Beyond the Subprime Crisis

Seeking Growth Amid Increased Uncertainty and Shifting Sources of Profit

by Nader Farahati & Rouget Pletziger

In 2007, the threat of a reversal in the fortune of U.S. mortgage markets, predicted a year ago by Oliver Wyman, became a reality. The well-documented mortgage meltdown and the ongoing liquidity crunch have left the financial services industry in a state of uncertainty. As a result, global growth for the industry – which had been considerably above its long-term trend line from 2003 to 2006 – was disrupted, and so was investors' trust.

The aggregate global value of all quoted financial services firms fell by 1.7% to a total of $10.5 trillion. At stable exchange rates, the industry would have even seen a value loss of 7.2%. Moreover, financial services has become a two-speed world in which mature economies (with the exception of Australia/New Zealand) see a mean reversion, and emerging markets still enjoy a stellar performance fueled by inflated asset prices. Below this high-level perspective, performance skews across sub-sectors and individual institutions widened significantly.

We expect further turbulence for 2008 and beyond; recently, in fact, there have been signals of wider and sustained market volatility. Significant additional subprime-related losses, write-downs, and business collapses sparked new shocks in global equity markets, this time equally affecting emerging markets and prior winning subsectors, such as exchanges and asset managers. Governments, central banks, and other external parties have come to believe in the real threat of a wider recession, not least since the latest bold cuts of the U.S. Federal fund rate.

With regard to share-price stability, the full impact of the ongoing credit and liquidity crisis is unlikely to manifest itself before the end of 2008. Analysis of historical crises shows that even if the profit-and-loss hits stopped today, consumer confidence would not return for another three quarters.

Beyond subprime-related market uncertainty, our outlook for 2008 and 2009 flags four new risk scenarios that could cause additional losses and volatility for financial services:

- Corrections in European real estate markets, with the U.K. and Spain among the most exposed;
- A major drop in Asian stock markets, especially in China and India;
- Further imbalances in global commodity prices, be it a crash or further dramatic inflation; and
- A further decline of the U.S. dollar.

This view on future conditions is not shared by all parties in the industry. A large number of financial services CEOs we surveyed as part of our *State of the Financial Services Industry 2008* report are assuming business as usual – implying continued capital and resource allocation to existing operations – even though short-term growth predictions were well off 2007 actual results. For 2008, CEO predictions suggest further industry growth of 5% to 14%, with 69% of survey participants expecting their firms to outperform the industry.

Underperformers and premier performers

Oliver Wyman's Shareholder Performance IndexSM (SPI) is a global measure of relative risk-adjusted shareholder performance. It reacts to slowdowns in growth as well as to increased volatility, and helps characterize likely future underperformers. To develop a profile of the firms most exposed to future disruptions, we examined "steady underperformers" – firms with SPI scores consistently below the averages of their respective subsectors and regions over periods of three, five, and 10 years.

The disruption in 2007 illustrates the sensitivity of steady underperformers to future crises and the predictive strength of the SPI measure: Steady underperformers as of June 2007 faced significantly larger hits by subsequent events than did their peers. Additional conclusions are that macro crises can crystallize almost anywhere and that being struck involves more than simply bad luck.

Premier performers, by contrast, remained strong after a turbulent year. Firms such as Sberbank, Russia's largest banking institution, and T. Rowe Price, the U.S.-based asset manager, provide models for thriving in a volatile world, where the winning formula for future outperformance will consist of two main pillars.

First, excellence in risk and resource management needs to take center stage in the short term. Quick wins include the review of lending standards and limit setting, adjustments to approval processes and the review of early warning tools and exit instruments. In addition, senior management should pay close attention to liquidity and internal sources of funding, talent, and a strategic alignment of cost management.

Second, delivering the required performance levels requires gearing to controlled growth. Firms need to deepen and expand their existing core profit zones, while finding the right levels of focus and innovation. This has different implications for different business models (e.g., generalists vs. specialists), but will in many cases lead to premier performers exploring new propositions and selective add-on investment opportunities in adjacent businesses. The active management of strategic risk, in alignment with available capital and resources, becomes one of the key related medium-term success factors.

Growth opportunities where traditional businesses intersect

Surveyed CEOs continue to seek new growth primarily in their domestic markets and through organic expansion into new areas. Product and service innovation remains at the forefront of cited strategies to counter increasing customer demands, with talent management and the alignment of internal governance models representing major challenges.

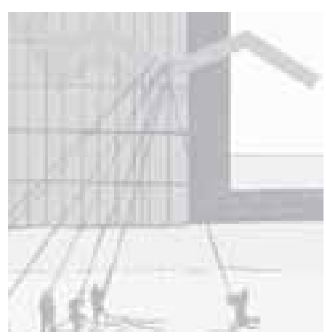
Sources of profit are increasingly shifting to the intersections of traditional sector boundaries.

New cross-sector approaches include these examples:

- New asset management propositions. The ongoing division into low-cost production and high-grade specialization will lead to overlaps with investment banking that allow one side to develop cross-sector innovations on its own or both parties to develop joint propositions.

- Cross-sector offering for dis-savers. Players serving the complex demands of the 50-plus age group can succeed by transcending traditional boundaries among banking, insurance, and wealth management. Where offered, boundary-crossing products and services including reverse mortgages, variable annuities with living benefits, and financial advice platforms are proving successful. However, only a few bold moves have been made so far.

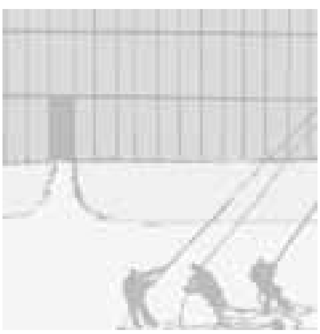
- Reinsurers thinking of providing asset protection solutions for insurers. Either by serving purely as an intermediary or by setting up their own in-house trading desks, reinsurers may become a one-stop shop for all risk transfers, competing with investment banks on the back of structural arbitrage opportunities, client proximity, and risk pooling facilities. This type of new offering could help reinsurers fully exploit synergies with other nontraditional solutions, such as securitization.



- Business-to-business partnership models with non-financial sectors (e.g., affinity sales) or with innovative entrants (e.g., peer-to-peer auction platforms or aggregators in the insurance distribution chain in the U.K.).

Industry evolution in the medium term

Recent events have exposed failings in certain areas of risk and liquidity management, as well as other excesses that require correction. Yet we still believe, unlike some commentators, that the established trends of modern finance will remain intact and are headed in the right direction. We are not witnessing the predicted collapse of modern risk management or the fundamental failure of a financial services business model that is based on the parsing and distribution of risks to the most efficient holders of that risk. If appropriate corrective actions are taken, the industry should emerge both stronger and more dynamic, with "originate and sell" and advanced risk transfer models to grow in new conditions – most importantly, these:



- Improved governance and market discipline, as well as stricter standards (lending and pricing), both at the front-end of origination and on the side of the regulators;
- Increased transparency regarding packaged risks, implying simpler structures (most likely with less leverage) and the active preparation for life beyond rating agencies; and
- Independent, educated investors with a clear appetite for and understanding of underlying risks.

A healthy next round of consolidation will favor those institutions that are prepared to cope with this medium-term evolution, and it provides windows of M&A opportunity and easier access to talent.

Against this background, CEOs and senior executives have a few high-priority items for their agenda. They will need a much tighter grasp of potential exposures and contingency plans for any worsening in the markets. They will have to anticipate how the sources of economic profit are shifting toward new regions, customer segments, and value propositions. And they must contend with new forces, including giants in emerging markets and sovereign wealth funds, which are not directly affected by the current crisis and are at the forefront of innovation in 2008.

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For further reading, see the State of the Financial Services Industry 2008 report at www.oliverwyman.com.