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Special Report: Dealing with the Downturn
Capital Markets

Can a new business model save investment banking?

By Robert P. Gach and James R. Sproule

Transparency, liquidity and increased oversight will be prominent features of the new capital markets landscape. The key to growth in this industry: customer-focused financial-product innovation that helps clients identify and manage risk.

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The axiom is as simple as it is sobering: The current global economic downturn began with the sudden widening of credit spreads in August 2007, which precipitated a crisis that soon engulfed financial markets around the world. Until strength and stability return to those markets, there can be no sustained recovery.

The damage to the banking system has been staggering. As of the beginning of March 2009, banks worldwide had announced losses of \$840 billion. Total damages could run as high as \$1.4 trillion.

Capital markets and investment banking play a key role in the global financial system and the overall economy. They are an important source of the financing critical to the health of the economy, as well as the ultimate arbiters of where value is being created. This article focuses on that sector by exploring the five areas where the future shape of the capital markets will be determined.

1. Revenues

Revenues are being hit by the flight from complexity and a slowing economy. But new products will emerge that deliver transparency and reduce risk or offer the possibility of significant outperformance.

No amount of cost cutting or margin enhancement can compensate for steeply falling revenues in this sector. Yet robust revenues are essential to everything from innovation to the extraordinary returns that financial services have been able to generate over past decades.

At least in the longer term, Accenture remains optimistic. We believe that the demand for traditional financial products such as equities and bonds will continue its historic trend of running up to 3 percent ahead of the supply. This demand is driven by both global demographics and the clear need to save for retirement. Savings in 2008 alone totaled \$5.8 trillion globally, and the trend will continue to support revenue growth as well as the creation of a host of new financial products and services.

Given their size, maintaining sales and trading revenues is crucial for investment banks' overall performance. Indeed, Accenture

research has calculated that sales and trading accounted for 75 percent of investment banking revenues during the recent boom years. At the same time, traditional corporate advisory work fell to 20 percent of revenues (although advisory revenues rose to 40 percent of total revenues in 2008, in light of losses in the credit markets).

Before the credit crunch, the financial markets may well have reached a high point in terms of both margin and volume. But for management, this may not prove to be as controversial a notion as might be imagined.

As investment banks are absorbed into larger, traditionally more conservative retail banking operations, their ultimate parent organizations may be less willing to take on risk or pay out commensurate reward. In fact, some banks' managements may prefer lower but possibly more stable earnings. For an industry accustomed to rapid change and high profits, this would be a radical shift indeed.

Some banks' managements may prefer lower but possibly more stable earnings.

Scope for recovery

Does this mean that a chastened industry will abandon the complex, high-margin products—entire new classes of securitized and monetized assets—that fueled the money-spinning trading operations before the credit crisis?

In analyzing what caused the house of complex financial products to collapse, two factors stand out: The potential for illiquidity should have been more carefully considered; and calculating liabilities for products was nearly impossible when those products had to move through multiple iterations to ultimately determine a valuation.

But Accenture believes that labeling all complex products as “excessively risky” is too sweeping a judgment. Although there have been clear failures across a wide range of new financial instruments, there is scope for recovery; it all depends on the product in question.

For products like collateralized debt obligations, the principle of diversification remains sound and relevant, and this alone points

to an eventual rebound. Where a financial product's underlying principle or added value is less apparent—as is the case in a number of complex and illiquid over-the-counter instruments, such as credit default swaps—demand and, hence, revenues have fallen and will not soon recover.

Successful, profitable financial products will be those that address liquidity concerns, have transparent ultimate liability and still offer an attractive risk-to-return ratio. These are most likely to be based on cross-product complexity, the linking together of highly liquid financial instruments.

The high degree of liquidity would mean that each piece could be priced separately. At the same time, these products would tie the pieces together in such a way that they would offer investors attractive returns for risks undertaken. What margins these products will command remains to be seen. But if complexity is to be profitable again, it must be more transparent, more liquid and utilize a wide range of financial products.

2. Risk and liquidity

Risk parameters have expanded to include liquidity. Efforts to increase liquidity and transparency will mean more on-exchange trading as well as new capital structures. At the same time, changes in accounting rules could promote the development of new structures that are capable of accepting illiquidity risks.

Although liquidity has always been vital to financial markets, the lack of it was seldom seen as a financial risk by investors and bankers—until the credit crisis. A combination of banks losing faith in counterparties that were assumed to be financially sound and a more general uncertainty about future losses as the economy

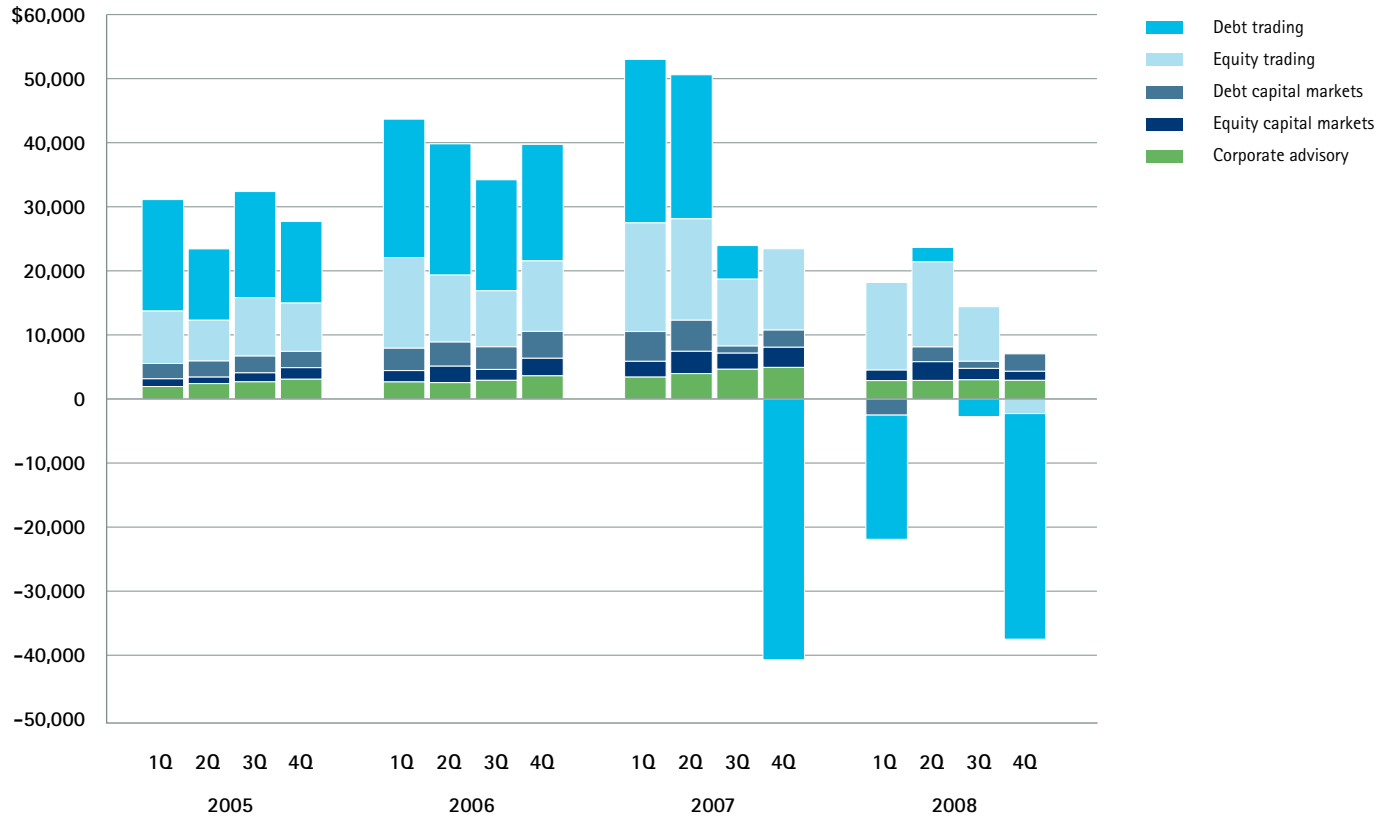
slid into recession has led to a collapse in liquidity.

This collapse has already had a significant impact on bank balance sheets and will have a similar impact on future bank revenues and profits. Exact percentages naturally vary, but with some investment banks generating

The Great Collapse

Investment banking revenues rose significantly from the first quarter of 2005 through the second quarter of 2007, driven in particular by higher debt trading revenues. These revenues stalled in the third quarter of 2007 and then plummeted in the fourth quarter of 2007 as trading losses were accumulated and declared in year-end accounts.

Investment banking revenues, 2005–2008, \$ millions



Source: Accenture research

up to 50 percent of trading revenue from proprietary positions, it is clear that illiquidity can quickly impair assets necessarily held on a balance sheet as a natural part of business operations.

As a result, some more conservative retail bank managements and shareholders, even regulators, may seek to scale back investment banking operations that take significant proprietary positions. Clearly, there is a need for better reporting and pricing transparency, as well as for risk assessment and liquidity support. Ultimately, some capital

markets firms may simply become less willing to accept risk than they were in the past.

Transferring risk

Where risks are known, informed judgments can be made about the wisdom of particular investments. The greatest danger comes, of course, where risks are unknown. Therefore, assuming that risks can be identified and assessed, an equally likely approach for other firms will be to transfer risk to new kinds of entities or to standalone divisions within more traditional existing institutions.

It is notable that funds simply write down the value of their investments rather than recapitalize their balance sheets. In a world where illiquidity risks are evaluated and these evaluations become an integral part of the calculations aimed at delivering outperformance, it may well be that fund-like structures become the most appropriate home for potentially illiquid financial products.

Concerns over liquidity are also going to have an impact on the once high-margin business of complex, custom-made derivatives. Banks are going to be increasingly unwilling to create illiquid over-the-counter financial products in light of investor reluctance to buy such products. This does not necessarily mean complex derivatives will disappear, but their use will increasingly shift to financial institutions that can better accommodate illiquidity risk.

For financial markets, the need for demonstrable transparency and liquidity is likely to lead to greater standardization and, thus, on-exchange trading.

These moves will be further enhanced by the exchanges themselves, which will encourage liquidity providers to enter the market.

Once something approaching normalcy returns to the markets, so too will the desire for outperformance. When this happens, banks are likely to move away from structures where illiquidity and attendant capital requirements are an issue, and create new corporate structures better able to cope with significant market fluctuations.

In accommodating new illiquidity risks, banks and funds will be able to take advantage of new opportunities and a new route to outperformance. But the need for better transparency and reporting will be absolute. The premium on illiquid products is certainly likely to rise, giving higher potential returns to investors who are less constrained by immediate capital requirements. Hedge funds could be one of the principal investors to take on this risk as they look to maintain returns in a world of lower leverage.

3. Capital requirements

The rising cost of capital is likely to hit financial institutions' returns, and lending dependent on a deposit base is not going to be sufficient to fund long-term growth.

While arguments will certainly continue about the origins of the credit crisis, there is no doubt about its chief impact on the banking sector: Substantial write-downs of assets have left banks around the world in need of significant recapitalization.

Part of the debate over bank solvency has focused on the application of fair-value accounting to complex financial instruments, something that becomes particularly complicated in illiquid markets. Prevailing rules have forced banks to "mark

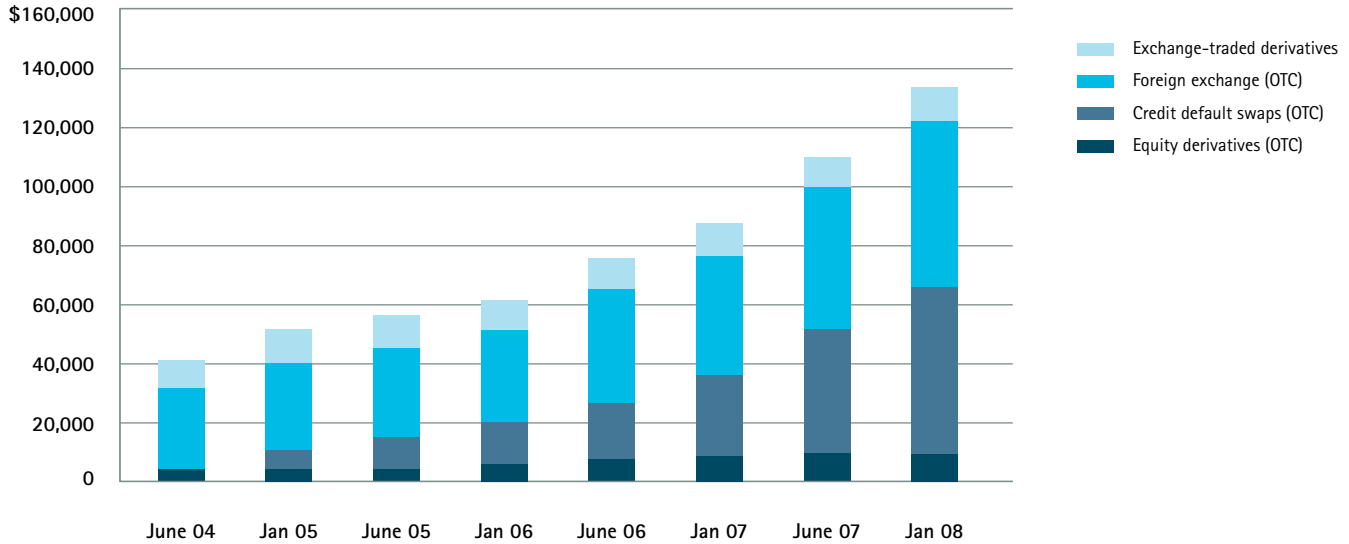
to market" products held on their trading books, resulting in valuations significantly lower than those implied by discounted future cash flow models. This undervaluation has amplified pressures on banks' capital reserves and has led to calls to recognize only realized losses and gains.

Proposed reforms include shifting a portion of trading-book assets to the banks' own accounts, essentially reverting to cost accounting and using the acquisition price and discounted

A wealth of ideas

Banks and hedge funds drove the development and trading of innovative financial products over the past decade with the total value traded rising to \$1.4 trillion in 2008.

Growth of financial products, \$ billions



Source: BIS; Accenture research

future cash flows to determine an instrument's value. Although this would ease solvency pressure, it would also mean less transparency for investors.

There is no clear and simple solution to this problem. But whatever the final outcome, capital adequacy will in all likelihood be the driving force in determining how firms and funds accommodate risks.

Revisiting leverage

Banks traditionally have had three principal sources of capital.

In the past, equity played a relatively minor role on banks' overall balance sheets—although this may well be changing with the injection of substantial government capital.

While banks will undoubtedly continue to use leverage, the higher

cost of debt means leverage levels will fall, and banks will find it difficult to maintain their historic return on assets. A reduction in leverage from 95 percent of capital to 66 percent, for example, could reduce average ROE from approximately 15 percent to 10 percent.

Although there may be little risk of regulators stipulating leverage levels, more cautious integrated-bank shareholders will undoubtedly demand a curtailment of the appetite for the sort of high-risk business models traditionally favored by investment banks. Where governments have become shareholders, the appetite for risk is likely to be even lower.

Retail deposits have once again become a key source of funding, especially as a number of commercial

banks absorb formerly independent investment banking operations and as former investment banks refashion themselves as bank holding companies.

Once established, a retail deposit base is a relatively low-cost source of financing and tends to be reasonably static. However, accumulating deposits is a slow and expensive process, and the most obvious way to attract more deposits—paying higher rates of interest—increases banks' cost of funding. In the medium term, growing an industry on a stable (even stagnant) depositor base is going to prove difficult.

For the moment, banks rightly remain focused on working through their current losses and assessing the length and depth of the global recession. In the medium term, however, banks will be unable to raise sufficient capital to accommodate future economic expansion unless they utilize the capital markets.

Banks, therefore, face two challenges. They need to reassure potential investors that in the future, they will not face the same risks that led to the present crisis. And they must find ways, without resorting to excessive leverage, to give investors an attractive return for the risks they are undertaking.

4. Innovation

There will continue to be a premium on financial-product innovation. But innovation will shift increasingly to the buy side. High fees will be dependent on demonstrable performance.

During the past decade, there has been a notable shift in power in the financial markets to the buy side, the end-consumer of most financial products. With this shift, sell-side investment banks no longer provide free research, control access to corporate clients, determine what financial products will be made available or, in many cases, even provide liquidity. This gradual change in the balance of power across financial markets has been accompanied by an equally important shift in the source of innovation.

Much of the recent innovation in financial markets has been driven by hedge funds. This does not mean, however, that fund managers are not feeling a good deal of pressure. Not only have their portfolios been decimated; even before the crisis, they were grappling with a number of challenges—the

higher costs of doing their own research, a reduction in the number of brokers they could work with and significant competition from low-cost index funds.

The capital markets will nonetheless continue to see rapid innovation. But precisely where innovation will occur—and what sort of risks and rewards will be involved—shall be subject to a good deal of change in the future.

What is certain is that product innovation will be more focused on customer needs, such as liquidity and transparency, than it has in the recent past. This customer-focused innovation will ultimately include process innovation and other ways to help clients better understand and assess risk, including risk associated with products that have already been developed.

Adding value

The search for returns will force high-cost active fund managers, particularly at hedge funds, to look where few others have gone before. This will drive managers to increase their funds' presence in areas such as less liquid, small company stocks and to continue their expansion into private equity. Fees will become more closely tied to performance, which will reinforce the need for innovation. Firms that can build on this innovation—by adding value or allowing value to be effectively added by others—are going to be the industry's high performers of the future.

As for the growing sentiment that hedge funds are something of an endangered species, this is certainly a possibility. But if they do disappear, they will be replaced by actively managed, leveraged funds with broad mandates—in other words, a more

highly evolved version of precisely the same thing.

Innovation may well require flexible capital structures. For products with an inherently high risk, it may well be that corporate entities that can accommodate illiquidity are more appropriate. These entities could be captives of larger integrated banks or completely independent.

As long as uncertainty grips the markets, large amounts of money will remain in cash or cash-equivalent instruments. Once this money reenters the market, there will be more than enough of it chasing top fund managers for them to maintain generous fee structures.

The rewards are potentially substantial. But more than ever before, they will fall to those who can deliver innovative instruments that offer a reasonable balance of risk and reward.

5. Regulation

Effective regulation will need to take a global, coordinated, flexible and holistic view of risk across all instruments and segments of the market.

The crisis in the financial markets has exposed two conflicting truths: Any regulatory scheme that does not seek to harmonize rules on an international scale is likely to be ineffective. But only a national government is going to have sufficient money and political clout to effectively underwrite a system in trouble.

What is needed today is a coordinated and structured global regulatory framework that actively identifies and manages shocks throughout the financial system. Moreover, any such global approach must strive to resolve a number of difficult and, at times, conflicting issues—including

ing concerns over moral hazard and a culture of excessive risk taking; an increasingly interrelated and complex global financial system; and the lack of consistency across markets.

Clearly, reaching broadly based agreement on what such a system will look like and how it will function is going to be a slow and difficult process.

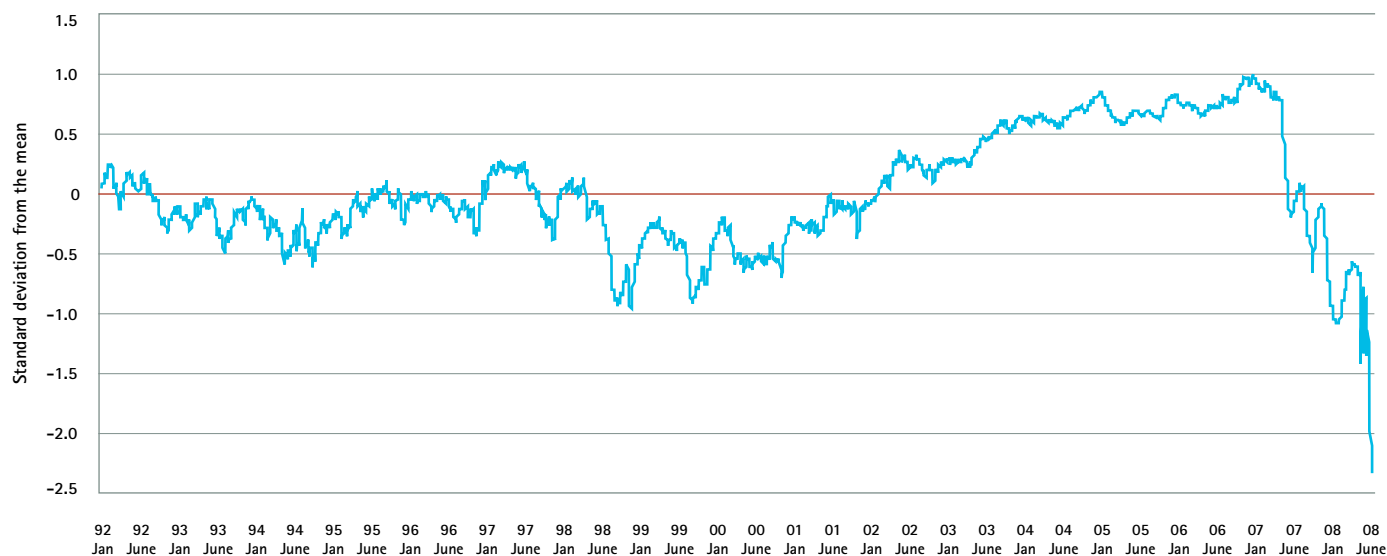
Emphasis on oversight

Regulatory regimes will continue to foster competition and support a technologically enabled market infrastructure. But there will be a new emphasis on repairing gaps

Cash strapped

The global liquidity index, which is based on nine different measures of liquidity that are then aggregated by the Bank of England, shows the total collapse of liquidity in the global financial system beginning with a severe contraction starting in August 2007.

Global liquidity index



Source: Bank of England

in oversight. There has long been an appreciation that international regulation is both necessary and should have some sort of risk assessment at its heart. What is now also being appreciated is that regulation cannot separate financing into various constituent parts.

The Basel II accords basically addressed commercial bank capital adequacy with little consideration for what was going on in the wider debt capital market. While the system is an improvement on what preceded it, Basel II has put rating agencies at the core of its risk assessments. Risk weighting is undoubtedly to be welcomed, but there are serious questions about the ratings themselves as well as about whether the agencies were appropriately responsive to the credit crisis as it developed.

We believe regulators need to address five issues.

- **Accounting rules.** Fair-value, historic-value and mark-to-model systems all have advantages. Looking at where each system might be best employed and by whom has to be a pressing priority as banks rebuild their businesses. Strict guidance as to when each set of rules should be employed may be necessary, but a greater degree of flexibility certainly looks to be desirable.
- **Capital adequacy.** Rules for many complex financial instruments need to be reviewed. Transparency must be central to any solution, which obviously places a premium on the understanding of such instruments.

The real winners will be those who have been brave enough to use this downturn to acquire new market share at steeply discounted prices.

- **Emerging markets.** Countries such as India and China are already major players in the global capital markets. If these countries are to be financed rapidly, with minimum risk to investors and at minimum cost to local companies, new capital adequacy regimes will need to be created to draw them into new international agreements.

Looking to the future

Deriving a definitive forecast from these trends is not our intention. Rather, it is crucial to understand that each of the five factors listed above will be important—no matter which scenario we consider most likely.

Two important variables will determine the shape of financial markets in the immediate future: how the economy recovers and how those markets are regulated. These two factors are obviously intertwined. Overzealous financial regulation could hinder an economic recovery, for example, just as a quick economic recovery could cool the current enthusiasm for tougher regulation.

Looking ahead, Accenture envisions three plausible scenarios for capital markets, each with its own challenges.

1. Deep regulatory engagement

Governments around the world have invested unprecedented sums of taxpayer money in their banks, just when recession is biting deeply into the global economy. In the first scenario, in an attempt to protect these investments as well as to shield electorates from the worst ravages of the economic downturn, governments, through their regulators, take a highly active role in banking operations.

Under this scenario:

- **Regulators determine, or help to guide, broad levels of bank**

- **Regulatory scope.** Principles-based regulation will continue. However, regulators are going to take a much broader, more dynamic and interactive view of their role.
- **Transparency and liquidity.** Both must be improved, although how this will be achieved in full remains to be seen.

lending and terms of lending.

Historically, allowing political priorities to direct bank lending has seldom been successful. For the moment, there remains broad agreement that even where a government has invested considerable sums of taxpayer money, banks should be run at arm's length from politicians. However, this general agreement has not entirely muted calls for using the financial system for largely political ends.

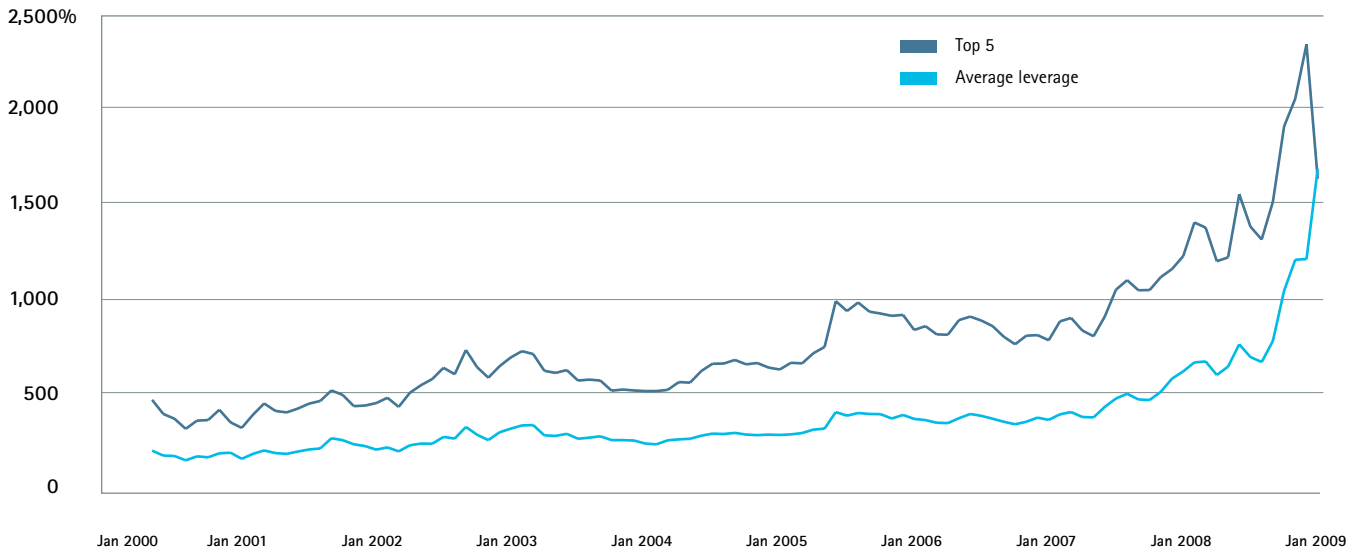
The danger is that as recession progresses, political priorities overcome the best of government intentions to refrain from unduly influencing banking operations.

- **Businesses or activities deemed “too risky” by regulators are either discouraged or disallowed.** By stipulating what sorts of products are allowed, or by closely circumscribing products, regulators will discourage the kind of financial innovation and product creation that sustained margins and, at least in part, returns over the past decade. Yields would fall in the broader financial markets as demand drives up prices, and any economic recovery would be slowed by a lack of dynamic capital.
- **Regulators seek to influence, if not set, executive compensation.** The question of whether prevailing executive compensation schemes in the capital markets

Risky business

Leverage ratios at banks rose over the past decade and then began to spike in late 2007 as share prices fell. The five banks that had the highest leverage ratios since 2000 peaked at a ratio of 2,300 percent total debt-to-market capitalization.

Selected banks' leverage ratios



Source: Bloomberg; Accenture research

encourage disproportionate risk is a matter of considerable debate. For the moment, in those cases where no public money has been sought for a bailout, there is little regulators are proposing to do.

But where there has been a government injection of public funds, there will undoubtedly be some danger of the regulation of executive compensation. This may lead to a flight of talent to lightly regulated funds, where far higher compensation (for taking far higher risk) can be earned away from the glare of public oversight. Whatever the outcome, executive compensation will remain a highly incendiary political issue as long as taxpayer money is involved.

- **Regulatory compliance becomes a major expense and an effective barrier to entry into financial**

services. Wide-ranging regulation would largely be dictated to the industry, which could become a serious burden. For example, regulatory compliance costs could rise considerably. As a consequence, competition would be reduced across capital markets as entrepreneurial firms would be discouraged from entering markets due to high initial costs and lower potential returns.

2. Ragged recovery

This scenario, which we consider the most likely, foresees a normal recovery in due course. A ragged recovery is, in many ways, proof that life is fair. Those financial institutions that were most excessive in their risk taking in the past would be punished. The survivors would be those that had been conservative in their lending, effective in their risk management, or large enough to withstand losses.

Innovation is likely to shift to products that transparently meet a specific need and to emerging-markets financial products where sustained outperformance is realistically possible.

However, the real winners would be those who have been brave enough to use this downturn to acquire new market share at steeply discounted prices.

A renewed emphasis on transparency and liquidity is a certainty and will be a feature of all three scenarios. But in a ragged recovery, once the financial markets begin to recover, so too will the desire for outperformance. For banks that have had difficulty coping with illiquid financial products on their balance sheets, the solution is not to abandon innovation but to move product innovation and complexity to new organizational structures that can cope with the changing marketplace.

The potential for financial product innovation is no more likely to fade than human ingenuity. In a ragged recovery, complex and potentially illiquid products are going to be manufactured, sold and held by entities that can cope with illiquidity. Furthermore, innovation is likely to shift from complex products to products that transparently meet a specific need and emerging-markets financial products where sustained outperformance is realistically possible.

As for regulation, under this scenario:

- Regulators take a supervisory and directing role only in those firms they have rescued.
- New dynamic risk measures are utilized by both investors and regulators.
- It is accepted that mistakes have been made by both firms and regulators, and that the concerned parties work together on the next generation of regulation.

Regulation would seek to be principles-based and flexible enough to respond to changing circumstances within the wider market. This will push regulators and the regulated to work cooperatively on an ongoing

basis. The cost of regulation under this arrangement would rise and may, in the process, curtail new entrants into the market. But this will have only a marginal effect on overall competition.

3. Rapid recovery

Unlikely as this now might seem, the potential for the global economy to recover more rapidly than is being forecast must be considered. For the capital markets, the most important feature of this scenario would be a rapid return of those underlying factors that drove the business during the past few years: demand for financial products and the push into emerging markets.

Considerable amounts of investor capital have been withdrawn from markets over the course of 2007 and 2008. In a rapid recovery, this money would quickly reenter markets. This would not only automatically repair many balance sheets and boost pension funds, it would also provide capital for a renewed expansion.

While there would be a new regulatory regime, the expanding recovery would reduce the political pressure to use intrusive or draconian measures to punish bankers. Under this scenario:

- Regulators take a supervisory and directing role only in those banks they have rescued.
- New dynamic risk measures are utilized by both investors and regulators.
- Pressure for new regulations is lessened and international agreement becomes more difficult.

None of our scenarios foresees product complexity as it existed pre-crisis. However, a rapid recovery would quickly create demand for new products. This would lead to both a complexity of products drawn from across silos and a

renewed interest in products from emerging markets.

This scenario would also take the pressure off politicians to act for the sake of acting, with the result that there would be relatively little regulatory change over the next few years. This would be particularly true for comprehensive international regulation, which, in the absence of an obvi-

ous imperative to act, becomes even more difficult to agree upon.

The danger of this scenario is that the lessons of the past few years are not absorbed, and that in the medium term, the imbalances that have led to the present difficulties will simply reemerge. And presumably, this is a path no one in the capital markets wants to go down again.

During the past seven years, financial markets were so buoyant that even capital markets firms with poorly conceived, undifferentiated strategies could prosper. But it is now clear that the business model that prevailed until the summer of 2007 was not sustainable. And any firm that seeks to resuscitate that model is bound to fail.

But turning their backs on the past is not enough. High performers in capital markets will be those who understand not only how the world has changed but also how, with the right market positioning, distinctive capabilities and performance anatomy, they can take advantage of those changes.

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