FROST & SULLIVAN

FINANCIAL SERVICES INDUSTRY OUTLOOK: CHALLENGES AND OPPORTUNITIES IN 2008

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"We Accelerate Growth"

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THE CURRENT U.S. ECONOMIC OUTLOOK

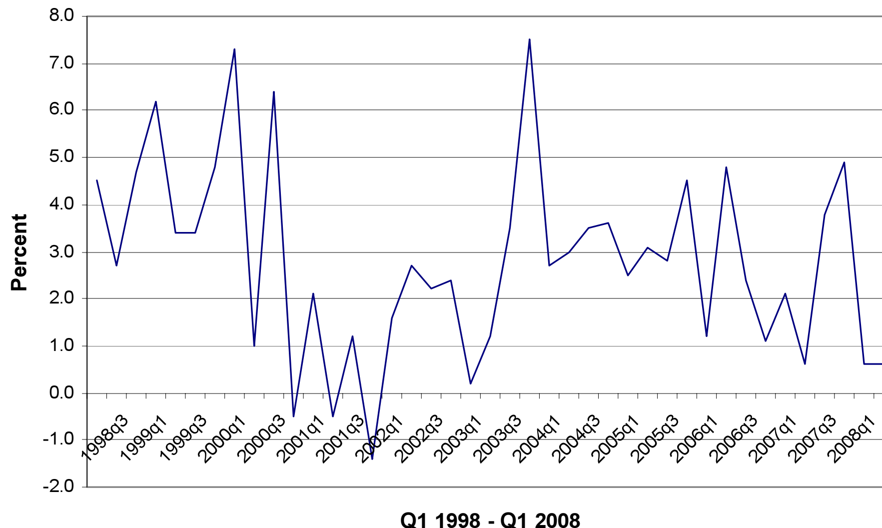
The U.S. economy has been experiencing a period of turbulence brought on by the declines in the housing market, the subprime mortgage crisis, and the subsequent debilitating credit crunch. There has been incredible volatility in the global markets, including the plummet of the European and Asian markets in January; global markets have seen losses of more than $5 trillion this year. The U.S. markets have been volatile as well; year-to-date the Dow has dropped 2.4%, the S&P 500 has dropped 3.6%, and the Nasdaq is down 4.9%. March brought significant changes; the financial sector was rocked when Bear Stearns neared collapse before drastic moves by the federal government ensured that did not happen and altered the financial services landscape. As things change almost daily, the full effects of this move will be played out over weeks and months. Anxiety levels are high, and nervous investors are still trying to interpret the latest economic data, determine if the housing market has hit bottom, and evaluate the impact of the losses in the financial services sector and the total effect of these losses spreading to other areas. Declining economic indicators and even more announcements of major losses at banks suggest the U.S. might be heading into the first recession since 2001, although this continues to be debated by economists. Fundamentally, however, the market seems to be pricing as a recession and investors have been taking advantage, providing some buoyancy in the markets for the last few months.

This paper discusses the economic situation since the beginning of 2008, including briefly what led up to it and the possible implications. Also assessed are potential strategies for financial services companies, which may optimize the current situation and position them for growth in 2008 and beyond.

Economic Fundamentals

While the Gross Domestic Product (GDP) is still rising, the rate of growth decreased to 0.6% in Q4 2007 after an increase of 4.9% in Q3 2007 (Chart 1). Whether the U.S. economy is sliding into a recession or not remains uncertain and debatable, though the slowdown in growth to near stagnation is a major concern. The most recently released information was for Q1 2008, and the GDP growth rate remained at 0.6%, staving off some worries about further decline.

Chart 1
GDP Percent Change from Preceding Quarter
Q1 1998 - Q1 2008



Source: Bureau of Economic Analysis

In addition to the slowdown in GDP growth, there are other indicators giving investors pause. The uncertainty in the financial services industry is pervasive. The housing market continues to contract, both in new home sales and housing construction, and the bottom might not have been hit yet. This uncertainty surrounding the severity and when that bottom might be seen is impacting the markets; the fallout from the subprime crisis and the credit crunch is rippling and not yet showing signs of stopping.

There is also evidence that the labor market is softening, corporate spending is slowing, and consumer confidence is declining. In fact, consumer spending outpaced GDP growth over the past ten years at a rate of 3.6% vs. 2.9%; this difference is possibly unsustainable and we are likely facing a period of retrenchment and belt-tightening. The surge in price of energy, food and gold will also play parts in the continuing U.S. economic woes. Now that the Fed has moved to make momentous changes in the financial industry by lending to and bailing out Wall Street firms, however, it is possible that we have seen the worst of the credit and financial crisis. The weak U.S. dollar is actually helping businesses by increasing foreign exports; and economic indicators such as real money supply and manufacturers' new orders for consumer goods and materials were positive at the end of February, signaling a possible overall stabilization of the economy.

The Federal Reserve's Response

In response to what it has called a "weakening of the economic outlook and increasing downside risks to growth," the Federal Reserve has cut interest rates six times since September 18, 2007. In a surprise move on January 22, 2008, it slashed the target for the

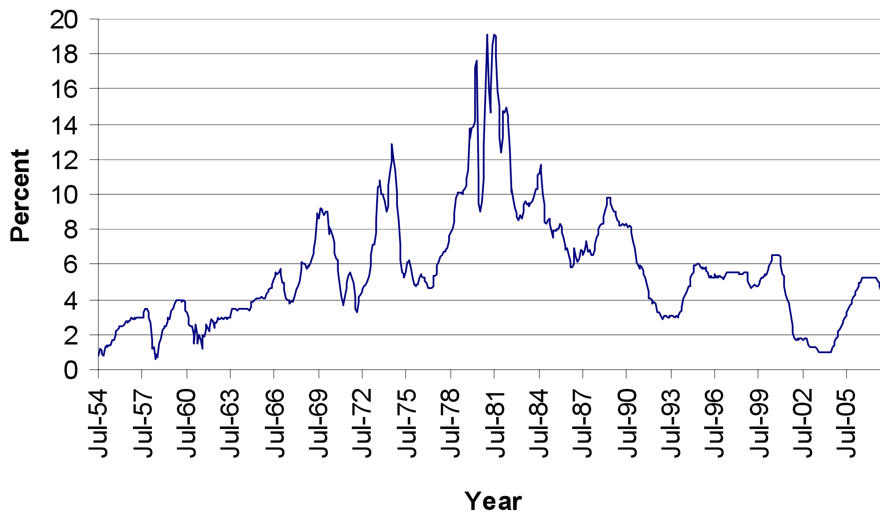
federal funds rate by 75 basis points to 3.5%. The Fed followed that with another cut on January 30, 2008 of 50 basis points, reducing the target rate to 3%. Additional factors for the cuts listed in its press releases include the continuing decline in the housing market, credit tightening, and a softening in the labor markets. It is being debated if the Fed cut rates fast enough in the beginning, and after meeting again on March 18, 2008, they cut rates once more by ¾ of a point, bringing the federal funds rate down to 2.25% – the lowest it has been since 2004. After that meeting, President Bush announced that the government would take further action to help the flagging economy, if necessary. Inflation is a serious concern as the rates get lower, but currently this concern is outweighed by that of the economic slowdown. Chart 2 depicts the monthly changes in the effective federal funds rate. The latest available data reflected in the chart had the effective funds rate at 2.28% as of end of April 2008.

Subsequent to the rate cuts in March, the Fed made several unprecedented decisions. The first was to bail out Bear Stearns from its liquidity emergency and agreeing to take on $30 billion in securities for J.P. Morgan in order to get the deal done, which involved J.P. Morgan's purchase of almost 40% of Bear shares at $2 each. The price J.P. Morgan will pay has since been increased to $10 per share as of March 24 – one week after the original deal was made.

The Fed also decided to lend money to other investment banks, providing a significant source of needed funds. It also allowed Fannie Mae and Freddie Mac to increase its investments in U.S. mortgages by $200 billion, giving the mortgage market a lift. This represents a huge turn of events, and though questions remain regarding what kind of implications this will all have going forward for government involvement in the markets, this seems to have had a positive effect thus far. These initial moves predicated another major overhaul to regulations announced on April 1, with the intention being prevention of future catastrophes, including consolidating bank regulation, creating a new type of insurance charter, improving the oversight of mortgage lending and increasing transparency for the Fed.

Historically, the Fed had the limited portfolio of protecting depositors in commercial banks and influencing the money supply. This is the first time the Fed has interceded in the investment banking industry to this extent. It is practical then to now expect the pendulum of regulation to swing back. There has been a post-regulatory environment in finance for some time, at least since the repeal of Glass-Steagall of 1933. It is likely that regulations will now tighten; consider, for example, the regulatory response to Enron, which was Sarbanes-Oxley. It follows that there will be a regulatory reaction to the current situation.

Chart 2
Monthly Effective Federal Funds Rate
July 1954 - April 2008



Source: Board of Governors of the Federal Reserve System

THE WEAKENED FINANCIAL SERVICES INDUSTRY

The financial services industry has been heavily impacted by the subprime mortgage crisis, itself brought on by the bursting housing bubble that began in 2006. In fact, it has been suggested that the Fed contributed to the housing bubble by keeping rates too low for too long after the recession of 2001, leading to easy borrowing. This, combined with the low inflation rates and strong growth in the economy, propelled financial institutions to look for and take on risk in the influx of collateralized debt obligations (CDOs) backed by mortgage-backed securities (MBS). However, as the housing market dropped, the default rates on subprime and Adjusted Rate Mortgages (ARMs) to risky borrowers increased, leading to defaults and foreclosures. The mortgage lenders were impacted first, but the losses soon extended to others holding mortgage-backed securities and other derivatives related to securitized debt. Major banks and other financial institutions have reported losses of over $280 billion between the middle of last year and the end of April 2008; and many speculate losses could spiral upwards of $500 billion.

Among the hardest hit have been UBS, Citigroup, and Merrill Lynch, with losses of $38.2 billion, $35.3 billion, and $31.7 billion, respectively. These numbers include an announcement made on April 1, where UBS added $19 billion to its previous writeoff total of $18.7 billion, and Deutsche Bank tacked on $3.95 billion to its $3.1 billion from 2007.

The market is still reeling from the sale of Bear Stearns as well. The credit crunch has the potential to damage the economy further; banks will likely become increasingly cautious

about lending to one another as so much uncertainty still surrounds which other institutions will be hit and the exact extent of subprime losses. The lack of liquidity that Bear was facing was crippling; as of March 13, its cash position was down to $2 billion, which was going to force a bankruptcy protection filing if a last-minute loan did not come through. Lehman Brothers, for instance, looked to be in a precarious position right after the Bear Stearns debacle, but has since recovered and seems to be stable for now. Lehman and UBS also publicized the selling of more shares to increase liquidity on April 1 and stocks rebounded, partially as a result.

Chart 3 summarizes major losses to date. In addition, numerous mortgage and/or subprime lenders have filed for bankruptcy, including New Century Financial, American Home Mortgage, Ameriquest, American Freedom Mortgage, and Global Mortgage, Inc. Chapter 11 filings numbered 6,237 in 2007, up from 5,010 the year before.

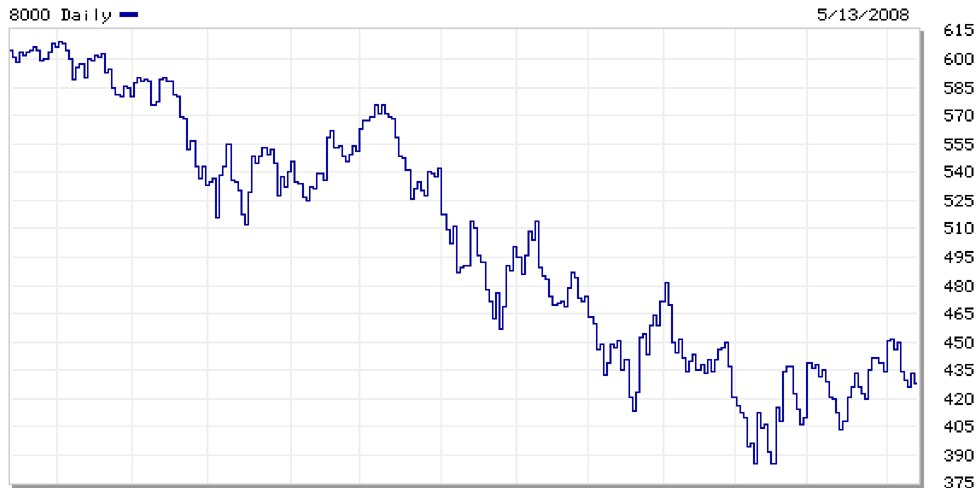
Chart 3
Writedowns on the Value of Loans, MBS and CDOs

Firm	Writedown ($ billions)	Firm	Writedown ($ billions)
UBS	38.2	Goldman Sachs	3.0
Citigroup	35.3	HSBC	3.0
Merrill Lynch	31.7	Nomura Holdings	2.5
Royal Bank of Scotland	15.2	E*Trade	2.5
Morgan Stanley	12.6	ABN Amro	2.4
Credit Suisse	9.6	HSH Nordbank	2.3
Bank of America	9.2	Bank of China	2.0
IKB Deutsche	8.9	LB Baden-Wuerttemberg	2.0
Deutsche Bank	7.6	Natixis	1.9
Credit Agricole	6.4	DZ Bank	1.5
HBOS	5.9	UniCredit	1.5
Mizuho Financial Group	5.5	Lloyds TSB	1.3
JPMorgan Chase	5.5	Commerzbank	1.3
Wachovia	4.6	BNP Paribas	1.3
Canadian Imperial (CIBC)	4.1	Caisse d'Epargne	1.2
Societe Generale	4.0	Gulf International	1.0
Fortis	3.7	Hypo Real Estate	1.0
Bayerische Landesbank	3.6	Wells Fargo	0.6
Dresdner	3.4	National City	0.5
Lehman Brothers	3.3	Washington Mutual	0.3
WestLB	3.2	European banks not listed	8.8
Barclays	3.2	Asian banks not listed	7.3
Bear Stearns	3.2	North American banks not listed	3.0
		Total	280.1

Source: Bloomberg.com

Chart 4 illustrates the stock performance of financials since April 2007 through May 2008. There has been an overall decline, but very recently, it is beginning to climb back. However, under the current cloud of uncertainty, it is unclear if the markets have hit bottom or if the declines will continue.

Chart 4
Dow Jones US Financials Index Performance
June 2007 - May 2008

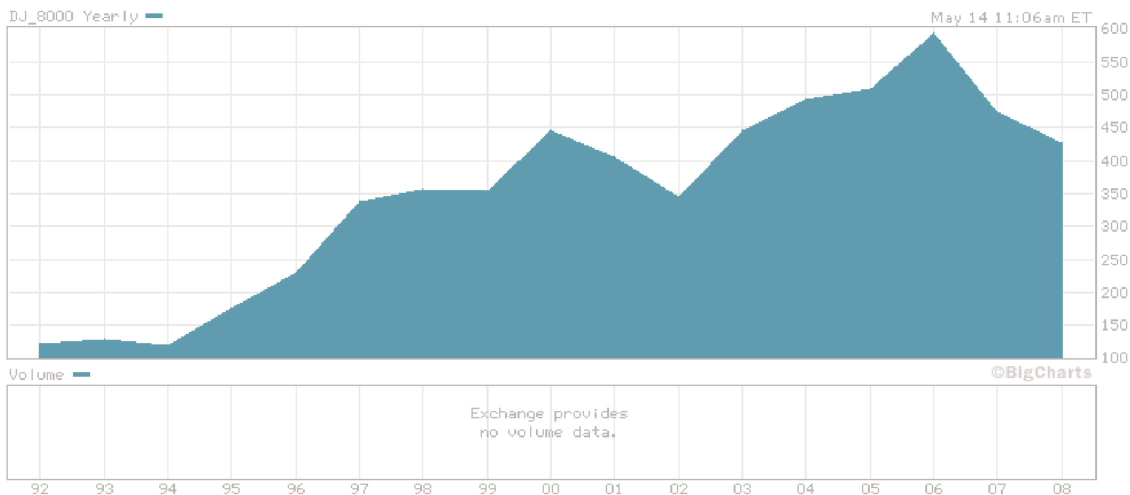


THE IMPORTANCE OF PERSPECTIVE

It is crucial to keep the current economic environment in perspective, and to realize that while there are certainly negative indicators, the U.S. economy is technically not yet in a recession. Of course the housing market continues its decline, but other economic data released recently has been more mixed, possibly pointing to a period of a slowdown in growth rather than a recession. The Fed's rate cuts and bailout along with the government's fiscal stimulus package will help, but to what extent remains to be seen. Anxiety over many uncertainties surrounding the subprime crisis is certainly affecting the markets, and as the extent of the losses and who is incurring them becomes clearer, some of this anxiety should subside. It is possible there has been an overreaction in the markets to some of the news, and the recently proposed Fed regulations should help reduce anxiety.

It is important to keep in mind the financial services industry has experienced incredible growth over the past decade (Chart 5). The Dow Jones US Financial Index – which is made up of 178 banks, financial services and insurance companies – peaked in 2006 at almost 600. Moreover, historically, financial services companies have rebounded within the 12-18 months following a recessionary period, boding well for 2009.

Chart 5
Dow Jones US Financials Index Performance
January 1992 - May 2008



OPTIMIZING GROWTH OPPORTUNITIES IN THE CURRENT ECONOMIC CLIMATE

While challenges abound in the current economic climate, there are abundant opportunities for financial services firms to optimize the current situation and position themselves for growth in 2008 and beyond.

Consider Spending, Not Cutting Costs

The usual reaction to downturns in the economy is to tighten the belt and cut costs internally. However, while it might seem counterintuitive upon first consideration, now is a prime time to consider expansion and acquisitions. In many ways it is a buyer's market, and savvy companies understand this and take advantage of this time to improve their situation. J.P. Morgan seized the opportunity with Bear Stearns, and was able to do what it did because it got the deal together so quickly, and because it was in a position to do so financially – it had the leverage necessary.

Opportunities will exist in sectors excessively penalized by the uncertainty surrounding the subprime crisis. While this includes the real estate and mortgage markets, the construction and building products industries, and financial services, other retail and consumer sectors like entertainment and restaurants could also suffer. There will be opportunities to acquire companies that are in a bad position; investors will eventually come back if they see a bargain with potential. Mergers and acquisitions could be on the rise this year as 67% of financial CEOs in North America expect to do a small acquisition in 2008, according a recent Oliver Wyman study.

One of the common cost cutting initiatives is to cut back on talent. In fact, about 34,000 Wall Street jobs have been cut since July of 2007 with experts predicting up to 100,000 in the next few years. This represents an opportunity for savvy companies to hire away from competitors and build a strong internal talent base, and a cautionary tale for those considering desultory or across-the-board labor cuts. In a softened job market, many of the best and brightest sales and marketing people, managers, and executives will be looking for work and can elevate a workforce.

For example, at the start of the 2001 recession after the bursting of the stock market bubble, firms such as Credit Suisse First Boston, Merrill Lynch, and Goldman Sachs made huge employee cuts. The industry as a whole cut jobs by 30,000, or up to 10% of the workforce at the time. Many employees who managed to keep their jobs had to take pay cuts. However, Lehman viewed this time as an opportunity to hire talent cut by its competitors, and it could do so at a discount in the soft job market. Lehman was prepared when the economy turned around.

The current environment could be a time to investigate internal weaknesses and strengths, and then invest in the latter. Therefore, it can also be prime time to consider spending on innovation and technology, to be ahead of the curve when the economy bounces back. Where possible, investing in productivity-enhancing technology and equipment can be part of a longer-term turnaround plan and become a significant competitive advantage. Evidently many financial services companies recognize this; whether driven by opportunism or necessity such as compliance, organizations are spending more. Forty-two percent of sell-side firms, for example, expect their IT budget to increase 11% this year.

Think Globally

The strong global economy coupled with a weak U.S. dollar means it is a logical time to consider global opportunities. For example, Citigroup, one of the hardest hit companies in the subprime mortgage crisis, in January announced plans to expand further in China as a part of its growth strategy, less affected by the current crisis. Other companies have similar plans for Asia and Europe; Deutsche Bank is significantly expanding its offices in Singapore, for example, and Morgan Stanley has moved its global investment banking and M&A heads to London. These regions have a higher growth rate than the U.S. and financial institutions which draw significant sales from abroad will continue to take advantage.

Also, foreign governments through investment pools known as sovereign wealth funds are increasingly looking to the U.S. for opportunities to exploit in the aftermath of the subprime crisis. The low valuations and weak U.S. dollar make financial services firms in the U.S. attractive for foreign buyers. Over the coming weeks and months, large diversified banks that have the capital may seize any prospects. The emerging markets'

financial institutions which are looking to expand can essentially snap up bargains in the U.S. J.P. Morgan's deal to buy Bear Stearns is a domestic example of what may be to come. Japanese banks are another example of investment; they have outstanding loans in the U.S., the total of which rose to an eight-year high of $320 billion on February 29, spurred by the subprime aftermath.

Currently, sovereign funds control up to $3 trillion in assets, and it is expected to reach $10 trillion by 2012. For example, the Abu Dhabi government announced in November 2007 it was buying 4.9% of Citigroup for $7.5 billion; and in December 2007 UBS announced it was selling a 10.8% share to the government of Singapore and an unnamed Middle Eastern investor for $11.5 billion. This trend is not limited to Citigroup and UBS, others with investments from sovereign wealth funds include HSBC. While some have raised concerns about this trend, the general reaction has been positive as these firms attempt to make their way out of the subprime crisis.

Since the beginning of the year, decoupling has emerged as another reason to look beyond the U.S. for opportunity. Decoupling asserts that European and Asian economies, particularly emerging ones, have developed so greatly that they no longer depend on the U.S. for growth, providing insulation from a slowdown. It is probably no longer strictly true that when the U.S. sneezes the rest of the world catches cold. In fact, China's exports to the U.S. now account for only 8% of Chinese GDP due to the growth of internal consumption. In the developing world, trade within developing regions accounts for more than 60% of GDP. This is not to say that global opportunities are not without unique risks. The dual Chinese banking system presents huge risks. Within the official, state-sanctioned system, more than 50% of loans are not performing and are at risk of default. More liquidity exists in the unsanctioned banking market, and the default rate is perhaps below 7%. Therefore, the financial services industry needs to take a more aggressive approach to measuring and calibrating risks.

CONCLUSION

There are lessons that can be learned from the current situation. While hindsight is naturally 20/20, the subprime crisis was not entirely unpredictable. Critics argue, for example, that the Fed had substantial regulatory power that it did not use to limit the excesses during the boom. Some companies, however, recognized the potential risk in advance and were better prepared than others.

For example, Goldman Sachs realized the risk involved, and that problems would emerge down the road, so it pulled out of subprime ahead of the game in 2007. It shorted the market, and it was able to protect itself from the packaged loans it had sold and was positioned to profit from the decline. Goldman's differentiator in this area seems to be its ability to measure and manage its risk; its controller office, which is responsible for valuing the firm's positions, and has a very high level of authority. In contrast, other firms

such as Merrill Lynch and Morgan Stanley asserted their firms' expertise in risk management and how it would prevent losses from trading. However, if the market was hedged against a downturn, the large profits generated on the way up should have been a signal of the threat ahead. However, when the market is booming, there is little incentive to decrease profits by insuring against a dive. On the downward slide, the firms pay for skirting safety, in this case with massive writeoffs of these securities.

The subprime market is marked by complexity. Combine this sheer complexity of some of the loans with uninformed consumers and the crisis was manifested. There were several factors which came together and ushered in the crisis, including the lack of transparency in the true risk involved in certain MBS and CDOs. There is an inherent conflict of interest in these securities. The dilution of risk by securitizing loans into CDOs separated mortgage lenders from the high risk of the poor loans they were writing, and they believed themselves to be shielded from the consequences. In addition, old-fashioned bravado of banks; many deals were excessively leveraged, risk management was poor, and there was an over-reliance on credit agencies' high ratings.

In business, particularly financial services firms, there tends to be a focus on short-term profits and fierce competition over long-term, sustainable performance. This balance is constantly strived for in large public companies. While the market works to rebound, and companies refocus and continue to innovate, opportunities will continue to present themselves for savvy companies and investors. More certainty regarding the exact extent of losses and companies' strategies to infuse more capital are making headlines daily. Moreover, the Fed's actions to lend to banks and ease liquidity issues will spur companies and investors to make that leap, and confidence will return.

The more complex financial transactions and instruments become, the more opaque they become to the underlying risks which may indeed be several layers removed from the parties that ultimately bear the risk. The financial services industry needs to heed this, and take a hard-line approach to measuring risk. In addition, it is likely that government regulations will tighten in the coming months with regard to these transactions and the firms overseeing them. First-rate due diligence and proactive research is always necessary.

Maintaining perspective is key to navigating the current ambiguous environment. There will always be ups and downs in the economy; ideally companies should be prepared for these cycles. However, while U.S. recession discussions continue, and daily news regarding the markets is digested, staying focused on the opportunities here and abroad can put both companies and individuals in a position to ride the next uptick and grow exponentially. The current issues will take time to correct, and in the meantime leading firms will find and exploit growth opportunities in serving the needs of their customers.

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