also borrowers, investors and regulators.

**1. Intervention, regulation and the role of government.** One of the top agenda items for the new Democratic administration and Congress is regulatory reform of the financial services industry. Soon after the inauguration, we are likely to see numerous regulatory proposals put forward, as well as political will and populist pressure for fast, dramatic, and widespread changes.

In the United States and across the globe, there has been significant governmental intervention in financial markets. Governments in the United States and Europe have provided billions in capital to banks, increased deposit limits on insured individual bank accounts, issued guarantees on bank debt, and have begun to purchase short-term commercial paper. While unlikely, there is the possibility that global banking could be fundamentally changed as a result of this economic crisis. The signs are there: World leaders, convening in Washington D.C. for a mid-November emergency meeting to combat the economic crisis, agreed to a far-reaching action plan to reshape international financial institutions and reform worldwide regulatory and accounting rules. At the meeting, members of the Group of Twenty (G-20) backed a coordinated response to the global economic crisis, agreeing on the need for measures to kick-start growth, better financial market regulations, and more say for emerging market countries. In their final communiqué, leaders from nearly two dozen countries also endorsed a series of broad goals to avoid future economic crises and to revive the world economy. They mentioned the need for a College of Supervisors, something the G30 also proposed in their recently released study, and the report outlines the need for the international financial institutions such as the World Bank and the International Monetary Fund to help developing countries weather the economic turmoil.

In the U.S., the discussion concerning the future role of the government in the industry will continue and, with the new administration in place, begin to take more concrete shape. Look for the following to begin to be addressed in 2009:

- The restructuring of the regulatory agencies involved in the banking industry.
- The possibility of an explicit market stability regulator and regulatory oversight over any large firm (including nonbanks and hedge funds) that could threaten financial stability.
- The reform of the business proposition of and restructuring of government-sponsored entities, e.g., Fannie-Mae and Freddie-Mac.
- New requirements from the regulators that provide greater public disclosure and improved transparency from financial institutions.
- Increased regulatory coordination from a global perspective.

While the ongoing role the U.S. government may or may not take in the nation's financial institutions remains unclear, it will likely instill greater conservatism and produce increased focus on risk management, leverage and liquidity.

**2. The move from 'alpha to beta' markets.** Due to the turmoil in the financial markets, the pursuit of alpha – high-return/high-risk profile products – dramatically decreased as a strategy in 2008. From investment banking to hedge funds, those businesses with high-risk/high-return business models have been negatively impacted. Moving forward, it is likely that regulators may try to limit exposures and customers will be more risk-averse. This shift could have a number of implications including: governance and “exit strategies” for these high-risk businesses are becoming increasingly important, and institutions may need to refocus their businesses on more traditional, simpler products, with more predictable returns.

Businesses with predictable earnings streams and solid balance sheets are expected to attract a premium in 2009 as market conditions deteriorate and alpha-type

businesses, such as proprietary trading, recede. Institutions are expected to focus on the importance of more traditional products and services such as custody, cash management, asset management, and foreign exchange trading. Similarly, fee-generating businesses are expected to grow in importance. A key to being successful with this more traditional product mix is to focus on cost-efficiency and scale.

**3. De-leveraging.** The world financial system is undergoing massive de-leveraging. Many institutions, such as banks, hedge funds and private equity firms have become less leveraged. Some are implementing economic capital models to enhance risk management disciplines. The implication for banks and other non-bank financial institutions is that returns on equity will be lower than in recent years. The days of 25 percent ROE likely will not be seen again.

**4. Fragmentation to consolidation.** Historically the U.S. financial services market was one of the most fragmented in the world. For nearly two decades, consolidation has been creating larger entities across many segments of the financial services industry, and the current crisis has dramatically accelerated that trend. At the end of the third quarter in 2008, 64 percent of the U.S. banking industry's assets were concentrated in the top five banks. Likewise, the country's top 10 hedge funds account for 60 percent of the assets under management in that market. If the notion of “too big to fail” was a concern before, it will be a greater concern in 2009 and beyond as weaker entities fail or are absorbed by larger, more successful players. The flight to quality will continue to reinforce this trend as corporations look to the strongest and largest players for their financial services needs.

**5. From buyer beware to seller beware.** The law of unintended consequences has fundamentally altered the relationship between buyer and seller, as well as the responsibilities of each. In the last year or so, many financial institutions have taken on the responsibility to support products by putting structured investment vehicles or SIVs on the balance sheet, injecting money to restore the “buck” in money market funds, and covering

losses for auction rate securities. These efforts have been undertaken to restore the public's trust and confidence in financial products – and to avoid damage to the institutions' reputation.

As they enter 2009, financial institutions will likely return to basics. This could mean placing greater emphasis on more relationship-based and less transaction-based businesses in 2009, and promoting product simplicity, transparency, and enterprise risk management. Expect to see future products that provide far more clarity and greater assurances regarding likely performance, risks, and outcomes. Similarly, the notion of moral hazard (i.e., the notion that historically referred to banks that were "too big to fail") is now much broader and extends to individuals; regulators will need to consider changes to reflect this new reality.

#### Implications for financial services firms, corporate America and the consumer

Entering 2009, the financial services industry finds itself undergoing fundamental change. Market challenges are expected to continue for some time – while securities valuation write-offs may be waning, the slowing U.S. and global economy will likely continue to cause higher loan losses and charge-offs, as well as put downward pressure on top-line revenues.

As they endeavor to adapt to a new market environment, banking and securities organizations should consider staying focused on the things they can control by:

- **Maintaining their "fortress balance sheet."**  
Financial institutions will continue to take the necessary actions to show investors and regulators the strength of their balance sheets.
- **Reassessing risk management and overall governance.** Banking and securities organizations will likely need to refine enterprise risk management, transparency and overall governance as they strive to restore customers' trust.
- **Pursuing cost and organizational efficiency.** Maintaining margins and aggressively pursuing cost and operational efficiencies will be important.

- **Striving for fair and ethical treatment of customers.** As regulators and legislators focus on consumer protection going forward, it will be important for financial firms to elevate their focus on customer protection.
- **Looking for opportunities to acquire and grow.** As the economic situation unfolds and the pace of consolidation continues, there may be strategic opportunities for institutions that could have seemed unlikely a year ago. As always, it will be important for acquiring institutions to avoid hubris about the deal and thoroughly consider its underlying fundamentals.

Challenges in the banking industry and in the broader economy, constrained capital, and weak commercial paper markets will continue to have a considerable impact on corporate America and its credit needs in the coming year. Fallout from the credit crisis plus the de-leveraging of banks and consumers could have a profound impact on the economy through this downturn and beyond. What will corporations' future funding sources (both for short-term liquidity and long-term capital) look like? How vulnerable will these funding sources be? Uneasy corporate treasurers may need to wear both belt and suspenders.

The same could be said of consumers as well. The U.S. has long been a credit culture; however, with banks constraining the nation's credit addiction, will consumers return to post-Depression-era habits of financial conservatism, higher savings rates, and cash-only purchases?

#### Charting a future course

2008 was a difficult year for financial services. 2009 could be better, but much depends on how the global economy responds to the downturn and whether or not we become mired in an extended recession, as many economists now believe is likely. In the past, many in the banking and securities industry entered downturns and the credit cycle with strong financial fundamentals. Currently, it is unclear how the industry will fair in this downturn in the credit cycle, given fundamentals have been weakened.

Regardless of the length and breadth of the downturn, it seems clear that U.S. and global regulators plan to move forward with regulatory reform aimed at enhancing regulatory oversight, risk management, leverage and liquidity. Despite the significant steps already taken, the work of governments is far from over. Financial institutions will need to respond to any new standards – and business models – accordingly.

The golden era of banking is gone, at least for now. However, in its place may arise a dynamic new marketplace that is anchored by a stronger, more secure U.S. and global financial system.

*NOTE: Because the financial services industry landscape is changing so rapidly, please visit [www.deloitte.com/us/centerforbankingsolutions](http://www.deloitte.com/us/centerforbankingsolutions) for current analysis and thought leadership publications.*

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