WORLD ECONOMIC FORUM

COMMITTED TO
IMPROVING THE STATE
OF THE WORLD

The Future of the Global Financial System

Navigating the Challenges Ahead

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World Economic Forum
91-93 route de la Capite
CH-1223 Cologny/Geneva
Tel.: +41 (0)22 869 1212
Fax: +41 (0)22 786 2744
E-mail: contact@weforum.org
www.weforum.org

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The Future of the Global Financial System
Navigating the Challenges Ahead

A World Economic Forum Report
in collaboration with
Oliver Wyman

Contents

Preface

The financial crisis of 2008 and the “Great Recession” of 2009 have shaken the very foundation of the financial architecture and raise challenging questions about the future of the global economy. They also highlighted the economic interdependencies, governance gaps and systemic risks intrinsic to globalization. These revelations compel us to rethink the purpose and business models of financial institutions, the role of financial innovation and governance of the global financial system. Rethinking has already triggered attempts at redesign. National legislatures, supervisory authorities and international organizations are now transforming institutions, policies and regulations with the aim of closing governance gaps, preventing systemic failures and restoring growth.

Over the past months governments and central banks have been forced to intervene in an unprecedented fashion to avoid a collapse in the global financial system. While it seems that the worst has been avoided, significant challenges remain ahead. Attention is turning to the question of how to responsibly deal with the consequences of these rescue operations. The fiscal and monetary stimuli enacted to ease the pain of the crisis are now fuelling anxieties about the creation of new economic bubbles and ballooning deficits which will have to be corrected. Beyond assessing steps in fiscal and monetary policy, governments are looking to protect over USD 700 billion of direct taxpayer equity investments in financial institutions. Furthermore, financial institutions themselves are undergoing significant change even as they work to rebuild the trust they have lost during the crisis.

It is in this context that the World Economic Forum is releasing this second report from its New Financial Architecture project. It is being launched at the 40th World Economic Forum in 2010, which, with its organizing theme "Improve the State of the World: Rethink, Redesign and Rebuild", will provide leaders from industry, government and civil society with a unique and timely opportunity to actively advance solutions to the critical challenges outlined above. Key tracks of the meeting will be focused on strengthening economic and social welfare, mitigating global risks and addressing systemic failures.

We trust that the World Economic Forum’s New Financial Architecture project and this publication will both provide relevant input as well as catalyze important dialogue between governments, the private sector and other key stakeholders regarding the challenges ahead for the global financial system.

Above all, we hope the insights it provokes may contribute towards ensuring that together we will learn from the challenges of 2008 and 2009 in order to promote long-term financial stability and to revive global economic growth.

Professor Klaus Schwab
Founder and Executive Chairman
World Economic Forum

Introduction

The World Economic Forum is proud to release this second report from our New Financial Architecture project. The project was initiated in January 2008, in the midst of the evolving financial crisis, to explore the near- and long-term forces that are shaping the global financial system.

The first report *The Future of the Global Financial System: A Near-Term Outlook and Long-Term Scenarios*[1], published in January 2009 explored:

- how the financial crisis, and the changes it has precipitated in financial regulation and supervision, will affect the near-term structure of wholesale financial markets and how these changes will likely impact players in the banking, insurance, and the alternative investments industries.
- four long-term scenarios for the future of the global financial system up to 2020. The scenarios – re-engineered Western-centrism, rebalanced multilateralism, fragmented protectionism, financial regionalism – were driven by two unfolding forces: the shift of geo-economic power from West to East, and the degree of global coordination of financial policy.

Building on the first report, the present publication dives deeper into select near-term challenges with the goal of exploring collaborative strategies for improvement. It therefore moves the discussion from identifying 'potential outcomes' towards identifying ways in which key stakeholders might shape 'desired outcomes'.

In particular, this report aims to assist those shaping the future financial architecture through a structured look at three questions that were identified as crucially important going forward:

1. Given the significant developments since the first publication in January of 2009, what will be the key forces driving the post crisis evolution of the financial services landscape in the coming years?
2. Having deployed a broad and deep set of tools to combat the crisis, how can governments now best meet the challenges of managing and resolving their newly acquired equity interests in financial institutions?
3. How can financial institutions begin to restore trust lost through the crisis?

In doing so, this report adopts a complementary perspective to the ongoing discussion about financial industry reform led by international bodies such as the Group of Twenty (G-20), Financial Stability Board (FSB), International Monetary Fund (IMF) and Bank for International Settlements (BIS). Understandably, most of these discussions have been focusing on reform at the systemic level. However, the public dialogue is far less advanced in exploring specific strategies that should be adopted by key stakeholders such as financial institutions and governments as they deal with immediate challenges emerging from the crisis. For that reason, this report emphasizes the stakeholder perspective.

The report is the result of a year-long multi-stakeholder collaboration of the World Economic Forum and Oliver Wyman with over 150 leaders in public policy, academia and business participating in interviews and workshops around the globe. Throughout this process, intellectual stewardship and guidance was provided by a global and actively engaged Steering Committee chaired by David Rubenstein, Co-Founder and Managing Director, The Carlyle Group.

1 To download the report go to www.weforum.org/nfa

This report is one of a series of related publications addressing issues concerning financial institutions which are being published in advance of the 2010 Annual Meeting as part of the Investors and Financial Services Industry Partnership programmes. Together these publications will give a broad range of proposals and insights into different elements of the crisis.

On behalf of the World Economic Forum and the full project team we wish to particularly thank the members of the Steering Committee, the interview and workshop participants and our partners at Oliver Wyman (especially Julia Hobart and Ben Hoffman) for their invaluable support.

Max von Bismarck
Director and Head of Investors Industries
World Economic Forum USA

Bernd Jan Sikken
Associate Director and Head of Project Management,
Centre for Global Industries
World Economic Forum

Kevin Steinberg
Chief Operating Officer and
Head of the Centre for Global Industries
World Economic Forum USA

Steering Committee members

Paul Achleitner, Member of the Board of Management, Allianz SE

Sameer Al Ansari, Executive Chairman, Dubai International Capital LLC

Bader Al Sa'ad, Managing Director, Kuwait Investment Authority

Sir Howard Davies, Director and Head, London School of Economics and Political Science

Robert E. Diamond Jr, President, Barclays Plc

Volkert Doeksen, Chief Executive Officer and Managing Partner, Alpinvest Partners

Tolga Egemen, Executive Vice President, Garanti Bank

Jacob A. Frenkel, Chairman JP Morgan Chase International, JP Morgan Chase & Co.

Johannes Huth, Managing Director, KKR & Co Ltd

Antony Leung, Senior Managing Director and Chairman of Greater China, Blackstone Group (HK)

Scott McDonald, Managing Partner, Oliver Wyman

Daniel Och, Founder and Chief Executive Officer, Och-Ziff Capital Management Group LLC

David M. Rubenstein (Chair), Co-Founder and Managing Director, The Carlyle Group

Heizo Takenaka, Director, Global Security Research Institute, Keio University

Tony Tan Keng-Yam, Chairman, Government of Singapore Investment Corporation GIC

Ruben K. Vardanian, Chairman of the Board and Chief Executive Officer, Troika Dialog Group

Executive Summary

The global financial and economic crisis of 2008/2009 has shaken the very foundation of the financial architecture. With the most dramatic events of the crisis likely behind us, the complex set of stakeholders to the financial system – most notably governments, central banks and financial institutions – are working individually and collectively to define the best path forward.

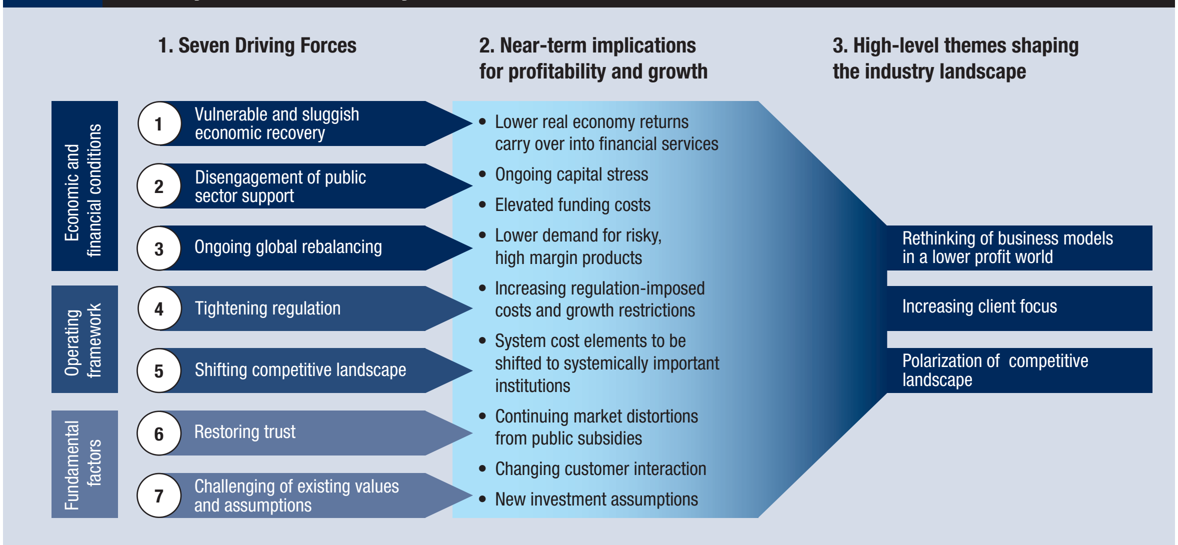
Building on last year's report which explored how the governance and structure of the financial system might evolve over both the near- and long-term, this report aims to assist those shaping the future financial architecture through a structured look at three important questions:

1. Given the developments since the publication of *The Future of the Global Financial System: A Near-Term Outlook and Long-Term Scenarios* in January of 2009, what will the near-term post crisis evolution of the financial services landscape look like?
2. Having deployed a broad and deep set of tools to combat the crisis, how can governments now best meet the challenges of managing and resolving their newly acquired equity interests in financial institutions?
3. How can financial institutions begin to restore trust lost through the crisis?

Chapter 1 - Evolving industry landscape

The crisis brought two decades of prosperity and growth in the sector to an abrupt end. No longer buttressed by deregulation, expansionary monetary policies, globalization and innovation, the leaders of financial institutions should take stock of the likely near-term evolution of the industry in order to rapidly adjust to new realities.

Figure 1 **Summary of near-term industry outlook**



Source: Authors' analysis

Ultimately, three high-level themes will shape the financial services industry in the near- to medium- term:

Rethinking of business models in a lower profit world
A multitude of factors point to lower industry profitability in the near- and medium-term: a dampened real economy, ongoing capital stress, increased costs imposed through regulation, elevated funding costs and generally less appetite for risky (but high margin) products. While this decreases the relative attractiveness of the sector, like any other disruptive change it creates room for the emergence of new winners and losers. Institutions will need to rethink their business and human capital models in order to adjust and differentiate. Successful strategies will likely involve a focus on operational excellence, risk management and innovation.

Increasing client focus
In an environment in which customers are more demanding of financial institutions, and where profit pools are lower and grow at a slower pace than historical levels, delivering meaningful value to customers needs to be a top priority of all financial institutions. Fortunately, the two decades of 'easy' profits means many opportunities remain to provide new and valuable products and services to customers.

Polarization of competitive landscape
The competitive landscape is likely to polarize along several highly contentious dimensions. No longer operating in a "can't lose" market, financial institutions will increasingly need to justify their strategies to investors and regulators who will apply much more scrutiny than they previously had. The first dimension of polarization is the regional footprint, where some firms will choose to limit their international presence while others will build on their competencies in building global economies of scale. Secondly, as regulation will make it increasingly costly to operate a complex universal model, there will be more polarization along the universal versus niche dimension. Finally, financial institutions have already begun to some extent to abandon the middle ground between low-risk utility and specialist risk taker and more of that is likely to be observed in the coming years.

Chapter 2 - Governments as shareholders

As the financial crisis that began in 2007 threatened a complete systemic meltdown and a global depression, governments were forced to deploy a broad set of tools to support the global economy. From economic policy to regulation, and from asset support to recapitalization of struggling institutions, the response has reached broadly and deeply across the financial architecture. With most new interventions now in the past and risk of systemic collapse no longer looming as large, governments' attentions are shifting to management and eventual resolution of their many forms of crisis intervention.

Among interventions entering the management and resolution phases, newly acquired equity stakes in financial institutions pose a new and unique challenge for many governments. As a result of crisis interventions, over 20 national governments have acquired equity interests in some of the largest and most complex financial institutions in the world (e.g. AIG, Freddie Mac, RBS, Hypo Real Estate), over US$ 700 billion of taxpayer investment is at stake, and the relationship between government and the private sector has been redefined in many countries, at least temporarily. Therefore, this chapter does not seek to answer the question of whether and how governments should intervene, but rather addresses the question, "How can governments best meet the challenges of managing and resolving their newly acquired equity interests in financial institutions?"

In addition to representing hundreds of billions of dollars of taxpayer investment, equity ownership is closely connected to issues of systemic risk, market distortion and the long-run health of the financial sector. The critical decisions of how to manage and resolve these investments will be made in a period of extreme market turmoil, with pending regulation on such critical issues as financial leverage, risk management and incentives.

Navigating the new role of government-as-shareholder in these difficult times will require continuous focus on three guiding principles: transparency, governance and leadership. Transparency helps restore trust in leadership and governance processes, and holds those leaders and processes accountable for results. Governance ensures continuous and unobstructed focus on core objectives. Leadership will be needed to decisively, thoughtfully and skillfully navigate both the government shareholdings and the institutions in which governments have invested.

Exploring these three themes, this chapter draws on extensive research as well as consultations with over 150 of the world's leading experts in global finance including private sector leaders, academics and policy-makers. In conclusion, the chapter presents six critical recommendations for effectively managing and resolving newly held government equity stakes in financial institutions (see table below) on behalf of the World Economic Forum's Investors and Financial Services communities (as represented by the steering committee for the New Financial Architecture project).

Chapter 3 - Restoring trust

Trust in the global financial system, and the institutions and individuals that comprise that system has significantly eroded through the crisis. The past two years have seen banks unwilling to lend to each other during a liquidity crunch, retail customers diversifying their bank exposure, and taxpayers insisting on resignations, compensation reductions and criminal prosecutions of financial institution executives.

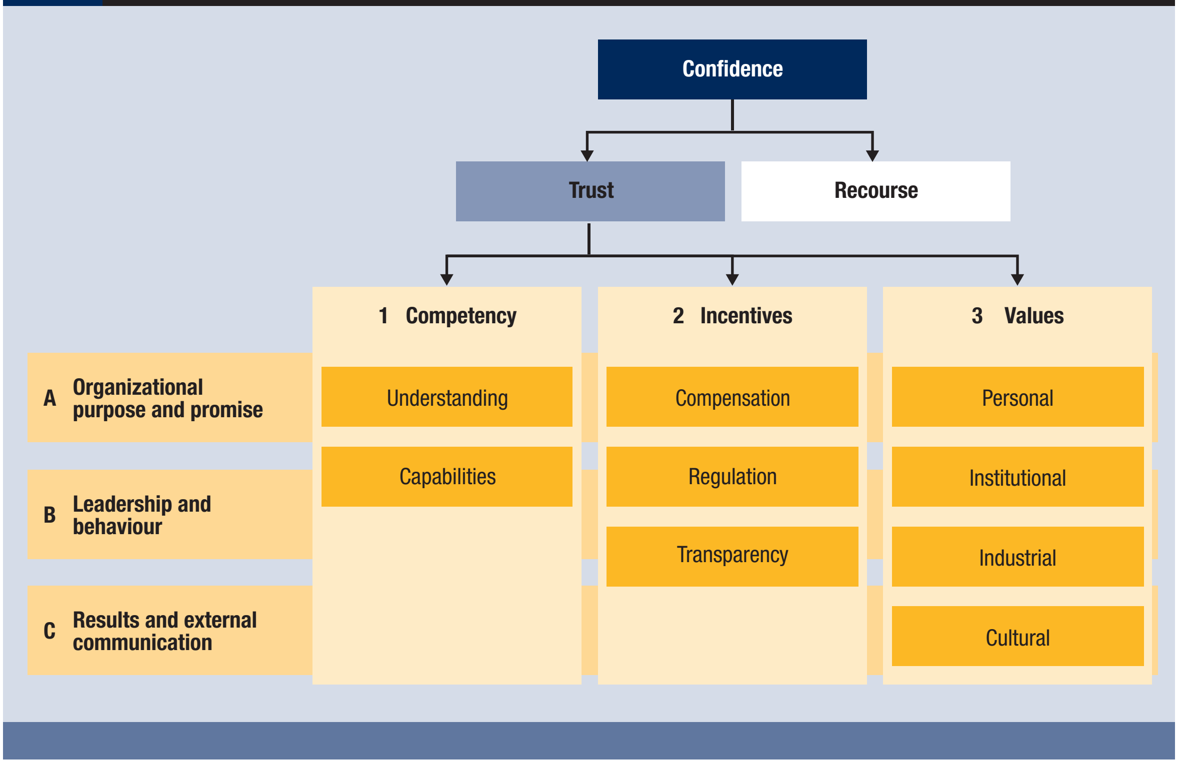
Today, as bodies such as the G20, Financial Stability Board, and the European Commission work to restore trust in the global financial system as a whole, individual financial institutions are working to restore counterparty trust necessary for competitive success and long-term durability. In order to successfully restore trust lost through the crisis, financial institutions will need to understand the importance and role of trust in their organizations, be able to systematically diagnose problems of trust, and develop strategies and tactics geared at restoring trust.

Figure 2 **Recommendations from the financial services and investors communities**

	Recommendation	Rationale
Foundational	1. Conceptually separate equity ownership from other forms of crisis intervention	• Challenges of ownership are distinct from those of other forms of intervention • Muddled public dialogue risks mismanagement of resolutions
	2. State objectives as shareholder – balancing exiting quickly and protecting taxpayer investment	• Clarity of purpose is critical to move forward with resolutions • Ownership should not be used to pursue broader policy goals; need to balance speed of exit and protecting taxpayer investment
Structural	3. Set up independently governed process to manage and resolve ownership stake	• Independence limits political influence on managing and resolving government shareholdings • Clear mandate and effective structure and governance will be key to success in creating independence
	4. Restrict government influence on owned institutions to board composition, governance and proxy issues	• Private equity model is too invasive, retail model too passive • Influencing board composition, governance and proxy issues (including transactions) is necessary and sufficient for pursuit of government objectives • Board members should be independent and represent interests of all shareholders
Tactical	5. Secure and empower management talent for both government and private sector roles	• Complexity of tasks requires specialized talent • Value proposition must be competitive (remit, incentives, political support, etc.)
	6. Ensure high levels of transparency and accountability	• Both are necessary to allow managers to effectively pursue individual remits • Allows stakeholders to hold change agents to account for plans and actions and thereby helps restore/retain confidence

As with the other chapters in this report, a wide array of experts were consulted on the challenges of restoring trust to help build a fact base, common vocabulary and a high level set of strategies and tactics that could be deployed against this pressing problem. Using the framework presented below, this chapter takes a methodical look at these issues with the goal of advancing the very important dialogue on how financial institutions can regain and keep the trust of their diverse stakeholder communities.

Figure 3 **Trust framework**



Looking forward

In the process of consulting many of the world's leading experts in financial services on the topics covered in the three main chapters of this report, substantial energy was generated not just around the topics covered in those chapters, but also on the need to prepare for and ideally prevent the likely challenges the industry may face in the future. Though not the intended focus of this paper, we would be remiss in not recognizing and sharing some of the most commonly identified potential future challenges. These include both potential asset bubbles as well as structural flaws being built into the financial architecture as the public and private sector rebuild following the crisis.

In this closing section of the report, we present some of these scenarios in the hope that this report will help stakeholders to the global financial architecture not only to address today's most pressing challenges, but also to prepare for and prevent the challenges of tomorrow.

Chapter 1 Evolving industry landscape

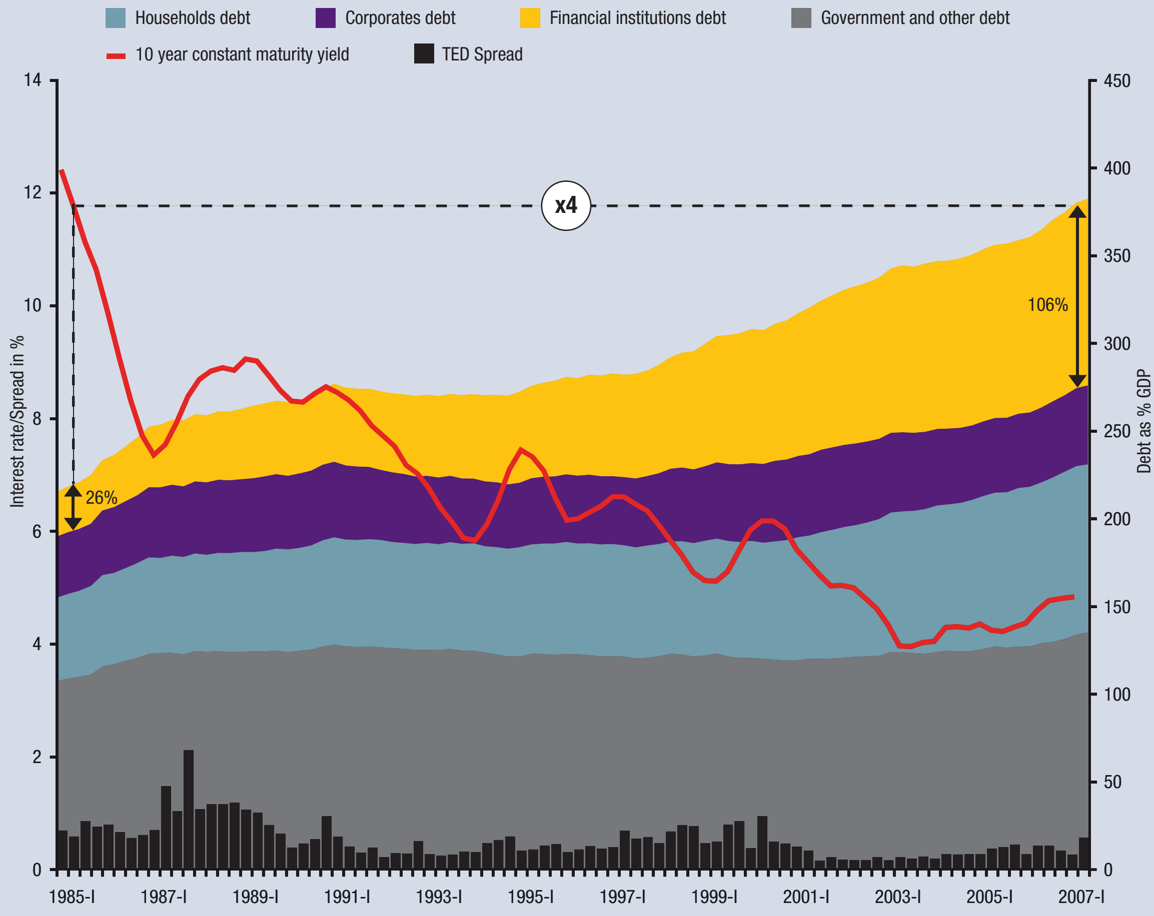
Industry landscape refresh

Leading into the crisis

The two decades leading up to the unfolding of the financial crisis in mid-2007 were characterized by a remarkable degree of macroeconomic stability and prosperity. Many factors contributed to this trend, the most important being expansionary monetary policies (e.g. a prolonged downward trend in interest rates since the early 1980s), liberalization and deregulation of financial markets, financial globalization, technological and financial innovation, and the expanding global economy.

Easy access to financing, in terms of relaxed lending standards and low interest rates, supported by upward drifting asset prices and a stable macro-environment, fuelled an increase in debt as a percentage of GDP, notably in the United States and Western Europe. During this period, indicators of financial risk (e.g. the interbank TED spread) remained unusually subdued, reflecting the general expectation of a prolonged period of economic stability (see figure 4).

Figure 4 **Select US financial indicators leading into the crisis**



Source: Federal Reserve, Bloomberg

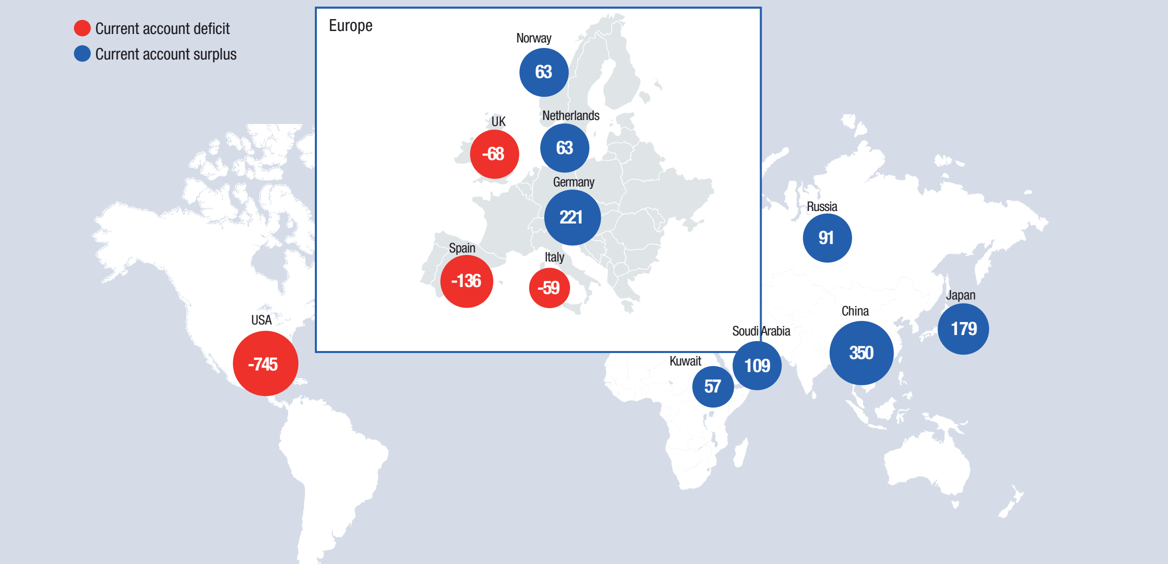
The ease with which money could be borrowed and what is now understood to have been a mispricing of the risk attached to debt drove asset prices up around the globe, especially in some of the world's largest real estate markets.

Moreover, in this apparently stable environment, households, corporations and governments allowed savings ratios to fall substantially and expanded their spending, comfortable in the mistaken belief that assets would continue to appreciate.

While these trends were largely global, differences in policy and behaviour between East and West allowed for the development of a highly significant global geo-economic imbalance (see figure 5). Many Western economies, particularly the United States, ran significant current account deficits that were financed by current account surpluses in emerging Asian economic powers, particularly China. As the world's emerging economies transformed themselves from debtor to creditor economies, geo-economic power began to shift towards them.

Figure 5 **Global imbalances in current accounts**

Average current account balance 2006-2008 (countries with average surplus or deficit in excess of US$ 50 billion)
US$ billions



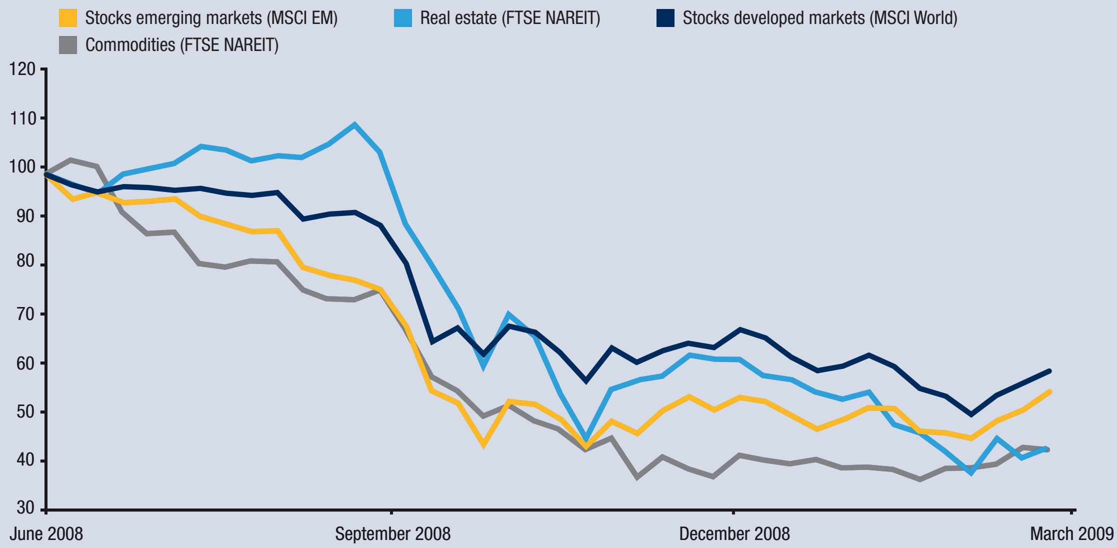
Source: IMF

Bursting of the bubble(s)

With hindsight, the apparent prosperity and growth of the two decades leading into the crisis were never sustainable. The cycle of falling rates, increasing debt, decreased savings, increased spending and increasing gap between East and West simply ran out of runway.

Like Wile E. Coyote looking down having run off the cliff, the market descent began when investors noticed decayed performance in certain asset classes and began to investigate the fundamentals. While this began in the assets most closely linked to US subprime mortgages, the contagion quickly spread to virtually all major asset categories worldwide, leading to the destruction of trillions of US dollars in global financial wealth[2] in a matter of a few months (see figure 6).

Figure 6 **Financial market performance (6/08-3/09), indexed to 100 at June, 2008**



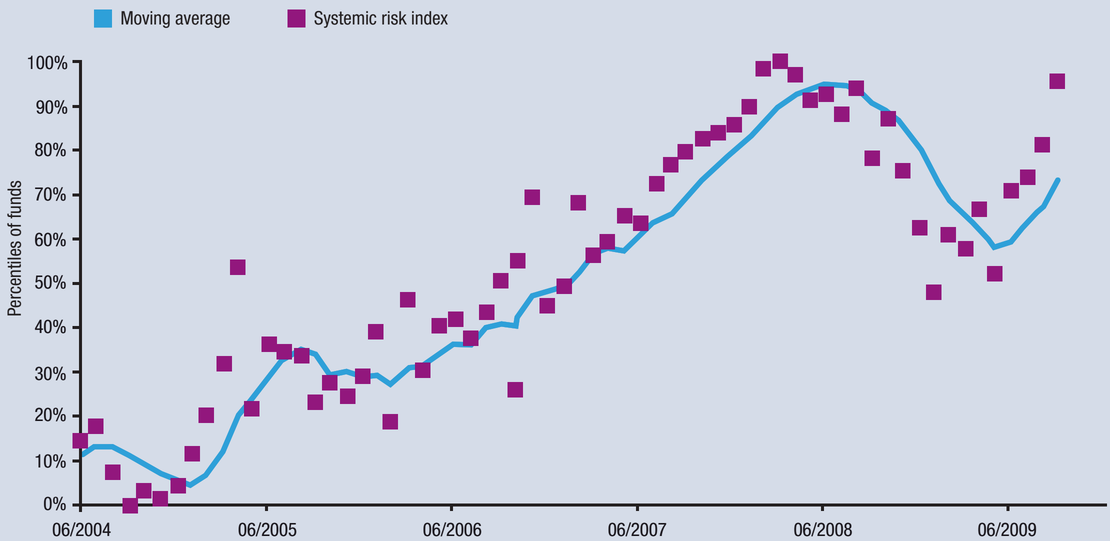
Source: Datastream

2 In May 2009, Oxford Economics estimated than total global financial wealth has fallen some US$28 trillion, or 14% from its peak.

As the crisis spread throughout the globally interconnected financial system, a major complication became apparent. It was not at all clear which investors and market participants were most exposed to the steep falls in asset values. Widespread ownership of complex and often opaque investment instruments, including collateralized debt obligations and many other structured investment products, made counterparty risk exposures difficult to evaluate, especially when they were held off balance sheet. Market participants soon realized that external ratings might not accurately represent the true quality of some of these instruments. This uncertainty also led to a general distrust of financial markets and instruments that seemed to lack transparency and liquidity.

Facilitated by a lack of transparency, another cause of the crisis was herding behaviour among market participants. Data on fund asset allocation reveals that, while individual investment decisions were made independently, the majority of funds ended up with similar asset allocation profiles (see figure 7). This in turn constitutes a systemic risk element as, when concentration of asset exposure goes up, asset price declines affect more investors simultaneously and individual diversification becomes less effective.

Figure 7 **Systemic risk based on fund diversity**



Footnote dedicated to this chart:

Chart shows the similarity between a sample of about 17,000 funds, covering pension funds, mutual funds, sovereign wealth funds and insurance funds. Each fund is classified according to its % exposure to 80 different asset classes. From these it is possible to construct a hypothetical 'median' fund. Each fund is compared with this hypothetical fund, summarized by the sum of squared exposure differences. The chart shows the current percentile position of the average value of this sum of squared differences across the 17,000 funds, compared with its historic range. So if the value is high, then funds tend to have similar exposures concentrated in a few asset classes and systemic risk is high; if the value is low then the fund holdings are diversified and systemic risk is low. The scale runs from 0% to 100%, reflecting the current position within the historic range. A value of 100% means that systemic risk is at a maximum for the period shown.

Monthly data points are in red and the blue line shows the 6 month moving average

Source: Data Explorers

As asset values plummeted, risk premiums increased and liquidity dried up due to lack of transparency, many of the world's largest financial institutions – primarily hedge funds, insurers and banks – were wounded and some fatally so. Liquidity problems, lack of high quality capital and pro-cyclical mark-to-market accounting forced asset disposals at fire sale prices and loan loss reserving at many multiples of previous levels. These in turn necessitated large capital raises. The IMF's Global Financial Stability Report in October 2009 estimates that globally US$ 1.3 trillion of write-downs have already been realized by the banking sector. At the same time, institutions that had excessive structural maturity mismatches in their funding strategies suddenly found themselves unable to borrow. With so many institutions facing simultaneous liquidity and solvency concerns, capital markets were overwhelmed with surging demand from financial institutions for both debt and equity instruments. For a number of large banks and hedge funds, liquidity was often the final straw – with unprecedented levels of redemptions to be observed in case of the latter. While for insurers and more retail-oriented banks, the greater risk was from insolvency due to rapid asset devaluation.

The result was a series of headline-grabbing collapses and shotgun weddings of financial institutions during 2008, culminating in the Lehman Brothers bankruptcy in September and the seizure and sale of Washington Mutual Bank by US regulators later the same month.

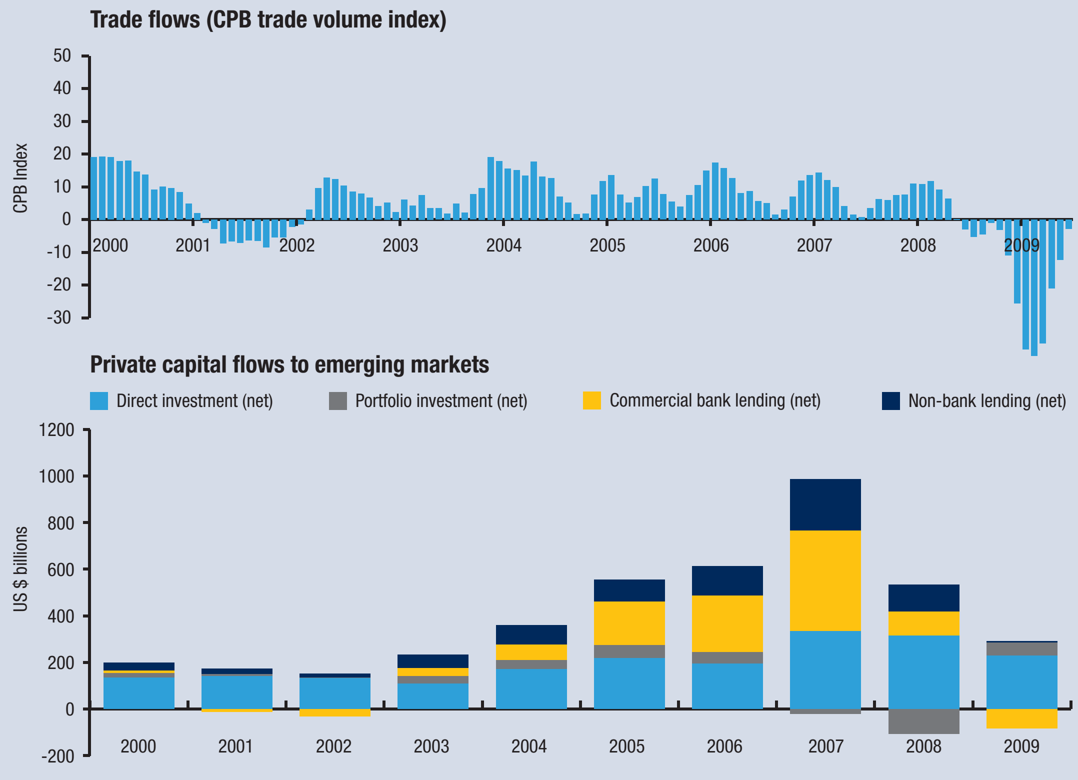
As governments worked to pull the global financial sector from the brink of systemic collapse, the damage done in the financial sector was already beginning to spread into the real economy.

From Wall Street to Main Street – Impact on the real economy

The banking industry's fight to preserve capital and liquidity led to a significant tightening of lending globally, which in turn had a number of severe implications (see figure 8 and 9):

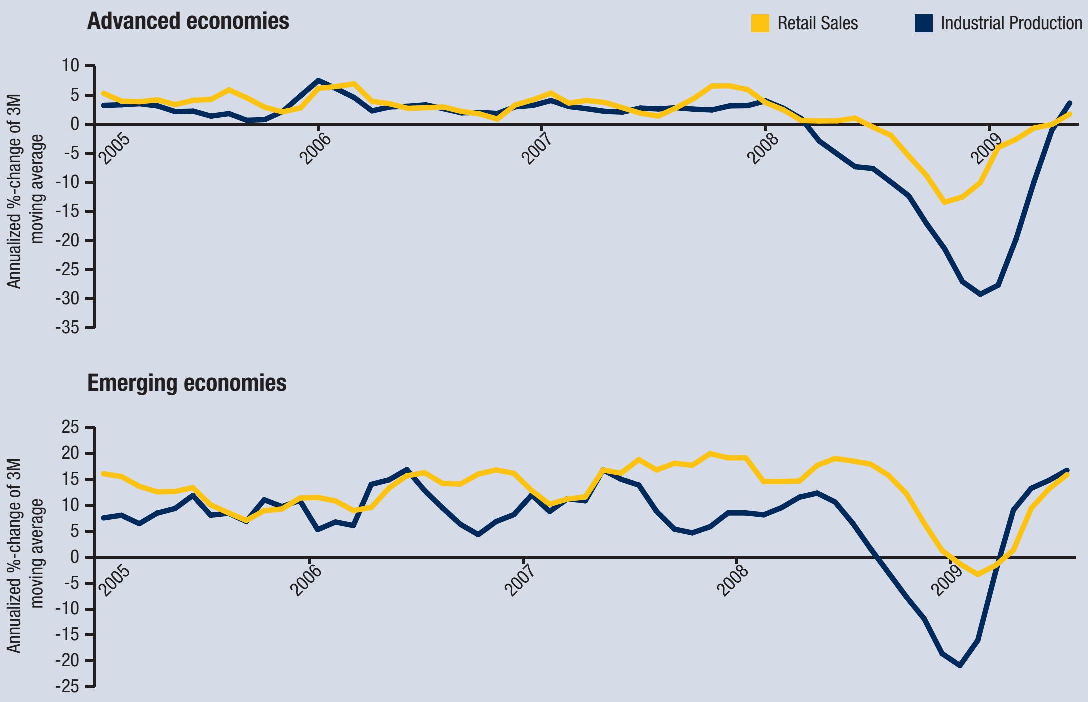
- Led by a retraction in bank lending, global capital rushed away from developing economies that previously experienced significant private capital inflows, leaving many weakened economies exposed to severe financing problems and pressure on their currencies (e.g. Baltic States).
- Along with capital flows, global trade volume and industrial production diminished as companies prepared for a reduction in demand for capital intensive goods and a fall in consumer spending, and experienced challenges in securing new financing.
- Finally, as consumers reassessed their financial position, they cut their spending and started to save more – exacerbating the fall in demand for products and services. Retail sales fell accordingly.

Figure 8 **Impact of crisis on world trade and private capital flows**



Source: IMF, IIF

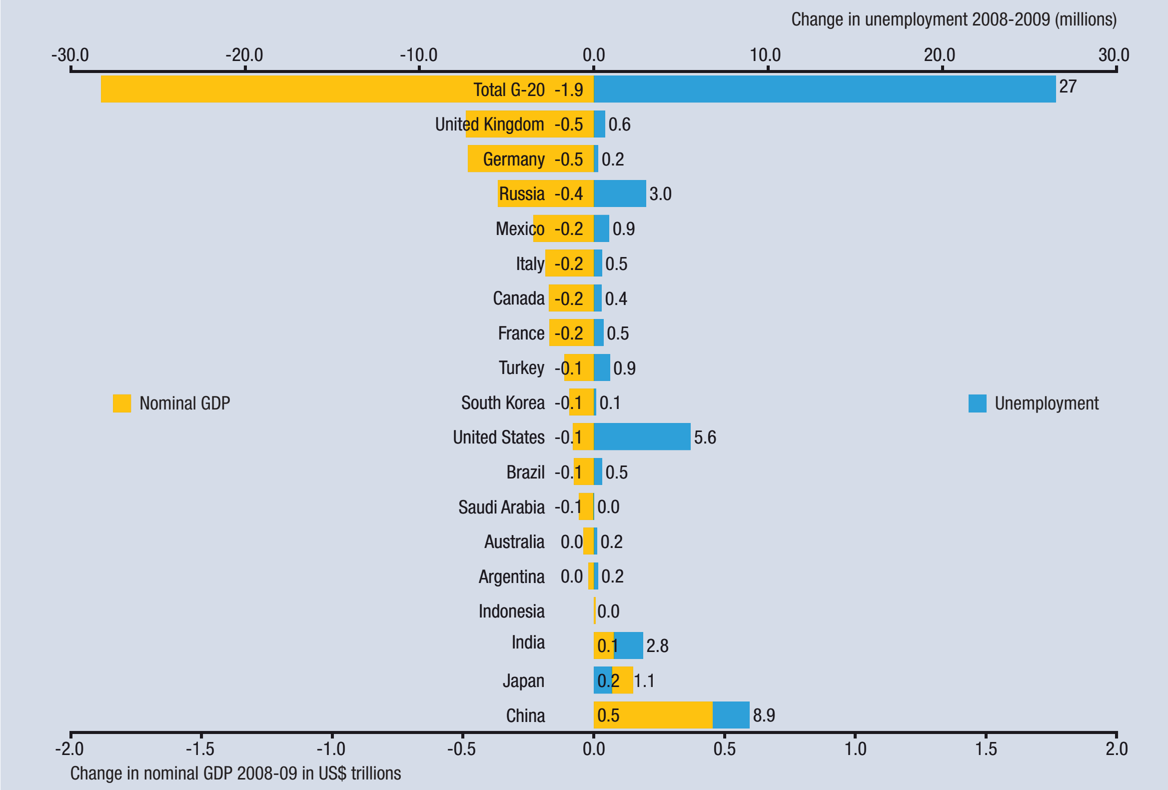
Figure 9 **Impact of crisis on industrial production and retail sales**



Source: IMF

As a result, many countries around the world went into severe recession or suffered a significant economic slowdown. Unemployment started to rise significantly and, by the end of 2008, economic output seemed about to collapse. In the first months of 2009, fear grew of a depression similar in scale and extent to the Great Depression of the 1930s, with a significant fall-off in economic activity and millions of people becoming unemployed (see figure 10).

Figure 10 **Impact of crisis on GDP and unemployment**



Source: Economist Intelligence Unit

By the autumn of 2009, however, economists began to see light at the end of the tunnel. There had been significant rallies in key markets since spring 2009, particularly the world's stock markets and commodity markets, which seemed to be pricing in a significant economic rebound. Indeed, some emerging markets seemed to be back on the path of significant growth and there were even worries that new asset price bubbles were beginning to form on the back of expansionary economic policies initially designed to combat the crisis.

At the same time, most economists and market participants remained cautious. While growth was picking up, it appeared largely driven by unsustainable public-sector interventions, and supported by transitory inventory cycle effects, as companies restocked in 2009 after drastically cutting back on inventory during late 2008. Many also pointed out that even if the recovery continued, GDP in most developed countries would not reach pre-crisis levels in the near future.

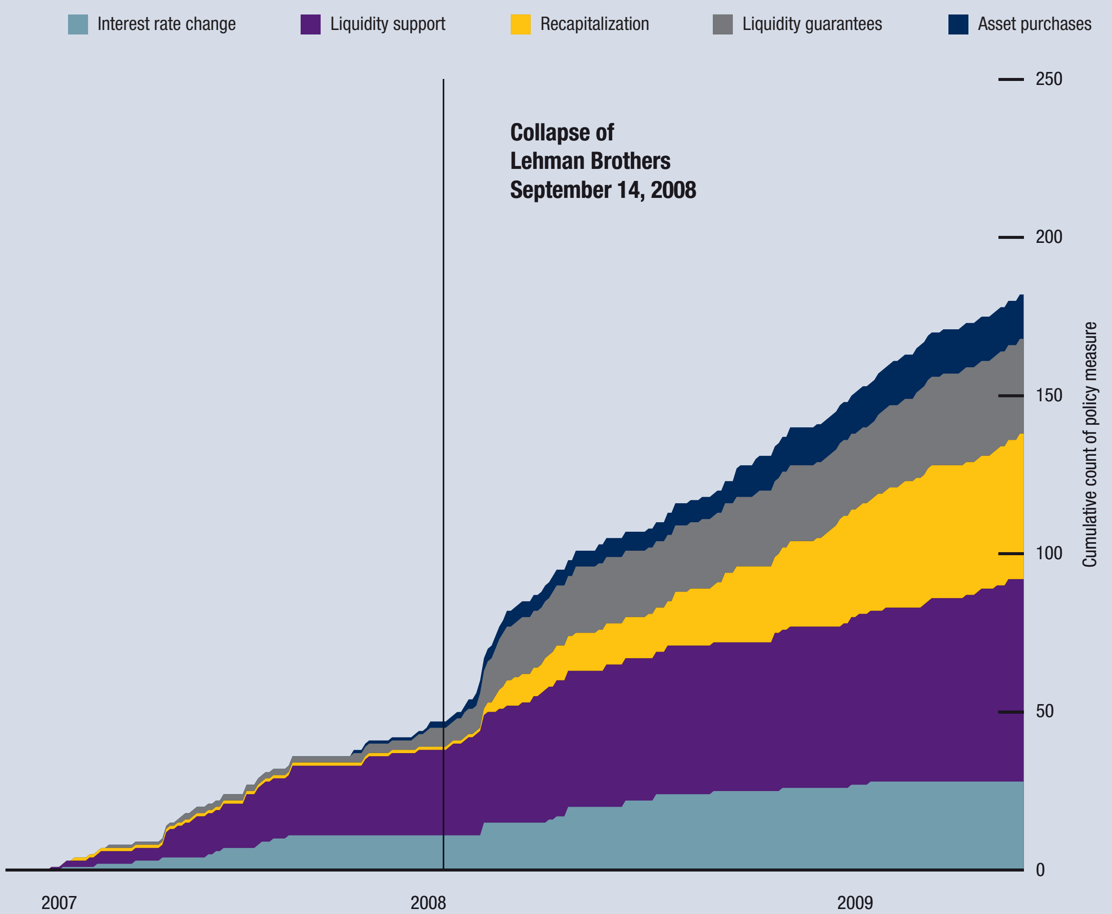
One question loomed particularly large in the minds of pessimists and optimists alike. What would happen to the early signs of recovery when governments – inevitably – began to reverse their unprecedented levels of intervention in the banking system and wider economy?

Global policy response

The question was prompted by the remarkable public-sector response to the crisis. As the impact on the real global economy unfolded, policy-makers and regulators around the world reacted to the crisis in a manner that was unprecedented in terms of its speed, force, global breadth and coordination.

Parallel to the evolving crisis, governments and central banks engaged in a series of both traditional and extraordinary measures intended to safeguard the stability of the financial system and to prevent the crisis from entering an even more damaging phase (see figure 11).

Figure 11 **Time pattern of crisis intervention measures**



Note: Euro area sample countries, Japan, Sweden, Switzerland, United Kingdom, and United States. This figure adds up the total number of policy measures intrduced over time; it disregards the scale of each intervention, in both relative and absolute terms.

Source: IMF

Beyond monetary and regulatory policy responses, massive fiscal stimulus programmes were designed in most countries to counterbalance the global economic slowdown. As a result of all these measures, central bank balance sheets have expanded dramatically and fiscal deficits and public debt are on the rise.

Lessons learned

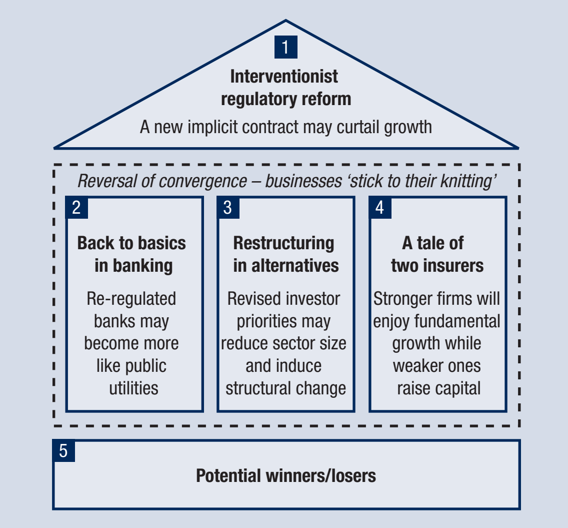
While the comprehensive analysis of the causes of the global financial crisis is still ongoing, with hindsight, it is safe to say that it was set in motion by a hazardous combination of several elements rather than a single triggering factor:

- Too loose macroeconomic policies, resulting in ample liquidity, asset prices being decoupled from their fundamental values (helped by mispricing of risk) and increasing debt levels
- Risk management that was overwhelmed by the complexities of financial innovations and the lack of transparency, and which overly relied on external ratings
- Corporate governance mechanisms that did not impede inappropriate management decisions
- Inadequate regulatory and supervisory systems (e.g. procyclicality of capital requirements, lack of regulatory scope and macroprudential oversight, and insufficient international coordination)
- Consumers (along with other market participants) that had unsustainable positions with respect to savings ratios and leverage, as a result of a lack of education around financial planning and products
- Market distortions from certain policy goals, e.g. those aimed at promoting home ownership in the US and the UK

Near-term outlook

Last year's report on the Future of the Global Financial System explored the question as to how the financial crisis and responses to it could ultimately affect the structure of wholesale financial markets and who might emerge as winners and losers (see figure 12).

Figure 12 **Summary near-term outlook for wholesale financial markets**

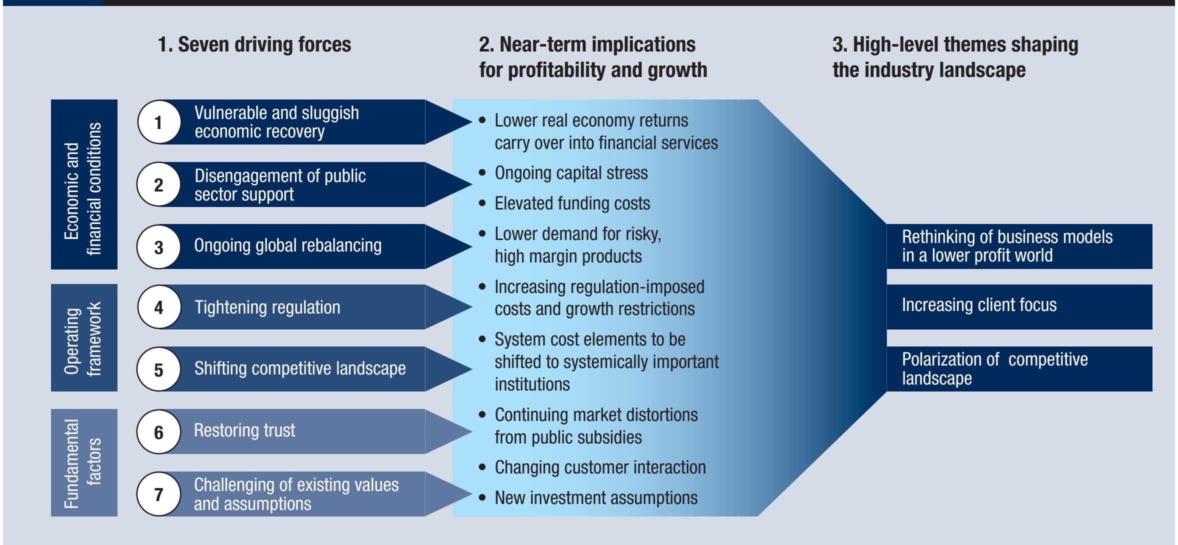


Source: Authors' analysis

A year later, a fresh look at the likely near-term evolution of the financial architecture is warranted. Not surprisingly, a number of the driving forces identified in last year's report are still relevant today. However, recent history has changed the relative importance of some of these factors and introduced new ones directly resulting from some of the market surprises in 2009 and policy reactions to those surprises.

The updated near-term outlook presented in this section will start with revisiting the driving forces that will likely shape the financial services industry over the next three to five years while it emerges from the worst crisis since the Great Depression. We will then explore their near-term implications on the industry's profitability and growth outlook. As a third step, we synthesize these implications into three high-level themes that are likely to shape the industry landscape in the years to come (see summary in figure 13).

Figure 13 **Summary of near-term industry outlook**



Source: Authors' analysis

Before delving into the analysis of the driving forces, however, it is worthwhile to briefly note how much more deeply the financial crisis of 2007-2009 impacted the world and the financial services sector in particular than was predicted even at the beginning of 2009. Questions that previously sounded absurd were suddenly above-the-fold headlines: Will the US dollar continue to be the world's reserve currency? Will the US maintain peak credit rating? Truly, unlike in previous crises, the events of the past two years hit at the very core of the global financial system. And, just as any complex system experiencing a significant shock to its foundation is likely to experience important, long-lasting and in some cases unpredictable systemic effects in order to readjust, the financial architecture is very much in flux and unlikely to ever look as it did in the 20 years of relative ease and prosperity leading into this crisis.

Despite the whole industry being in crisis management mode for most of 2008 and the first months of 2009, some institutions appear to have reverted to their old business models (suddenly, and perhaps temporarily, profitable again) and are aggressively looking for new business opportunities – even while they are benefiting from significant public-sector support.

Given the magnitude of the crisis, however, a caesura seems warranted to contemplate the lessons learned, to think about required changes to existing models and to take decisive actions to adapt to new realities. While many institutions have already made significant changes, an appropriate reflection on the crisis will be a key step in developing and securing competitive advantages in the evolving post-crisis world. While this document should not serve as that reflection for any institution and is not meant to provide a comprehensive discussion of all elements relevant for the industry's evolution over the next few years, it may provide the starting point for a deeper investigation into the crisis and its implications.

Seven driving forces shaping the near-term outlook

As identified by experts from the World Economic Forum's Financial Services and Investor communities, there are seven main driving forces that determine the industry's near-term outlook. They can be grouped into three broader areas, namely the economic and financial conditions in which the industry operates, the operating framework of the industry composed of the regulatory and competitive landscape, and more fundamental factors like trust, shifting values and the revision of existing assumptions.

1. Vulnerable and sluggish economic recovery

While economists vary markedly on the expected global economic recovery, a number of factors suggest that the global economic recovery is likely to be sluggish and vulnerable to further shocks. Primary among these is that high and sticky unemployment rates in some of the key advanced economies – with the US exceeding the 10% mark for the first time since 1983 after having shed 8.2 million jobs since the beginning of the recession – are likely to drag down consumer spending, and with it economic recovery.

The knock-on effects of this uncertainty, in particular risk of further asset bubbles (e.g. commercial real estate which typically lags residential real estate markets and where a large amount of refinancing is due in the next few years), and inability to effectively refinance debt in the banking sector, suggest continued lack of credit availability, and thus dampened economic growth.

2. Disengagement of public-sector support

Contributing to the cautious economic outlook is the inevitable retraction of public-sector support. Many elements of bank balance sheets have been supported in some way by government actions – increased deposit guarantees, asset purchases and guarantees, subsidized lending facilities, etc. – and the overall economic environment in which financial institutions operate have been propped up by massive fiscal stimulus packages.

Policy-makers seem to be well aware of the need to disengage. But they also recognize the potentially damaging effects of both exiting too early (e.g. re-introducing market instability) and those of exiting too late (e.g. creating long-term market distortions)[3]. However, there remains great uncertainty in the market as to the timing of fiscal and monetary stimuli unwind and their impact on inflation, aggregate demand and the functioning of financial markets.

3. Ongoing global rebalancing

While the pace of economic recovery and government extrication from a broad series of interventions is very much uncertain, the deleveraging and de-risking of market participants that have accumulated unsustainable levels of debt over the past several decades is an absolute certainty.

Quite to the contrary of public opinion, it appears that the deleveraging process has actually yet to begin. In fact – due to large amounts of new debt being issued in reaction to financing and capital problems – private debt did not decrease drastically between 2007 and 2008. Meanwhile, asset levels have come down significantly. The net effect is actually an increase in the aggregate leverage within the global financial system, and an even greater need for rebalancing. On top of private-sector leverage drifting upwards, public debt has grown significantly in 2008 and 2009 due to private debt being shifted to the public sector in the form of central bank asset purchases on the one hand and the financing of fiscal stimuli on the other. And with a preponderance of economists, policy-makers and business leaders agreeing that a deleveraging is needed, such rebalancing (and its impacts on industry players) seems inevitable in the short- to medium-term.

4. Tightening regulation

The pending regulatory changes perhaps best exemplify this period of extremes and extreme uncertainty. With the stated aim of preventing another crisis of this magnitude, regulators, accounting standard-setters and governments around the world are collaborating intensely in order to increase the system's resilience, to reduce excessive risk taking and to improve oversight of the financial system. This process is underpinned by a remarkable degree of international coordination, as evidenced by the communiqués from the G20 summits in London and Pittsburgh.

With a crisis of unprecedented scope in recent memory and a strong political will to act, significant regulatory tightening is inevitable. While changes are unlikely to fundamentally restructure the industry, the basis of competition, profitability of certain businesses and core business processes will be impacted enough to change the competitive landscape dramatically.

5. Shifting competitive landscape

The starkest shift in the competitive landscape has occurred in banking with such leading names as Lehman Brothers, Bear Stearns, and HBOS disappearing as standalone entities, driving industry concentration upwards. Similarly, though less of a headline item, the alternative investment space is consolidating at a rapid pace. This process left many competitors losing ground or disappearing completely, but also saw a number of winners emerging who are stronger coming out of the crisis than they were before.

While many players have exited – some more gracefully than others – private institutions still find themselves facing one new, or certainly newly active, competitor: national government. Whether as an outright owner, partial shareholder or implied owner (through the "too big to fail" doctrine), governments' impact on the competitive landscape is unmistakable (as can be observed e.g. with the super-tax on bank bonuses in the UK). As the new government role and uncertainty in exit timing and path persists, the impact, and in particular market distortion, is likely to increase. The role of governments in managing and resolving ownership stakes in financial institutions is a focus point of the analysis in chapter 2 of this report.

3 As demonstrated for example by the US Treasury's paper on "The Next Phase of Government Financial Stabilization and Rehabilitation Policies" published in September 2009, or the Financial Stability Boards report to the G20 on "Exit from extraordinary financial-sector support measures" released in November 2009.

6. Restoring trust

The events of the past two years have clearly demonstrated the role that trust plays at the very foundation of the financial architecture. Be it horizontally among themselves or vertically in relation to their customers and supervisors, trust was and remains critical to well-functioning financial institutions and the markets in which they interact. As regulators look to create a trustworthy financial system, individual institutions are struggling to regain the trust of their stakeholders and, in so doing, the societal license to operate.

The industry's ability to regain trust in the near-term will shape the public debate on a broad range of issues (from compensation to systemic risk management) and thereby tremendously influence the regulatory/policy response to the crisis. Chapter 3 of this report is dedicated to a deeper exploration of this critical issue – restoring trust in financial services.

7. Challenging of existing values and assumptions

One irrevocable effect of the crisis is a fundamental undermining of many of the values and assumptions long held true in financial services. For the first time in a long time, financial institutions in developed economies are being asked to justify their role in society and the profits they earn. More subtly, the definition of good leadership is being re-evaluated as is the role of values within financial institutions. For the most part, the ultimate fallout from the introspection and critical evaluation by stakeholders is far from clear. However, it will undoubtedly play a critical role in shaping the industry over the coming years.

One fundamental mindset shift that is already impacting the industry, concerns the fundamental approach to risk taking and risk measurement. Before the crisis, significant faith was put in third party risk ratings, quantitative models, and the belief that financial institutions were significantly advantaged underwriters and holders of a wide range of products meant to transform financial risks. Today, and increasingly so in the near-term future, financial institutions and their customers are increasingly wary of risk and traditional methods of measuring and managing it. This evolution might ultimately lead to an increased price of risk which could broadly impact the financial services industry. However, even this scenario has a silver lining. Investors willing to hold risk will be increasingly rewarded for doing so.

Implications on profitability and growth of the industry

Regardless of the uncertainty around each of the seven driving forces described above, collectively they will undoubtedly have a number of significant implications on the financial services industry in the near-term. These will impact the profitability and growth outlook of the industry in a number of different ways (see sidebar).

- Lower real economy returns to carry over into financial services
  - Coming out of the global recession, the IMF forecasts average GDP growth in 2011-2014 to be 2.5 % (relative to 2.9 % pre-crisis) in advanced economies and 6.4 % (relative to 7.7 % pre-crisis) in developing and emerging economies[4]
  - Lower real returns will transcend to financial services as the real and the financial economies are inextricably tied together, and market players need to adjust accordingly
  - And with banks being a geared play on the real economy, financial services are likely to see a hit on returns from both the lower real economy returns and the decreasing leverage (driven e.g. by tighter capital requirements).
- Ongoing capital stress
  - The IMF forecasts that barely half of necessary write-downs and impairments have been recognized by the banking sector globally to date[5], putting more pressure on earnings and making more capital raisings likely (also as capital requirements will go up)
- Elevated funding costs
  - Driven by limited credit availability, ill-functioning securitization markets, the risk of an unwinding of policy support measures and an altered approach to risk assessment in general, funding costs are likely to remain elevated in the near and medium term
  - While this affects the whole industry, highly levered players as well as those heavily relying on volatile sources of funding are most exposed
- Lower demand for risky, high-margin products
  - Lower ongoing demand for risky and complex products with relatively high profit margins (e.g. complex packaged solutions like CDOs)
  - And consequently reduced revenue pools
- Increasing regulation-imposed costs
  - Expected new restrictions on capital, liquidity, leverage and compensation will increase the costs associated with risk taking and restrict growth opportunities at the same time
  - Regulatory arbitrage will be more expensive due to increased supervisory coordination
  - Institutions will be forced by regulation to act more transparently
  - While not imminent, there is still a looming risk of policy overshooting that might also lead to additional costs to be introduced to the system (for example, unilateral matters like windfall taxes or trading restrictions)
- System cost elements to be shifted to systemically important institutions
  - Systemically important institutions will likely not to be allowed to benefit for free from the moral hazard created by implicit or explicit public-sector guarantees[6]
  - Regardless of the path chosen to resolve the issue, institutions identified as systemically important (and by extension their shareholders and bondholders) are likely to bear an increased share of the systemic costs that an ultimate failure of these institutions would create
- Continuing market distortions
  - Any public support unwinding, even if started immediately, is likely to take quite some time, thus extending the impact of inevitable market distortions of these support measures
  - Distortions may impact the competition within a market (e.g. funding benefits for government-sponsored institutions) or for whole markets (e.g. mortgage market support measures)

4 IMF: "World Economic Outlook", October 2009
5 IMF: "Global Financial Stability Report", October 2009
6 The alternative is a two-tier banking system with systemically important institutions on the one side and all other financial institutions on the other. In such a two-tier system, systemically important institutions would have a competitive advantage from abnormally low funding costs given the government's implicit or explicit guarantee to bail them out. Further, these institutions would be encouraged to take on excessive risks as they are provided with costless insurance.

- Changing customer relationship
  - The relationship between financial institutions and their customers has been significantly degraded through the crisis and the pace of rehabilitation for specific institutions as well as for the financial services industry as a whole will play a major role in shaping firm and industry performance over the coming years
  - Industry players in banking insurance and asset management will need to fundamentally rethink how they provide value and interact with their customers
- New investment assumptions
  - Investors, especially those with a long investment horizon, will revisit the strategic asset allocation of their portfolios
  - With a re-evaluation of the risk/return trade-off in several asset classes, asset managers will need to rethink their investment frameworks and methodologies

Three high-level themes define the medium-term industry landscape

Collectively, the near- and medium-term industry drivers identified above point to three high-level themes that are likely to define the financial services landscape in the medium term.

A. Rethinking of business models in a lower profit world

While a number of financial services firms are experiencing record profits this year, and others are surviving solely due to government support, for the industry as a whole, the long-run reality will certainly involve lower run-rate profits than enjoyed prior to the crisis. Aggregate demand for existing products will fall (some products such as CDOs may cease to exist entirely) and margins will be compressed (all products will be impacted by the higher price of risk and increased regulatory compliance costs). The question becomes, how can financial institutions attain sufficient profitability and growth to succeed in the new world?

It is important to first recognize that some businesses and business models will not survive. The mortgage monoline model is already nearly extinct, as is the wholesale-funded investment bank. Access to stable funding and patient capital will be necessary for long-term survival in the post-crisis world. The scarcity of these resources – primarily consumer deposits and patient capital (e.g. from sovereign wealth funds) – and the increased demand for them due to market and regulatory pressures will force a fair amount of capacity out of the market. Concentration is needed to reduce industry capacity, and it is likely to increase in the near term as more small institutions fail and others are “absorbed” via a renewed wave of M&A activity by those who can gain scale benefits as institutions take advantage of large valuation gaps between institutions perceived to be “winners” and those perceived to be “in peril”.

For some, later to be judged as “winners” by the market, the path forward may be bright and clear. However, for the vast majority of institutions, survival, and ultimately success, is very much up in the air. For those institutions, evolution is required along two dimensions.

First, surviving financial services firms will need to replace the pre-crisis aspiration of leverage and growth with the new realities of operational excellence and risk management. The knee-jerk reactions of cost cutting and increased conservatism across the business may have been necessary to survive the turmoil of the crisis, but they will not be sufficient to thrive in the post-crisis world. Rather than getting “back to basics”, financial institutions must get better at their core activities.

On the cost side, this can be accomplished through better risk management, efficiency gains at the institutional level, scale improvements through mergers and acquisitions, or the creation of best-in-class utilities. On the revenue side, in a world with shrinking demand and compressing margins, only true innovation will result in growth. Perhaps innovative ideas that have been overlooked in a world where risk was near free and leverage unconstrained deserve a second chance. We address some aspects of this needed innovation in more detail below.

The second necessary evolution is in the human capital model that is a core element of the business model and self-image of many financial institutions. While lower profits will necessarily translate into lower overall compensation, the change will be more than a simple and linear step-change in compensation levels. Rather, as is being discussed in other forums, a fundamental rethinking of compensation models is in order and will emerge from a combination of regulation from the public sector and innovation in the private sector. The change is inevitable and will likely reach broadly across financial services.

The challenge, however, is how institutions (and the country regimes in which they operate) will maintain access to and deploy top talent. Continuing to offer a compelling value proposition to college and business school graduates will be more challenging, but more important than ever as companies compete for a smaller profit pool.

B. Increasing client focus

In an environment where continuously earning customers' trust is a necessary component of the license to operate, where regulations constrain financial institutions' abilities to take risk, and where profit pools are lower and grow at a slower pace than historical levels, delivering meaningful value to customers needs to be the absolute top priority of all financial institutions. Basic corporate responsibility towards clients will be carefully monitored and regulated. Success will come from better understanding and better serving the customers.

The need for greater customer focus is perhaps best illustrated in the retail banking context. The revenue model in most markets is predicated not on effectively meeting the needs of the customer, but instead on punitive fees and wide spreads between interest rates on deposits and consumer loans. As fee income is limited by regulation, and spread income constrained by higher capital requirements, retail banks will need to return to solving customers' problems instead of focusing on increasing fee income, margins and leverage.

Fortunately, there are many customer problems to solve. For example, with two-thirds of American households with a 40-62 year-old head of household projected to not be able to support themselves in retirement[7], customers need new longevity protection products. With high home price volatility, customers need ways to plan for home ownership and protect equity built up in their primary residences. With financial uncertainty at its highest point in recent memory, consumers are in need of sound and affordable financial advice.

As retail banks develop offerings to solve these and other problems, insurers, investment banks and asset managers are quickly needed as well (e.g. to price protection products, to package and distribute assets, and to provide capital for new products). The same possibility for "trickle-up" in business opportunities exists in corporate banking as well. Therefore, there is an imperative for all financial institutions to refocus on identifying and solving customer problems.

C. Polarization of competitive landscape

The section above addresses business evolution change from a business-line perspective. However, in a competitive landscape largely dominated by multinational, multi-line financial giants, there is another aspect of changing business models that must be addressed. That is the likely polarization of the competitive landscape along a number of highly contentious dimensions. While a few business models may disappear, the biggest change will happen as firms are forced to justify their strategies to investors and regulators who will apply much more scrutiny than they previously had.

Ultimately, the polarization will occur along three dimensions:

- **Domestic versus global footprint**
  With lower run-rate profitability in many businesses, expansion for its own sake is harder to justify. Therefore, institutions with only limited presence and competitive disadvantage in foreign geographies will likely divest those businesses. On the other hand, companies with perceived core competencies in building global economies of scale may choose the opposite course (particularly, should regulatory regimes converge, thereby making multinational business models easier to manage). In the end, this will result in fewer but stronger global institutions with most markets dominated by domestic specialists.

7 Oliver Wyman. "Reverse Mortgages -- Still Moving Forward". April, 2009

- **Universal versus niche providers**
  Just as with geographic expansion, past business line expansion fuelled by a "can't lose" market will likely be reversed in the coming years. Furthermore, systemic risk regulation and efforts to preclude institutions from being "too big to fail" will make it increasingly costly to operate a complex universal model. Those who choose to do so must commit to operational excellence in each business line and the enhanced risk management necessary to satisfy global regulators.
- **Low-risk utilities versus specialist risk takers**
  While few expect a return to Glass-Steagall, financial institutions have already begun to some extent to abandon the middle ground between low-risk utility and specialist risk taker. With a core continuing purpose of the banking system being the transformation and transfer of risk, this evolution in the competitive landscape is very much a zero-sum process. That is, as primarily retail banks scale down their riskier operations (e.g. portfolio lending), this creates opportunities for specialist risk takers (e.g. alternative asset managers). More than simply parsing low-risk businesses (e.g. consumer deposit taking) from high-risk business (e.g. proprietary trading), this dimension will separate those pursuing risk-loving approaches to a certain business from those taking a more conservative approach.

Summary

While the challenges for the financial industry explored above are plentiful and significant, it should be noted that the world is not completely dark for financial services. In fact, after having survived the perfect storm of the global financial crisis, market participants do have the chance now to respond decisively to the changes the crisis has brought about and to make necessary changes to their business models. The opportunity – supported by lowered expectations of profitability and increased acceptance of uncertainty – to take bold actions to reposition the business will not come again any time soon and the players who are willing and capable of taking advantage of this opportunity will prosper in the future.

Comment on long-term scenarios

The New Financial Architecture's report on the near-term outlook and long-term scenarios, published in January 2009, contained a long-term analysis that applied the tool of scenario thinking to create four different visions of the future of the global financial system in 2020 (see figure 14). These were based on two major driving forces, the pace of geo-economic power shifts from West to East and the degree of global coordination of financial policy.
One year, albeit a formative one, into a 12-year scenario, it makes little sense to re-examine the scenario planning exercise that generated the two dimensions and four scenarios. However, it is worth briefly commenting on the events of the past year in the context of geo-economic power shifts and global coordination of financial policy.

Figure 14 **Long-term scenarios up to 2020**

Source: Author's Analysis

Looking back to the developments over the last year, especially with the G7 having effectively been displaced by the G20 as the primary forum for international policy coordination and with the efforts to boost emerging economies' representation in the IMF, it would seen that geo-economic power shifts have happened more quickly than initially anticipated. Applying the framework presented in the figure above, it appears that we are leaning towards the right of the diagram. As financial institutions look to adapt their business models to the new market realities, close attention to these power shifts – both in terms of sources of economic growth and loci of political influence – is warranted.

Moreover, while the final outcome of the regulatory discussions remains unknown, there is some evidence that the coordination of financial policy among some the world's key economies has already increased. The G20's commitment to coordination and the strengthening of institutions with mandates to ensure coordination (e.g. FSB, IMF) seem to be indicative of a broader trend towards greater coordination. However, while international coordination has increased, national interests still remain the primary focus of activities – mainly because this is where policy-makers' mandates have their origin. No global macroprudential regulator has emerged, and none is likely. And, to the contrary, protectionist measures taken in response to the crisis are still a possibility. All things considered, while the past year has seen an increase in international coordination of financial policy, the long-run prospects appear unchanged from a year ago when many of these developments were seen as likely . What is more likely now is that the critical uncertainty will be resolved sooner than previously expected. Firms would do well to prepare plans for competing both in a coordinated regulatory regime and one that returns to its previous level of fragmentation (or perhaps is further fragmented due to protectionist measures).

In sum, while there may be some more certainty around geo-economic power shifts than there was a year ago, looking to the next decade, the evolution of both dimensions remains uncertain in the long-run and the implications remain critical for all financial institutions. Moreover, the pace of change has been radically accelerated by the crisis. And, while scenario planning continues to be an important element of the managerial toolkit, there are a number of near-term challenges that require immediate solutions. The following chapters explore two of these in some detail.

Chapter 2 Governments as shareholders

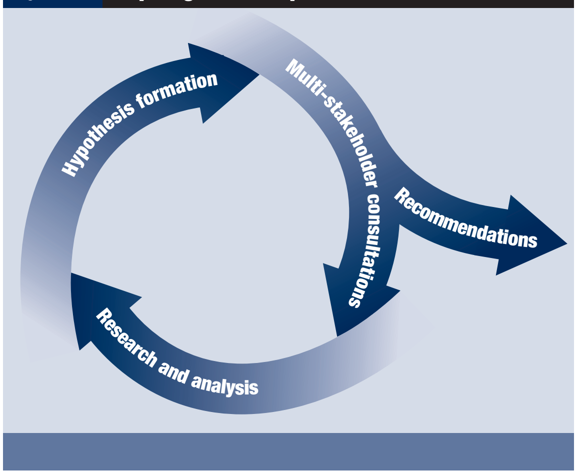
Introduction

Governments around the world have used a broad range of tools to combat a crisis that rapidly escalated from the unwinding of the US subprime mortgage asset bubble in 2007 into a global recession in 2008-2009. While the full story is not yet written, it appears that the most dramatic period of new government interventions in the financial system – and in financial institutions – is over[8]. Finding the best way to bring these government interventions to some satisfactory resolution is another matter. Working out how to manage and ultimately resolve government intervention is perhaps one of the greatest near-term challenges to rebuilding a functional global financial system, particularly if governments want to be sure that their chosen approaches contribute to the long-term stability and growth of the financial services sector.

The purpose of this paper is to explore ways to manage and resolve perhaps the most challenging form of intervention – the new and significant government equity interests in financial institutions – and to advance the public dialogue. This paper presents the perspectives of a multi-stakeholder group including private sector leaders, academics and policy-makers[9], and concludes with a set of recommendations from the World Economic Forum's Investors and Financial Services Partners (as represented by the steering committee for the New Financial Architecture project). Figure 15 describes the process for generating this report.

First, however, the highly charged issue of government intervention is examined.

Figure 15 **Report generation process**



8 While there is room for critical examination of interventions through this crisis and development of frameworks to guide decisions on when and how to intervene, the focus in this paper is on managing and resolving a subset of interventions – recapitalization via equity investment – once they have been made.

9 The majority view is believed to have been captured. However, the complex nature of this topic, cultural differences across geographies and the broad canvas across many kinds of financial institution, meant that there was some difference of opinion on many issues.

Government intervention: four broad categories

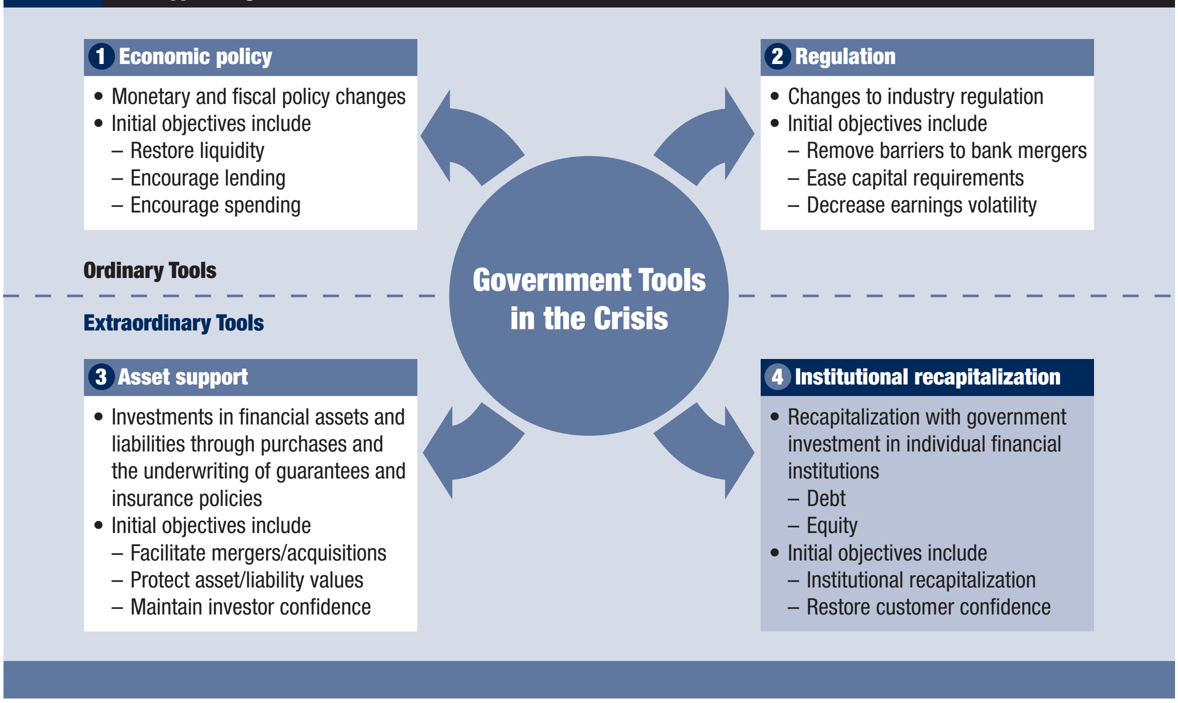
Government interventions can be grouped into four broad categories (figure 16). There are the traditional tools of economic and regulatory policy, and the extraordinary tools of asset support and institutional recapitalization (often resulting in equity ownership).

Each tool has been extensively deployed through the crisis. Trillions of dollars have been injected into the global economy through monetary policy. With large fiscal stimulus packages supporting many of the largest economies, national and international oversight agencies are passing significant regulatory changes, and governments have nationalized (partially or wholly) a significant number of the world's largest and most complex financial institutions.

Resolving interventions of the traditional sort will not be easy. However, this is a debate of known dimensions. As in previous crises, Monetarists and Keynesians will argue the merits of sustained government support of the markets with regard to both the provision of liquidity and fiscal stimuli. Risks and benefits of inflation, policy effects on currency valuations, and international coordination of systemic risk regulation are often addressed in the public dialogue.

It is the "extraordinary" set of government intervention tools that pose fundamentally new questions for policy-makers and private sector participants alike. For the purposes of this paper, we have focused on the US$ 700 billion worth of interventions where governments around the world have acquired equity stakes in financial institutions,[10] not least because this type of intervention poses the sharpest dilemmas in terms of determining the role of government. But why exactly is mapping out a sure-footed resolution for government equity investments so fraught with problems?

Figure 16 **Four types of government intervention**



10 More often than not, governments received debt instruments (including preferred shares, silent participations and other instruments that do not carry voting rights) in return for recapitalizations. As the purpose of this paper is to explore the new challenges of governments as shareholders (including when that holding is 100%) and the ownership responsibility that comes with that shareholding, this analysis is focused on equity holdings rather than debt positions.

Government equity investments: a widespread, new and important challenge

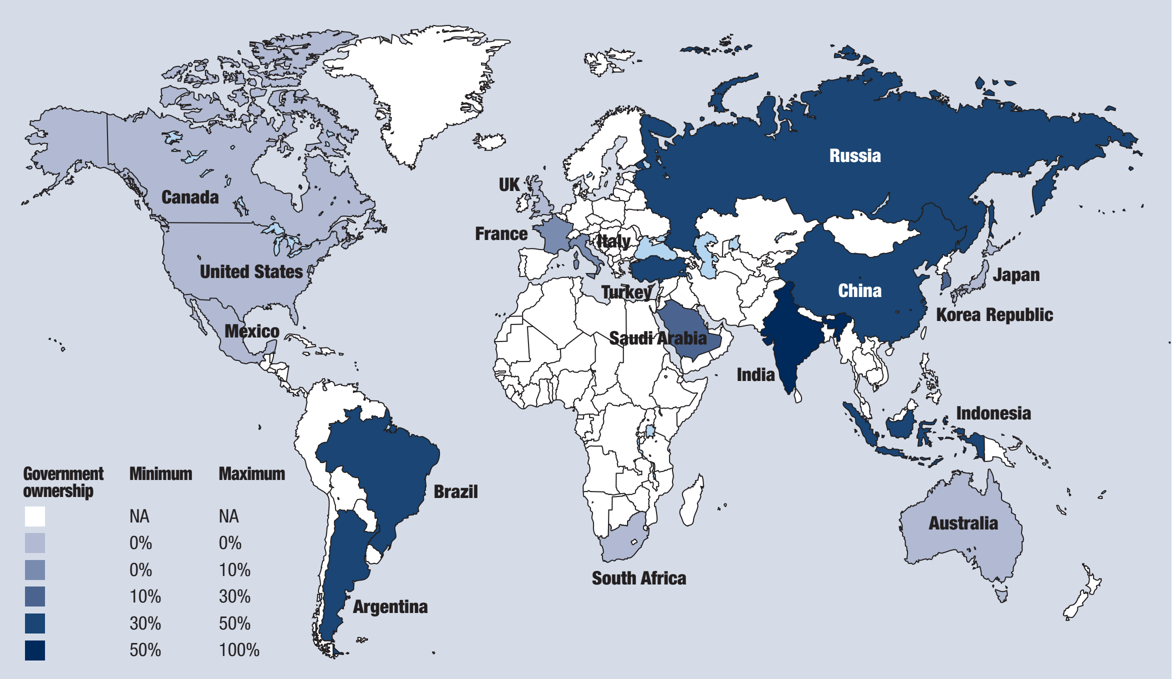
Widespread and New

While the United States and the United Kingdom have the highest profile nationalizations (and bear a disproportionate share of the burden, accounting for over 80 % of recent equity investments), roughly 20 nations from Denmark to Taiwan and Germany to Kazakhstan now find themselves with significant equity stakes in financial institutions[11].

For some countries, notably the United States and the United Kingdom, public ownership of financial institutions is an almost entirely new phenomenon (figure 17).

Continental European countries have a longer history of government ownership, but few have experience with the re-privatization process and management of investment stakes in institutions that are not owned for strategic reasons. Indeed, the vast majority of privatizations in Europe and Asia resulted from economic and regulatory liberalization (such as in Italy, Portugal, Spain and China), rather than from the re-privatization of companies nationalized in times of crisis.

Figure 17 **Government ownership of financial institutions pre-crisis (2007)**



Source: World Bank Research on Bank Regulation and Supervision (2007 database, updated June 2008); percent of banking system's assets in financial institutions with over 50% government ownership

11 Approximately 20 nations have new equity stakes in financial institutions. A precise number cannot be calculated due to ambiguity in some transactions as to whether the government received common equity.

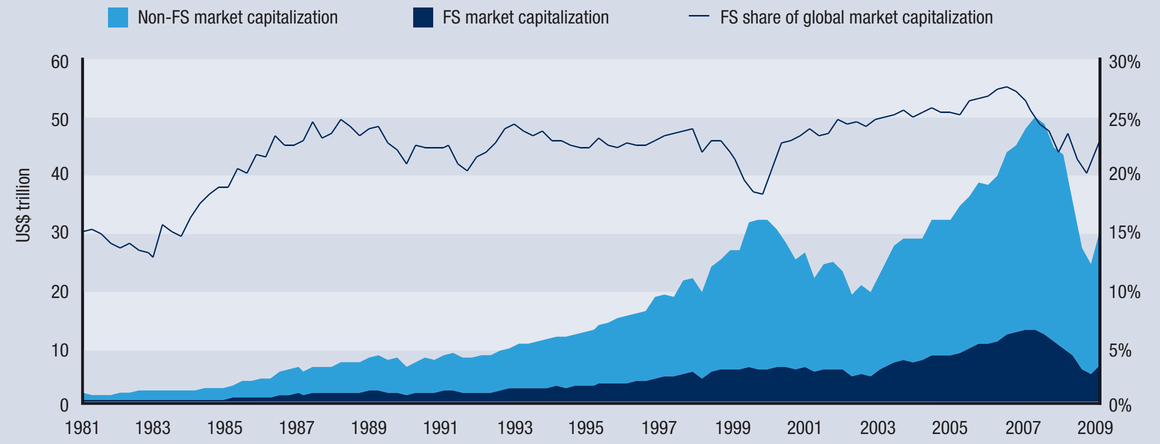
There are, of course, some notable historical cases of re-privatization (figure 18). Three of the most relevant examples are in the United States following the Savings & Loans crisis in the late 1980s, Sweden in the early 1990s after concurrent currency and real estate crises, and much of Asia in the late 1990s after the Asian crisis.

While each of these presents valuable lessons, unfortunately none offers the perfect analogue for the situation today. In the case of the United States and Sweden, the failed institutions were, for the most part, retail banks with traditional business models. That is, they gathered retail and brokered deposits and then invested them in consumer and commercial loans using relatively low levels of leverage. The financial institutions struggling today are larger, deeply interconnected with often unknown counterparties, operate with much greater leverage and have far more complex business models. In addition to institutions themselves being more complex, today's financial services sector as a whole is significantly larger, more systemically important and more interconnected than in any of the previous crises (figure 19).

Figure 18 **Historical financial crises**

	US Savings and Loans Crisis	Swedish Financial Crisis	Asian Financial Crisis
Period	1984-1991	1991-1993	1997
Key symptoms	Failure of c.750 savings and loans associations (S&L)	Failure of many of the country's leading banks	Dramatic depreciation of Southeast Asian currencies and asset prices
Origin	• Deregulation of thrifts in early '80s • Imprudent real estate lending • Brokered deposits facilitating riskier bank investments	• Deregulation-fuelled expansion of credit and asset prices in '80s • Currency crisis • Real estate bubble	• Rising asset prices and capital inflows pre-crisis • Fragile financial system with deficiencies in supervision, governance, transparency and risk management
Policy reaction / Bailout efforts	• Creation of new regulatory body for thrift supervision (OTS) • Establishment of dedicated deposit insurance fund • Foundation of Resolution Trust Corporation to resolve failed S&Ls	• Recapitalization of banks • Government guarantee for all bank obligations to avoid bank runs • Full nationalization of key banks • Nationalized banks split into continuing operations and bad bank • Solvency stress test for all banks	• IMF financing package for South Korea, Indonesia and Thailand • Structural reforms (supported by World Bank and Asian Development Bank) • Macroeconomic policies to support currencies and economic activity
Lessons learned	• Willingness to adjust approach given early experiences is necessary in multi-year, multi-institution context • Rapid reprivatization limits market distortion and minimizes costs to taxpayer • Transparency and inclusion of private sector experts helps in decision-making and with public acceptance	• Write-downs to be fully recognized before receiving recapitalization • Existing shareholders to be held responsible first • Retain upside for taxpayers by taking equity stakes	• Prevention is key as crisis is difficult to stop given the speed at which short-term capital moves • Weaknesses in macro-economic policy and regulatory framework preclude rapid/effective resolution • Any policy response should be swiftly executed

Figure 19 **Financial services contribution to global market capitalization**



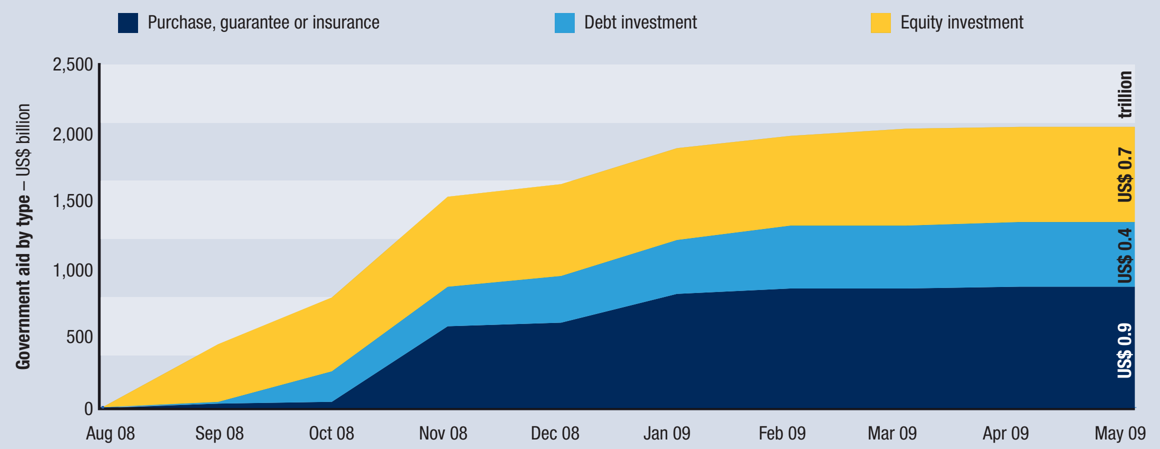
Source: Datastream, Oliver Wyman analysis

Important

Governments have directly invested almost US$ 2 trillion in financial institution bailouts. In the United States, the Troubled Asset Relief Program (TARP) alone accounts for over US$ 300 billion. Globally, equity investments in financial institutions add up to over US$ 700 billion (figure 20).

There have already been some important exits. For example, US$ 70 billion of TARP investments have been repaid and the complex, multi-government takeover of Benelux financial conglomerate Fortis ultimately resulted in the break-up and partial sale of the institution to BNP Paribas and Amlin. However, most government interventions around the world have not yet been resolved. For example, Freddie Mac and Fannie Mae, institutions with one-time combined balance sheets of over US$ 1.6 trillion and mortgage exposure of over US$ 6 trillion, remain in receivership with no clear path to resolution.

Figure 20 **Global government bailouts of financial institutions**



Note: Purchases, guarantees and insurance policies valued at total potential taxpayer exposure. Note: Grail Research, Oliver Wyman analysis

Finally, adding to the hard dollar investment and complexity of government interventions, there are three industry-specific concerns facing governments as they work through this process, namely the risk of distorting financial market competition, the problem of ensuring the long-run profitability of the financial services industry, and the challenge of mitigating broader systemic and economic risks (figure 21).

Figure 21 **Additional investment-related intervention concerns**

Market distortion and moral hazard	Long-run health of the financial sector	Systemic risk and broader economic impact
– Government ownership is likely to distort financial markets as owned institutions access more funding at below market rates (e.g. through government sources); these institutions will have a particular advantage in business endeavours that are balance sheet intensive. – Government-owned institutions have little incentive to act efficiently in the long run, as long as they are government backed. Meanwhile, the "too big to fail doctrine" encourages the development of overly complex business models and excessive risk-taking across the industry, due to the implied government backstopping of the system.	– With the financial services sector contributing an increasing amount to GDP in the 20 years leading up to the crisis, national competitiveness in a global market for financial services is at stake as individual governments rein in perceived excesses[12]. – Perhaps ownership may be a tool for governments looking to reform institutions requiring government recapitalization.	– The cautionary tale of Japan's "lost decade" from 1991 to 2000, following its economic crisis, demonstrates the cost of mishandling crisis intervention. – Many government-owned institutions still pose a systemic risk at the national and global level; mistakes could have rapid ripple effects throughout the global economy.

12 GDP contribution of financial services varies by country. Not surprisingly, countries with particularly high contribution in financial services (e.g. US, UK, Iceland) have had the most government intervention through this crisis.

Challenge

If the situation were new, the stakes were high, but the path clear and devoid of stumbling blocks, there would be no need for analysis or recommendations. Unfortunately, this is not the case. Four aspects of the current situation create a high level of uncertainty and the need for clear thinking and guidance.

A Root causes of the crisis are not yet resolved

Governments find themselves owners of financial institutions that, in addition to being troubled themselves, are part of a wider financial system that is evolving rapidly. From the design of compensation systems to risk management processes, many core activities within financial institutions will be rethought in the coming months and years. At the same time, national and international regulators are addressing many system-wide issues such as the "too big to fail" doctrine, the cyclical nature of loan loss provisioning, and whether some institutions may in fact be "too complex to work". Until the foundation of the financial architecture is repaired, owned institutions and the system as a whole will remain fragile, and mis-steps can have dire consequences.

B No clear definition of success

Many Governments have referred to themselves as reluctant investors. They would not have intervened had the future of the institutions (and in many cases the financial system) not been at risk. However, it is far from clear what needs to be done to de-risk these institutions, or even whether this should be the goal in the first place. What do the Icelandic banks, AIG and RBS need to look like to survive and prosper in the new financial architecture? What role should government ownership play in getting them there? A wait-and-see approach is clearly insufficient, but the range of potential end-states and paths remains quite broad.

C Multiple simultaneous issues to resolve

The problem of what to do with equity stakes in major institutions will not be resolved in a vacuum and is indeed one of several related challenges that governments face. In addition to the outstanding investment dollars, governments must simultaneously deal with the consequences of dramatic shifts in monetary policy and regulation, as figure 22 demonstrates. Whatever governments decide to do with their equity stakes, there are many difficult questions to answer with regards to timing and coordination with other aspects of government intervention. This is not to forget the additional complication of international coordination between governments.

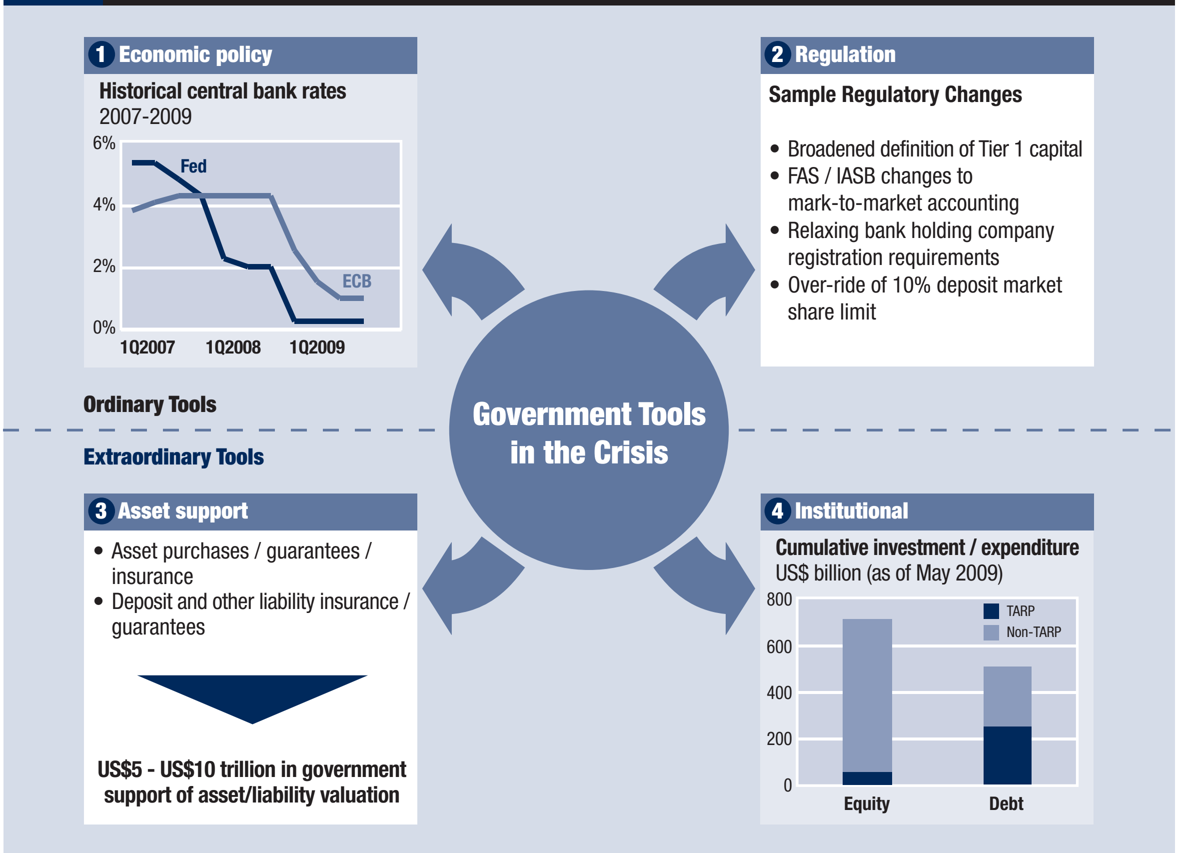
In many ways then, the desired end state for both individual institutions and the system as a whole is a moving target. Again, however, governments cannot play wait-and-see and must take many practical decisions on how to manage their investment stakes and their other forms of intervention.

The specific channels and instruments used to intervene in financial institutions are themselves a potential complication and restriction. For example, one issue explored later in this paper is the appropriate governance model for government investments. While, in some cases, this is statutorily pre-determined (thereby increasing the difficulty of changing the governance model), such as with TARP, in other cases governments have created unique agencies (such as UKFI in the United Kingdom) with dedicated staff and a specific charter for addressing government investment stakes in financial institutions.

D Exogenous changes to the financial services landscape

Independent of the crisis, in recent years the financial services industry has been in one of the biggest tectonic shifts in its history. The past decade has witnessed the early impact of the ageing of society and shifts in power and money from West towards East. Other trends such as the deleveraging of the economy and rethinking core business models within financial services, have been accelerated by the crisis and now further complicate the strategic decisions that must be made by government owners.

Figure 22 **Depth and complexity of government interventions**



Sources: Grail Research, Oliver Wyman analysis

Private sector view of the stakes: key concerns

The World Economic Forum's Investors and Financial Services Partners include many of the leading experts in global finance. What are their key concerns regarding the implications of government shareholdings in financial institutions?

Unlike the public at large, which may be focused on compensation and domestic lending policies, the industry experts tend to focus on longer-term and second-order effects. That is, they recognize the importance of recovering taxpayer investments, but they also want to understand how these investments will interact with potential "landscape shifts" that are shaping the environment for financial services, and how government intervention will influence market and management behaviour, particularly by introducing market distortions and through the creation of moral hazard.

Landscape shifts

The crisis has accelerated some of the landscape shifts already in progress, slowed others and put into motion some new changes that were previously uncontemplated. Last year, the New Financial Architecture project explored four long-term scenarios based on the pace of power shift from West to East and the degree of international coordination.

The importance of these two dimensions in defining the future state of the industry has been validated through the crisis.

International coordination has been highlighted as critical to the prevention of future crises and is likely to be a defining feature of the new financial architecture. From ensuring comprehensive and seamless hand-off of oversight responsibility to minimizing opportunities for regulatory arbitrage, it appears that international coordination is on the rise.

At the same time, the shift of power and wealth from West to East seems to have been accelerated through the crisis. We have seen significant inflows of capital into the West from untraditional sources such as Abu Dhabi, Kuwait, Saudi Arabia, Singapore and South Korea. Meanwhile, with consumption falling and savings rates rising in the West – particularly in the United States – the historical Asian export-led growth model is being reassessed.

Two other landscape shifts have risen to the forefront over the past year and are of crucial importance to financial institutions. These are: the changing relationship between government and the private sector, and the role of financial services in society.

Changing relationship between government and the private sector

The crisis has initially brought about a significant increase in the role of government in society, from increased spending to taking ownership stakes in troubled industries to limiting compensation within financial institutions. While governments across most of the world have been slowly extracting themselves from ownership and oversight roles – e.g. privatizations in China, liberalization in Central Europe and deregulation in the United States – the crisis appears to have reversed this trend. The question is whether this reversal is cyclical or secular.

If this is a secular shift, it may have radical implications for the financial services industry. In a world in which government views itself not only as an active shepherd of the macroeconomy but also as a direct investor in large and influential financial institutions, lower profits will become the norm (due to more conservative business strategies, lengthened innovation cycles, less effective management[13], etc.). With lower profits come less compensation and decreased access to top talent. Similarly, operating models will need to change, like in the pharmaceuticals or aviation industries, as governments will be viewed as key business partners in processes such as product development and risk management[14].

However, this secular shift is unlikely to occur. First, there is no evidence in the United States or Europe that the commitment to free markets has been reversed by the economic crisis. On the contrary, the increased government role seems to be more circumstantial than ideological, with governments reluctantly taking on ownership roles and often publicly declaring their intent to exit.

Role of financial services in society

The issue of what role financial services is meant to play in society has suddenly increased in salience, as many of the core business models have come under attack and products/processes commonly thought to add value to society are being second-guessed (e.g. high ratio mortgages to low-income families). What does society want from financial services? What is it willing to pay to attain it? Do certain financial institutions and managers therein have broad social responsibility due to systemic importance? Should they? And, most relevant to this discussion, should governments use their shareholdings in financial institutions to bring about a desired transformation in the industry? We return to this last question in the recommendations.

13 The effect of government ownership on management practice was empirically demonstrated in the World Economic Forum's Globalization of Alternative Investments series. (Bloom, N., Van Reenen, J. and Sadun, R. Do Private Equity-owned Firms have Better Management Practices? In Gurung, A. and Lerner, J. (eds) *Globalization of Alternative Investments Working Papers Volume 2: The Global Economic Impact of Private Equity Report 2009*, New York: World Economic Forum USA, 2009, 1-10).

14 In these industries, government is closely involved in product development (e.g. drug testing in pharmaceuticals) and ongoing risk management (e.g. US Federal Aviation Administration mission to "… provide the safest, most efficient aerospace system in the world").

In many ways, the concept of market distortion in financial services is less clear than it might be in other industries. Governments constantly intervene through monetary policy, regulation and social policies meant to influence private sector behaviour. Examples of the latter include the Community Reinvestment Act in the United States that encourages banks to engage in certain socially beneficial behaviours and regulations governing the cajas de ahorro in Spain (savings banks such as Caixa, Caja Madrid and Caja Navarra), which require them to give a certain percentage of profit each year to social projects and charities. However, these are steady-state programmes and hence are not "market distorting" but instead "market defining".

The current situation, in which governments backstop some institutions and not others, creates both first-order distortion in the behaviour of certain institutions, and second-order distortion in the behaviour of customers of those institutions. The risk is not only that profits will accrue to "less deserving" institutions (i.e. those that were bailed out and now effectively have government guarantees). It is also that rebuilding the financial architecture on a foundation that does not reflect market discipline will prove dangerous when the government does, eventually, remove the temporary backstops it has put in place.

In addition to market distortion, there is the moral hazard that owned institutions will adapt their behaviour to accommodate the new role of government. The explicit government backstop diminishes the imperative to manage the risk/return trade-off properly, and there is also a danger that market signals (i.e. share price) will take second place to the need to please elected officials, e.g. in Congress and parliament.

This problem is not only driven by direct government equity stakes in financial institutions. It is also driven by more implicit underwriting by many governments of their domestic financial sector. As long as governments continue to change the rules of the game (e.g. by making reactive regulatory changes) and as long as there is ambiguity about key policies (e.g. the maintenance of the "too big to fail" doctrine), the market will be shaped to some degree by the chance of future government intervention.

However, the degree to which governments make this situation worse or better through how they manage direct investments in financial institutions is critically important to the private sector.

Recommendations

Recognizing that the stakes are high and the path uncertain, the World Economic Forum's Investors and Financial Services Partners, as represented by the steering committee for the New Financial Architecture project, developed a set of six recommendations to guide policy-makers as they navigate the challenges of the new government role as shareholder.

These recommendations cover government action at three levels (figure 23) and are underpinned by the three principles of leadership, governance and transparency.

Figure 23 **Three levels of recommendations**

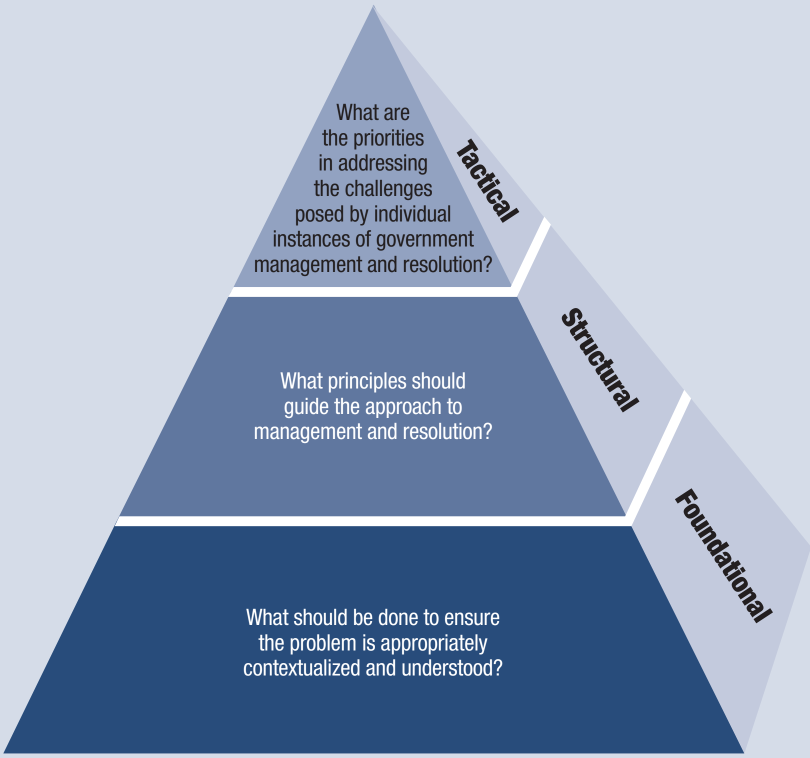


Figure 24 **Recommendations from the financial services and investors communities**

	Recommendation	Rationale
Foundational	1. Conceptually separate equity ownership from other forms of crisis intervention	• Challenges of ownership are distinct from those of other forms of intervention • Muddled public dialogue risks mismanagement of resolutions
	2. State objectives as shareholder – balancing exiting quickly and protecting taxpayer investment	• Clarity of purpose is critical to move forward with resolutions • Ownership should not be used to pursue broader policy goals; need to balance speed of exit and protecting taxpayer investment
Structural	3. Set up independently governed process to manage and resolve ownership stake	• Independence limits political influence on managing and resolving government shareholdings • Clear mandate and effective structure and governance will be key to success in creating independence
	4. Restrict government influence on owned institutions to board composition, governance and proxy issues	• Private equity model is too invasive, retail model too passive • Influencing board composition, governance and proxy issues (including transactions) is necessary and sufficient for pursuit of government objectives • Board members should be independent and represent interests of all shareholders
Tactical	5. Secure and empower management talent for both government and private sector roles	• Complexity of tasks requires specialized talent • Value proposition must be competitive (remit, incentives, political support, etc.)
	6. Ensure high levels of transparency and accountability	• Both are necessary to allow managers to effectively pursue individual remits • Allows stakeholders to hold change agents to account for plans and actions and thereby helps restore/retain confidence

1 Conceptually separate equity ownership from other forms of crisis intervention

As discussed, there are four broad forms of government intervention in the crisis, all in some sense linked and yet with different modes of deployment, intended effect and, arguably, resolution. However, conflating a government's new role as shareholder with other forms of intervention confuses the much-needed dialogue on direct investments in going concerns and obfuscates the decision-making process.

In particular, terms such as "the crisis", "exit strategy" and "role of government" permeate the public discourse but are frequently used with a striking lack of precision. Just as economic policy-making and regulatory reform are conventionally treated separately in the public dialogue, government equity ownership should be viewed as quite distinct from these two forms of intervention and from other forms of government investment (e.g. deposit insurance, loan guarantees and asset purchases).

While it may sometimes be necessary to coordinate the handling of the four different kinds of intervention, this should not be allowed to confuse the public dialogue. For example, whether mark-to-model accounting will be a permanent feature of financial institution accounting is generally discussed independently from the issue of how to reverse quantitative easing. Similarly, even where the sale of pools of bad assets is closely linked to the ability of governments to reprivatize financial institutions, both issues deserve to be recognized as separate (and separable) elements of government intervention. Equity ownership, in particular, deserves special attention due to the responsibilities of ownership that come with shareholding (unlike a debt investment that carries no rights of control). Consequently wrongly linking interventions (for example due to lack of clarity of thought) risks significant mismanagement of each intervention.

2 State objectives as shareholder – balancing exiting quickly and protecting taxpayer investment

Many governments entered into their new roles as investors with the sole objective of controlling what seemed to be a rapidly escalating crisis, fearing that the failure of individual institutions would have a massive impact on the financial system. Given that the initial task of stabilizing the institution has been largely achieved, objectives need to be set for the next phase of ownership. Typically, these objectives have not yet been articulated. Although both the United Kingdom and the US have made some progress on this front.

United Kingdom and US Government goals for shareholdings

United Kingdom

United Kingdom Financial Investments Ltd Framework Document (13 July 2009)

"The Company should […] develop and execute an investment strategy for disposing of the Investments in an orderly and active way […] within the context of an overarching objective of protecting and creating value for the taxpayer as shareholder and, where applicable, as provider of financial support, paying due regard to the maintenance of financial stability and to acting in a way that promotes competition. This objective includes:

a) Consistent with HM Treasury's stated aim that it should not be a permanent investor in UK financial institutions, maximizing sustainable value for the taxpayer, taking account of risk;

b) Maintaining financial stability by having due regard to the impact of value realization transactions (in respect of the Listed Investee Companies) and restructuring transactions (in respect of the Wholly-Owned Investee Companies); and

c) Promoting competition in a way that is consistent with a UK financial services industry that operates to the benefit of consumers and respects the commercial decisions of the financial institutions."

United States

Assistant Secretary for Financial Stability
Herbert M. Allison, Jr
Written Testimony
Senate Committee on Banking, Housing and Urban Affairs (24 September 2009)

"First, the US government is a shareholder reluctantly and out of necessity. We intend to dispose of our interests as soon as practicable, with the dual goals of achieving financial stability and protecting the interests of the taxpayers.

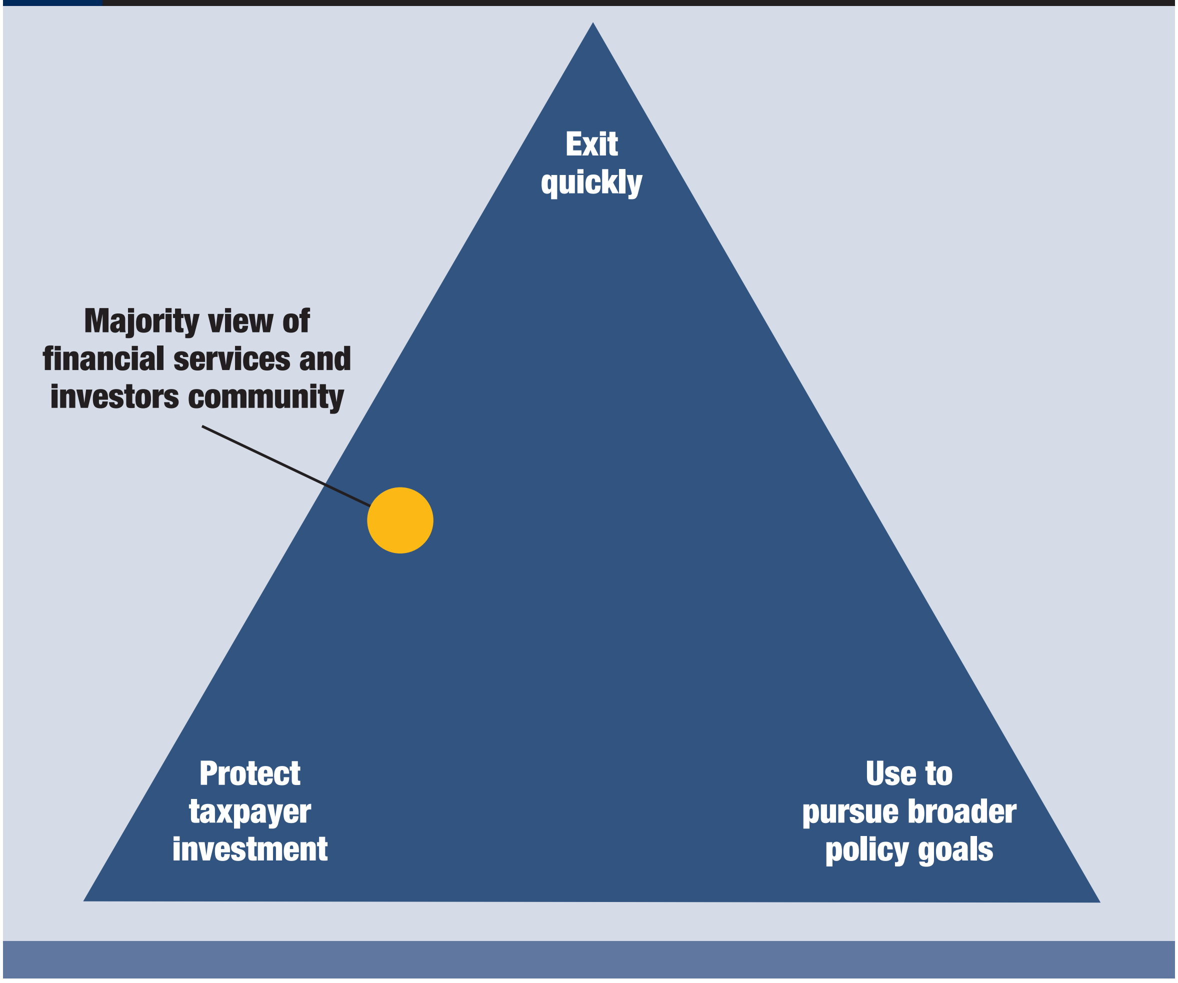
Second, we do not intend to be involved in the day-to-day management of any company. Our responsibility is to protect the taxpayers' investment. Government involvement in the day-to-day management of a company might actually reduce the value of these investments, impede the ability of the companies to return fully to being privately owned, and frustrate attainment of our broader economic policy goals.

Third, consistent with these goals, we will take a commercial approach to the exercise of our rights as a shareholder. We will vote only on four core matters: board membership; amendments to the charter and by-laws; liquidations, mergers and other substantial transactions; and significant issuances of common shares."

However in setting their shareholder objectives, governments, perhaps inevitably, face a number of difficult trade-offs. For better or worse, this was reflected in the differing priorities of the private sector experts consulted in the development of this paper. Of the three archetypal objectives of protecting shareholder investment, exiting quickly and pursuing broader policy goals, only a few favour the last while the majority differ only in how they prioritize between the first and the second (figure 25).

Governments should prioritize timely exit, not only to minimize market distortion but also to prevent a creeping politicization of the process. Except in countries that legislate the objectives of ownership management, those objectives are at risk following changes in political leadership. For example, TARP is overseen by an Assistant Secretary of the Treasury appointed by the President. Similarly, the chief executive of UKFI reports to the Chancellor of the Exchequer, a political appointee of the Prime Minister.

Figure 25 **Community prioritisation of government objectives**



There is another powerful argument in favour of rapid exit. Those in favour point out that as the entry rationale was to stabilize and prevent a systemic event, the goal in managing interventions should simply be to create the conditions under which governments can exit without reintroducing institutional and systemic risks. This implies minimizing government invasiveness, even if it means abandoning attempts to optimally protect taxpayer investments.

While this argument has an intellectual appeal, a more nuanced view is called for. Governments may have been focused on the need to stabilize the financial system initially; however, it would be foolish to turn a blind eye to the complexities that have since become apparent.

Exiting quickly with no consideration at all of, say, return on investment, might look like imprudent management of taxpayer funds and likely sets governments up to be "gamed" by savvy private sector investors. At the same time, aiming purely to maximize return is tantamount to asking governments to time markets or, potentially, turn into long-term shareholders (a hard ask, given that government shareholdings are largely financed through expensive public debt that in turn creates significant fiscal planning concerns).

Balancing these objectives is difficult, but not impossible. One can conceive of a single-minded focus on maximizing return on investment with the application of a high discount rate on future returns – thereby placing a premium on rapid exit. Similarly, the focus might be on making a rapid exit but with a mandate to maximize return during the holding period. Finally, and perhaps most persuasively, governments might aim to maximize the long-run enterprise value of owned institutions even while independently pursuing rapid exit. As governments were typically investors of last resort, exit will not be sensible until the underlying problems with the government-owned institutions have been resolved – a task best accomplished through focus on long-term value creation. Even if governments exit before the full value of their investments is realized, the dual goals can be pursued simultaneously without conflict as one dictates how governments work with owned institutions and the other how they work with potential investors in those institutions.

While rapid exit and return maximization can be balanced, the introduction of broader policy goals into the decision is fundamentally incompatible with the two other goals. This is because the pursuit of a political agenda, beyond creating shareholder value, is bound to require the sacrifice of the latter. This, in turn, puts the objectives of government as shareholder in direct conflict with those of other shareholders (where the government ownership share is less than 100%).

Similarly, any changes in the business practices of a company owned by the government for reasons other than shareholder value creation are likely to be reversed when that shareholding is reprivatized. The use of the government shareholding to pursue a broader policy agenda is therefore likely to encourage governments to extend the period in which they hold shares.

Indeed, governments already have sufficient tools for pursuing policy objectives in financial services. Effective before the crisis and with equal effect during and after the crisis, regulation, legislation and dialogue should remain the chosen tools through which governments pursue policy goals in the sector.

3 Set up independently governed process to manage and resolve ownership stakes

Insulating the management and resolution of government shareholdings in financial institutions from political pressures is critical to ensuring that the focus remains on the chosen objectives for those shareholdings.

While the success of the UKFI model is a frequent subject of debate – with some experts pointing to perceived successes and others to perceived failures[15] – the concept of codifying roles, responsibilities, objectives and incentives of the agency tasked with managing the government investments is generally viewed as a step in the right direction.

15 Currently, the institution is too young to pass meaningful judgment on its performance.

Figure 26 **Historical resolution mechanisms for government investments in financial institutions**

Government Entity	Resolution Trust Corporation, USA	Treuhandanstalt, Germany	Securum AB, Sweden	U.K. Financial Investments, United Kingdom
Year Established	1989	1990	1992	2008
Precipitating Event	Savings and Loans Crisis	German Unification	Swedish Financial Crisis	Global Financial Crisis
Overarching Objective	• Liquidate assets transferred from insolvent S&Ls	• Privatize, restructure or dissolve companies formerly owned by German Democratic Republic	• Manage and dissolve bad loans taken over from state-owned Nordbanken	• Manage and dispose government's equity stakes in troubled financial institutions
Guiding Principles / Limitations	• Maximize return from disposition of thrifts/assets • Minimize impact on markets • Expand affordable housing supply	• Exit quickly • Restore efficiency and competitiveness of companies • Guarantee employment and investment	• Stabilize Swedish financial and real estate market • Commitment to management independence and long resolution horizon (10-15 yrs)	• Protect and create taxpayer value (no permanent investor) • Maintain financial stability • Promote competition
Investments	• 747 thrifts with US$ 403 billion in assets (mostly real estate)	• 8,500 cross-sector companies with 4 million employees	• 2,500 real estate loans	• Four U.K. financial institutions (as of 09/2009)
Internal Governance (vis-à-vis government)	• Placed within jurisdiction of US Treasury Department • RTC Oversight Board chaired by Secretary of the Treasury • RTC Board of Directors including Executive Director • Three advisory committees	• Placed within jurisdiction of Finance ministry • Supervisory board members from private sector, Investee, trade unions, government • Management board with private sector president • Advisory committee	• Private asset management company with separate supervisory board • Government holds seats on board, but commits to not interfere • Governance designed to ensure commercial motivations – return value to investors (the taxpayers)	• Balanced board with four private sector members (including Chair) and three government officials (including CEO) • HM Treasury has approval rights over certain decisions
External Governance (vis-à-vis investees)	• Full authority to pursue mandate • Decentralized approach with many decision powers delegated to regional offices	• Full authority to pursue mandate • Decentralized approach but decision power not clearly allocated	• Full authority to pursue mandate (though no forma authority was legislated) • Centralized approach	• Investments managed on a commercial basis • No intervention in day-to-day management decisions • Investees with own independent boards and decision powers
Lessons learned	• Stay flexible to react to dynamic environment • Use private sector talent • Decentralized set-up needs clear lines of authority • Set-up used creates risk of politicization of decisions	• Key decisions (e.g. exit timing) driven by compensation (e.g. exit bonuses) • Decentralized set-up needs clear lines of authority • Set-up facilitates politicization of decisions	• Independence facilitates de-politicization of decisions • Commitment to longer resolution time frame puts focus on taxpayer value • Use private sector talent	• Publication of objectives and rules enhances transparency (framework document)

Sources: FDIC (1998): Managing the Crisis: The FDIC and RTC Experience 1980-1994 , Mark Cassell (2002): How governments privatize: The Politics of Divestment in the United States and Germany, Bergstroem et al (2003): Securum and the Way out of the Swedish Banking Crisis, UKFI (2009): Annual Report 2008-2009

Two factors will determine the success of government efforts to create an independent shareholding management and resolution process. First, there must be a clear mandate supported by appropriate staffing. The staff must be of the right calibre and in the right roles to run the management process without the need for additional material guidance from government officials. Second, beyond clarity of mandate, the integrity of the process must be preserved by isolating it from political pressures (including pressure from individuals managing and resolving other government interventions such as regulatory and monetary policy reforms).

While there is no template for such a process, lessons can be learned from historical and contemporary attempts at setting one up (figure 26).

Whether through legislation, costly signalling (e.g. public commitment to a specific course of action) or other mechanism, committing to independence of the resolution process is crucial. This is not to say that governments should cede the right to coordinate resolution of investments with other policy changes (e.g. regulatory change, contraction of money supply, etc.), but this coordination should occur the same way that it would with any private sector entity – through the standard channels of public-private dialogue.

Finally, where there is a single entity or process charged with managing all government shareholdings, each shareholding should be dealt with on a case-by-case (and transaction-by-transaction) basis instead of on a portfolio level. That is, the holdings in AIG should be managed and resolved according a timeline and objectives that are best for that investment, with separate timeline and objectives for each of Fannie Mae and Freddie Mac and separate still for each of the other government shareholdings in the United States. Contemplation of forced mergers in pursuit of synergies should be met with much suspicion, due not only to the low likelihood of realizing the hoped-for synergies, but also the competitive issues raised by merging large firms and the consequent (undesirable) increased complexity and systemic importance of the merged institution.

This is not to say that governments should not be willing to accept "failure" of any of its portfolio companies. This is certainly possible, as governments recapitalized many of the most imperilled firms. Rather, governments should pursue the optimal path for each institution, independent of the "portfolio" performance – even if this means wind down of an owned institution.

4 Restrict government influence on owned institutions to board composition, governance and proxy issues

As shareholders, governments must choose a model for how they interact with the companies in their portfolio of investments. To minimize market distortion and to make the most of market disciplines, governments should restrict their influence to board and board committee appointments, developing the mechanisms of institutional governance and proxy issues.

There are two prototypical governance models employed by investors in both the private and public sector (figure 27). The passive shareholder only votes on critical issues and otherwise watches the firm's performance from a distance. The active investor, typified by a private equity firm, may seek board appointments, retain an indirect veto over important management decisions and be deeply involved in strategy formation and execution.

The recommended model for governments with newly acquired interests in financial institutions is a hybrid between the passive and active models. Governments have a fiduciary responsibility to taxpayers to represent their interests to the boards of portfolio companies. This can be fulfilled by playing an active role in the nomination of new board members ensuring appropriate board committee membership and remit, and voting on key proxy issues such as major transactions. However, this should stop short of intervening in day-to-day management, where any benefits of intervention are far outweighed by the consequences of replacing market discipline with government command and control.

Figure 27 **Two typical and a recommended hybrid governance model**

	Passive Model	Intermediate Model	Active Model
Investment vehicle	Typical retail fund	Independent government agency	Typical private equity fund
Level of information	Outside-in due diligence	Typical board level information	Full access through captive board members
Alignment of interests	None/passive	Appoint and incentivize independent board members	Appoint and incentivize board & management team
Influence on management	Proxy voting	Board level only	Board level and direct involvement in management decisions
Intervention approach	Buy/sell/hold decision	Replace board members	Replace board members and management team
		Recommendation	

Furthermore, no board members should be especially beholden to the government so that they are able to represent the interests of all shareholders. Even in cases of 100% government ownership, an independent board capable of representing non-government shareholders will be necessary to effectively reprivatize.

5 Secure and empower management talent for both government and private sector roles

Bringing top talent to bear on the problem of managing government shareholdings of financial institutions is likely to be critical to success. But there are some big obstacles.

Only a small fraction of political officials and civil servants have significant business experience and even fewer have experience managing or restructuring complex financial institutions. Meanwhile, most governments are reluctant to pay the market rate to acquire suitable talent from industry due to the political controversy this tends to spark.

Too frequently, when highly qualified individuals agree to work for modest sums, they are immediately subjected to the full weight of public scrutiny. This scrutiny can become intense if elected government officials then attempt to distance themselves from any unpopular policies.

Given the amount of tax payer investment at stake governments should recognize the importance of obtaining top talent for key positions and make suitably attractive offers to prospective candidates. Accepting and explaining to taxpayers the appropriateness of aligning the incentives of professional managers with those of the investors (and rewarding managers for exceptional performance) will pave the way for acquisition of highly talented managers. Since private investors use incentive pay to compensate professional asset managers, and due to a competitive market for talent, taxpayers will likely be forced to carefully consider how they pay professional managers of government investments. In light of popular pressures, decision-makers should take care to ensure that compensation is proportional to and concurrent with returns to the taxpayers. At the same time, government offers need not rely entirely on monetary compensation. Insulation from political pressures, the pledge of support from senior elected officials and the resources to build a suitable team should all be part of the standard offer.

There are clear precedents both for failure and success in this endeavour. The empty posts in the US Treasury and the rapid turnover of leadership at AIG both point to the challenges of governments trying to attract necessary talent. By contrast, and despite persistent public questioning of the level of compensation awarded to portfolio managers, non-profit institutions such as the Harvard Management Company continue to pay market rates for top talent and have historically benefited from doing so. This model, like the private equity and hedge fund models that align the incentives of managers with the investors may hold the answer if politicians are willing to stand behind it. The alternative may, quite literally, be a lack of leadership.

6 Ensure high levels of transparency and accountability

Transparency and accountability are not easy to deliver, but they are vital if governments are to maintain public trust as well as confidence of the financial system and international credibility. The goal should be to disclose the rationale and outcome of all key decisions and insist on accountability in both the private and public sectors for any actions taken with respect to government ownership stakes. This should apply right through the process, from the early definition of objectives to establishing governance processes and compensating staff.

While regulators will undoubtedly look to improve transparency at multiple nodes within the financial architecture, governments as investors acting on behalf of taxpayers will need themselves to become increasingly transparent to maintain the trust of the financial sector and the public at large.

This has been a topic of discussion in the realm of Sovereign Wealth Funds (SWFs) for many years. Now that many nations without SWFs find themselves dealing with problems similar to those with formal investing bodies, there is cause to revisit the learnings from investigation of the role of transparency and accountability in that field. The OECD and IMF have done extensive work collating best practices and recommending a code of conduct. With respect to transparency and accountability, there are parallels that should apply to governments with new investment stakes, just as they would to SWFs: such as clear disclosure of policy purpose and legal framework of the entity managing investments, frequent public disclosure of financial performance, and independent audits.

Conclusion

Much work is yet to be done in rebuilding the financial architecture in light of the global economic crisis. At stake are hundreds of billions of dollars of taxpayer investments and the stability, growth and general structure of the financial sector.

The crisis and the interventions discussed in this paper pose new challenges to governments and other stakeholders to the financial system. Yet, the principles underlying the solutions are quite familiar:

Transparency – As seen at various points over the past two years, lack of transparency quickly spirals into a lack of trust and confidence; and when trust and confidence are lost, the financial system quickly grinds to a halt. Open communication between the complex network of stakeholders is not only necessary to maintain trust and confidence, but also minimizes market distortions and increases accountability for those navigating the crisis.

Governance – Political and corporate processes rely on appropriate governance to ensure independence, focus and accountability. The new role of government as shareholder increases the importance of establishing and maintaining good governance – both within government to ensure appropriate, independent management of shareholdings and within owned institutions to ensure development of and execution against sound business strategies.

Leadership – Strong leadership is needed to navigate the crisis, and governments must not shy away from seeking out leaders with appropriate skills, compensating them for their work and empowering them to be successful. This is true both for those managing government shareholdings and for private sector managers of owned institutions. The same bold leadership that resulted in government interventions and that prevented systemic collapse will be needed to exit those interventions and lay the framework for a more durable financial system. However, that leadership may need to come from different sources as the skills necessary to manage and resolve the government stakes are quite different from those that allowed for the initial government investments.

The road ahead for governments is not easy. But, in following the recommendations in this paper, governments will embed the values critical to maximizing probability of success into the process for managing and resolving government shareholdings.

Even having successfully navigated the challenges of government-as-shareholder, many questions will remain.

In the cases where governments look to reprivatize, who are appropriate/acceptable buyers? Should price be the only concern, or should consideration be given to factors such as proposed plans for the acquired entity and national/strategic interests with respect to the purchasing entity?

How should exit transactions be structured? While there is much talk of public offerings, trade sales (given availability of capital) seem likely to play an important role. Should governments retain some interest in previously owned entities in order to participate in asset appreciation? Should governments avoid allowing windfall profits for financial sponsors? If so, how?

There is much yet to be done before the “new normal” can be fully defined. However, the path can be made much smoother through rigorous analysis of the new challenges and an engaged, multi-stakeholder dialogue to critically explore the issues. It is the hope of the authors and the more than 150 experts contributing to this paper that the analysis, principles and recommendations presented herein contribute to that cause and to the beneficial construction of the new financial architecture.

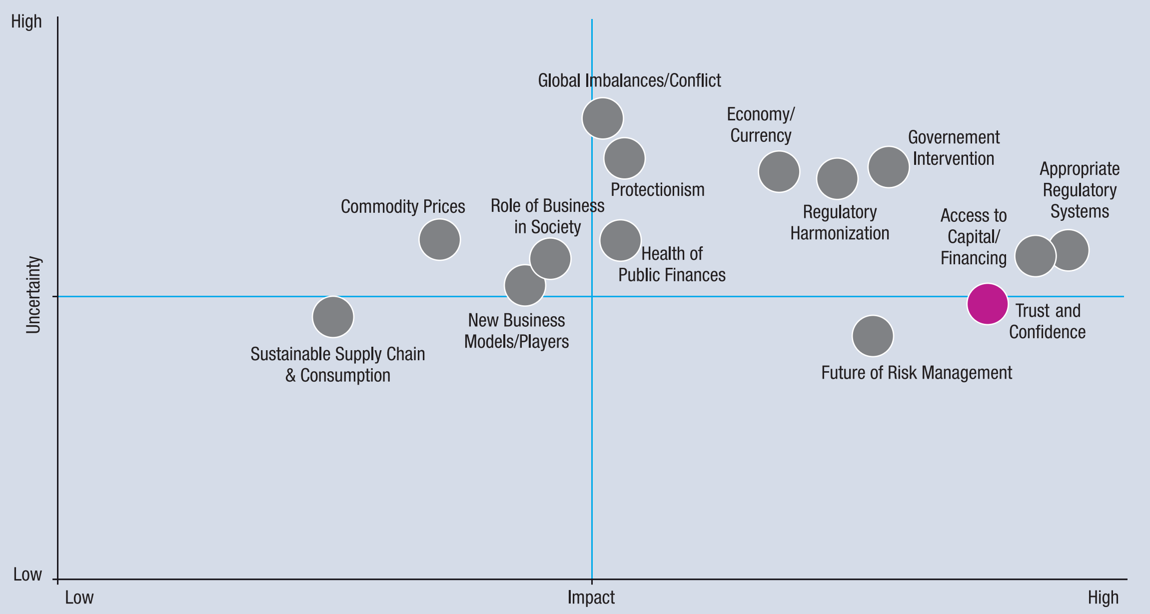
Chapter 3 Restoring trust

Introduction

"The Street's fundamental problem isn't lack of capital. It's lack of trust. And without trust, Wall Street might as well fold up its fancy tents."
– Robert Reich, former US Secretary of Labor[16]

Some might be tempted to dismiss Robert Reich's statement from September 2008 as hyperbole. After all, with capital markets at a standstill, financial institutions were starved – and some terminally so – by a lack of liquidity, not a lack of trust. However, over a year later, even with liquidity largely restored, many argue that the "fundamental problem" with financial institutions has not been addressed. In fact, a year later, in September 2009, when the World Economic Forum convened a meeting of strategists from its Financial Services and Investors communities, "Trust and Confidence" was identified as an issue of paramount importance (figure 28). Government intervention, risk management, regulatory harmonization and global economic imbalances all were identified as less urgent than addressing the trust gap.

Figure 28 **Priorities of the Financial Services and Investor communities of the World Economic Forum**



Source: World Economic Forum Issue Mapping Analysis 2009

16 *US News and World Report*. 18 September 2008. "Robert Reich: Government Needs to Rebuilt Trust in Markets"

Perhaps the urgent need for action stems from recognition of the fragility of the current situation. With strong government supports still in place and the general public reviewing institutions' licenses to operate, the current period of profitability enjoyed by many financial institutions should not be mistaken for a final return to normalcy. The need for action is also partially motivated by the near absence of a meaningful public dialogue on the topic. This brief chapter is meant to provide a starting point for continued multistakeholder dialogue, as well as discussion within individual institutions on this very important issue. The findings here represent a synthesis of the views of well over 150 leading experts in financial services, academia and the public sector. At the highest level, three key insights emerged:

1. Trust, and the need to rebuild trust lost in the crisis, is **a critically important issue** and needs to be recognized as such by all stakeholders to the global financial system
2. The lack of a **common vocabulary and framework** for discussing trust has hindered advancement of the public dialogue and the crucial task of diagnosing problems of trust within individual institutions
3. While trust is a highly idiosyncratic issue (and frequently a very personal one), common themes and recommendations emerge when systematically exploring **strategies for restoring trust.**

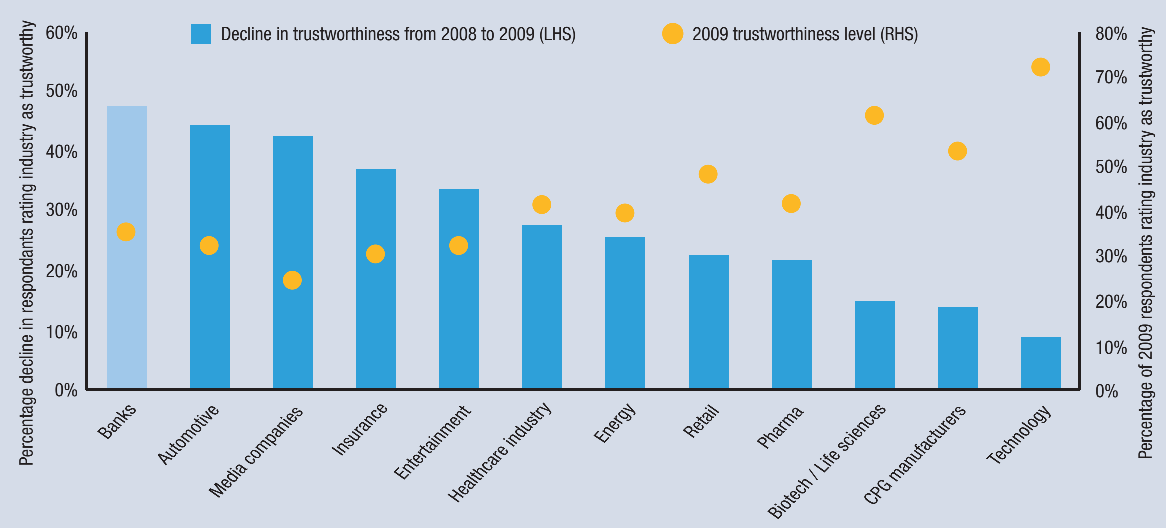
This chapter explores these three insights with an eye towards advancing the dialogue on this critical issue and providing managers of financial institutions a basic toolkit to better understand and act on the central role of trust in making their organization successful, durable and socially responsible. It concludes with six sets of strategies and tactics as recommended by the experts interviewed and listed in the acknowledgements of this report.

Before doing that, however, it is worth briefly noting that this chapter focuses on trust at the organizational level. Restoration of systemic trust is largely a regulatory concern and is being vigorously addressed by international governmental and non-governmental bodies like the G20, the Financial Stability Board and the European Commission, as well as by the World Economic Forum through its initiatives around systemic risk and financial governance.

A critically important issue

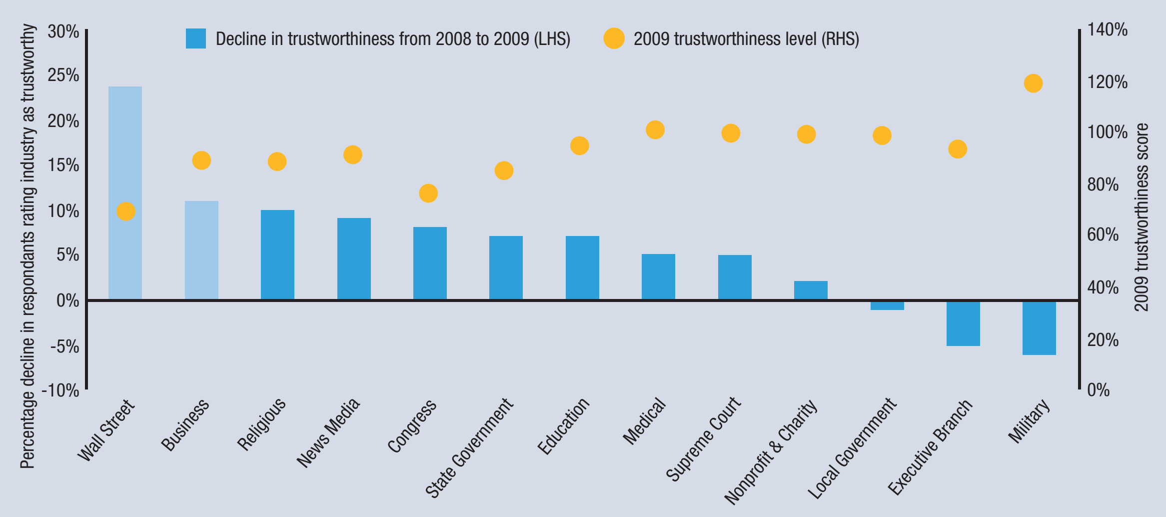
Trust in the global financial system, financial institutions and the leaders of financial institutions in general has been severely damaged through the financial crisis. Regulators no longer trust the systemic stability of the global financial system and hence look to revise the regulatory regime that manages it. Customers and other stakeholders no longer trust financial institutions as they once did (see figure 29) – now demanding greater levels of deposit insurance from governments, increasingly diversifying their exposure across institutions, and being quite vocal in a call for greater consumer protection in financial services. And the general public has lost trust in financial institutions' leadership (see figure 30), calling not just for resignations but sometimes for criminal prosecution and more often increased oversight of incentive structures. Leaders on Wall Street are now viewed as least trustworthy among municipal and federal government, religious, news media and general business leaders.

Figure 29 **Sector: decline in trustworthiness from 2008 to 2009**



Note: Informed public, ages 35 to 64 in the United States, 6-9 on 9 point scale considered "trusting" on question "How much do you trust businesses in each of the following industries to do what is right?"
Source: 2009 Edelman Trust Barometer

Figure 30 **Leadership: decline in trustworthiness from 2008 to 2009**



Note: Responses on four point scale indexed around 100; question "How much confidence do you have in the leadership of the following sectors?"; this survey also identifies trust as a primary driver of confidence
Source: Harvard Kennedy School, Center for Public Leadership, "National Leadership Index 2009"

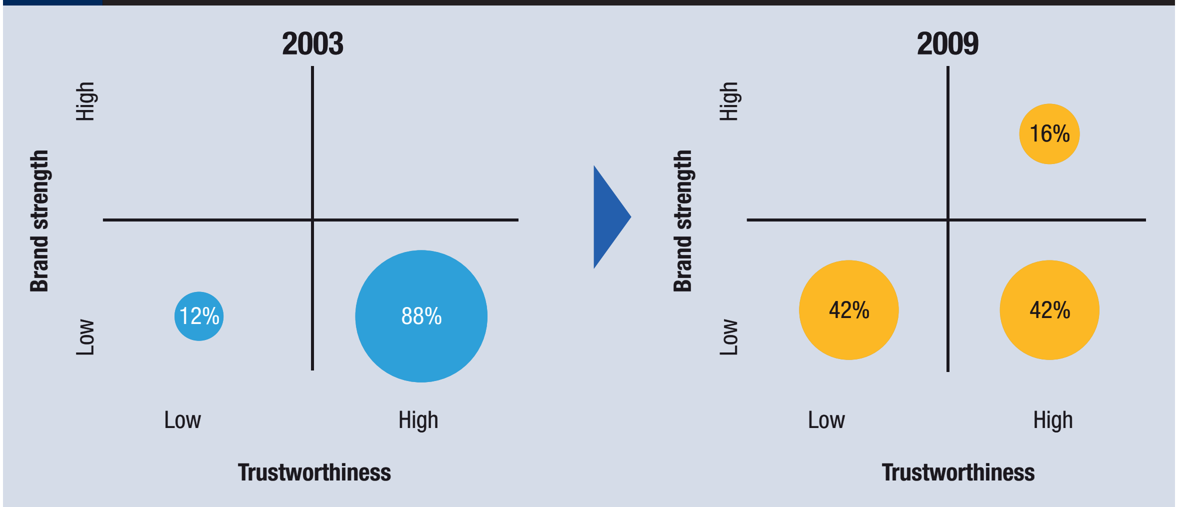
While survey data and an abundance of anecdotes makes clear that trust has in fact declined, should managers be concerned? In all industries, trust can be a source of competitive advantage. However, in financial services, wherein products can rarely be seen, felt, touched or heard, and in which services are often performed remotely or electronically, trust is particularly important.

Experts identified a host of specific contexts in which trust is critical to business success. Examples include:

- attracting and retaining clients in transactional and advisory relationships
- attracting and retaining top talent
- reducing transaction costs, for example by reducing the need for monitoring and reliance on extensive contracts
- lowering capital costs
- developing partnerships with other parties, both business and non-business
- commanding premium fees, for example on asset management services
- preventing isolated negative events from spiralling into crises

Further confirming the importance of trust in gaining competitive advantage, research by Brand Asset Consulting (figure 31) suggests that not only is trustworthiness a key driver of energized brand strength (ability to command premium pricing/valuation), but that the crisis has increased the extent to which trust can be a key differentiator of brand strength.

Figure 31 **Distribution of US banks by trustworthiness and brand strength**

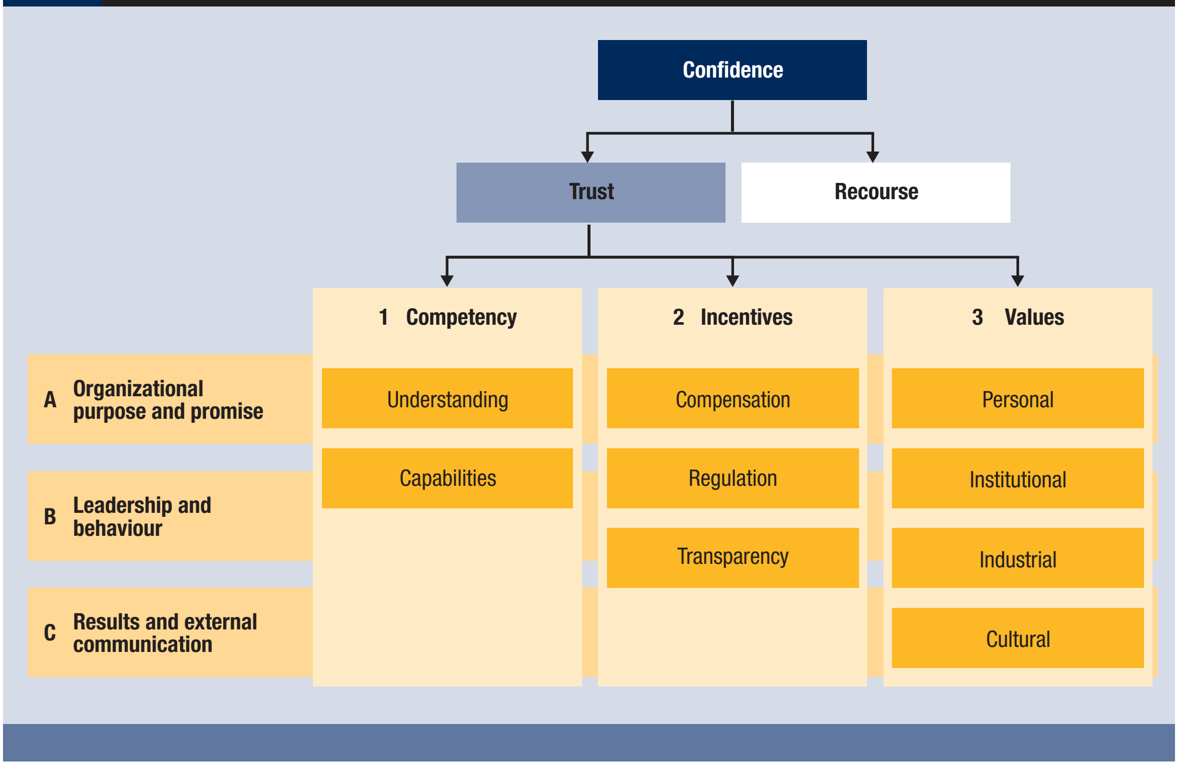


Note: Data represents survey scores of informed public for US banks in 2003 and 2009; trustworthiness and brand strength are proprietary composite scores of Brand Asset Consulting and are indexed to global cross-industry averages
Source: Brand Asset Consulting, custom analysis for the World Economic Forum

A common vocabulary and framework

The second insight emerging from the expert consultations was the need for a common vocabulary and framework for discussing trust, diagnosing problems of trust and designing solutions. Here we present one such framework (figure 32). We have attempted to capture the full range of business elements touching on trust – as represented by industry experts – and to contextualize them in a way that allows managers to efficiently examine trust issues within their own institutions and to address them in a structured manner. Here we will describe this framework and its applicability to financial institutions.

Figure 32 **Trust framework**



Confidence = Trust + Recourse

First, it is important to recognize that trust is neither an end in itself nor strictly necessary for the functioning of business relationships and markets. Rather, it is confidence that is crucial. Parties to a relationship must be sufficiently confident that their expectations in entering that relationship will be met – deposits will be available on demand, payments will be made on an agreed upon schedule, assets will not be diminished due to fraud or negligence, etc. This confidence can be created either through trust that the counterparty will fulfil its specific obligations and/or the availability of recourse.

Recourse typically takes the form of either formal insurance provided by a third party, or the ability to compel action through a governing body such as the legal system. In the throes of the liquidity crisis, governments attempted to increase recourse to fill the gap left by plummeting levels of trust. Numerous liability guarantees were issued with countries such as Ireland, Italy, Sweden, Switzerland, the United Kingdom and the United States all extending retail deposit insurance. Ultimately, these government policies – though not explicitly framed as increasing recourse to compensate for a decline in trust – were successful in maintaining confidence in retail banks and preventing bank runs.

Government system-wide backstops, similar to centralized counterparties that obviate the need for bilateral trust, can be effective mechanisms for maintaining confidence. However, the topic of the present discussion is the role of trust and how institutions can work to restore that trust on a bilateral basis.

Foundational Trust Factors

In the absence of recourse, in order to have confidence, counterparties must trust that both sides will fulfil their obligations. Three components make up that trust:

1. **Competency.** Is the counterparty competent? Does it understand its obligations and have the capabilities necessary to fulfil on them?
2. **Incentives.** Do incentives (including compensation, regulation and degree of transparency) align the interests of the counterparty with fulfilment of the relationship obligations?
3. **Values.** What are the values of the counterparty? Will the values (cultural, industrial, institutional and personal) encourage "good" behaviour?

The crisis has exposed shortcomings in each of these areas. While necessary repairs are subject to debate, with the benefit of hindsight, it is quite clear that risk management capabilities were sorely lacking in many institutions; incentives in some cases were very much not aligned with the interests of the customer, and positive values too often took a back seat to short-term, profit-seeking motives.

Observable Indicators of Trustworthiness

Just as in interpersonal and business relationships, in the financial industry, competency, incentives and values are not readily observable to customers and other stakeholders. Because of this, even institutions with a high degree of competency and strong incentives and values that align behaviours with interests of stakeholders can suffer from a lack of trust. In capital markets during the liquidity crisis, it seemed that no degree of competency or well-aligned incentives could instil sufficient trust in a counterparty to secure sizable loans.

However, there are three observable dimensions of a financial institution that relate closely to the foundational trust factors and are used by stakeholders to assess trustworthiness of an institution:

A. **Organizational purpose and promises to stakeholders.** At the highest level, how does the institution guide its actions? Is it designed to serve equity holders with near-term financial returns? Is it explicitly geared towards some social purpose? Does it have and hold to a well-defined mission? What promises does it make to its various stakeholders (customers, shareholders, regulators, employees, taxpayers)?
B. **Leadership and behaviour.** Does the leadership work to develop the necessary competencies, incentives and values within the institution? Does the historical observable behaviour of the institution bear out possession of the critical components of trust?
C. **Results and external communication.** Ultimately, do the results consistently demonstrate a high degree of competency, as well as incentive and value alignment? Does the institution communicate openly: recognizing successes and taking responsibility for and working to address shortcomings?

These indicators, together with the three foundational trust factors listed earlier represent the potential fault points in trust relationships. It is worth noting that business strategy and risk appetite do not appear in this framework. While strong risk management was frequently cited in interviews as important to demonstrating resiliency, risk need not be antithetical to trust and risk appetite to trustworthiness.

Whether explicitly or intuitively, customers and other stakeholders are constantly evaluating the trustworthiness of financial institutions. What can managers do in each of these domains – both the foundational factors and observable indicators – to restore trust lost through the crisis?

Strategies for restoring trust

In interviews and workshops during the Word Economic Forum's Annual Meeting of the New Champions 2009 in Dalian, People's Republic of China, and Strategy Meetings in New York, participants from industry, academia and the public sector were asked to identify strategies and tactics for restoring trust lost through the crisis. It quickly became clear that even with a framework with which to address the complex issue of trust, both the problems faced by individual institutions and the solutions appropriate to those problems are highly idiosyncratic. Cultural context, institutional history, government crisis response, and the competitive and brand position of the institution all play a large role in determining the magnitude and appropriate response to problems of trust. Therefore, we do not aim to provide explicit recommendations, but rather to highlight commonalities in the strategies and tactics discussed through the research and expert consultations. Hopefully, these strategies and tactics can serve as a jumping off point for further conversation – both multistakeholder and within individual financial institutions – and ultimately stimulate action to restore trust.

Figure 33 describes some of the highest priority and most frequently suggested of these strategies and tactics aligned against the six domains discussed in the previous section.

Figure 33 **Strategies and tactics for restoring and maintaining trust**

		Strategy	Tactics
Foundational Trust Factors	1	Align **competencies** with promises made to stakeholders	• Refocus on core competencies, including developing and selling products that meet fundamental customer needs, and effective management of risk
	2	Implement **incentives** that reward delivery on promises	• Align compensation with the magnitude and time frame of stakeholder value creation • Incentivize values (as manifested in behaviour) in addition to performance (as manifested in results)
	3	Develop and promote **values** geared towards delivering on the promises	• Promote and enforce positive values such as integrity and responsibility • Encourage collective responsibility and willingness to question critically
Observable Indicators of Trustworthiness	A	Set a **purpose** for the institution that is aligned with the promises to key stakeholders	• Reassess the stakeholder landscape • Develop a clear understanding of the explicit and implicit promises made to customers • Focus on delivering customer and social value
	B	Demonstrate **leadership** by driving necessary change and promoting "good" **behaviour**	• Focus on long-term value creation • Demonstrate a strong ethical compass • Learn from mistakes • Re-earn the trust of employees
	C	Deliver **results** that fulfil promises and engage in honest, two-way communication	• Acknowledge mistakes and openly communicate plans for corrective measures • Clearly articulate what the company stands for • Employ a mix of communication channels to enhance credibility towards key stakeholders, and particularly focus on the role of employees • Increase transparency on risks, incentives and to what extent the firm delivers on its promises

Conclusion

Many of the strategies listed in the preceding section are supported not just by the need to restore trust, but also by broader and more immediate competitive concerns. In an environment in which margin protection and volume growth are no longer viable strategies in many sub-sectors, innovation with focus on solving problems for customers will be critical for profit generation in the near term. Similarly, supervisors will increasingly require greater demonstration of risk management capabilities. Enhancing trust with both customers (e.g. through innovation) and regulators (e.g. through transparency) will enhance the probability of success in other strategic endeavours.

That said, even those trust-building strategies and tactics with little measurable short-term benefit should be evaluated as potential management priorities. With great uncertainty as to the competitive and economic landscape, the role of trust in building sustainable competitive advantage and institutional durability through periods of crisis is clear. It may be hard for a financial institution struggling under the weight of often competing pressures from regulators, shareholders and customers to prioritize restoring trusting relationships between employees and senior management. However, though not sufficient, rebuilding that trust is a necessary component to not just putting a financial institution back on track, but also ultimately on a path to competitive success.

The goal of rebuilding trust is a great challenge without a clear or universal roadmap for achieving it. Many international organizations are working to restore trust in the global financial architecture. However, those efforts must be supplemented by work at the institutional level to restore bilateral trust. The current period of redesign and rebuilding following the crisis presents a unique opportunity for meaningful change for managers and institutions open to taking advantage of it. The crisis has clearly demonstrated the importance of trust. Institutions and leaders that internalize this learning, diagnose issues of trust within their company and commit to building a trustworthy institution will be rewarded in the end – not only with competitive success, but with long-term durability and positive and meaningful relationships with customers, regulators and the broad stakeholder community.

Looking forward

When the New Financial Architecture project was first mandated by the Investors and Financial Services communities of the World Economic Forum, the intent was to explore the likely medium- and long-term evolution in industry players, business models, customer segments, and assets that define the financial architecture. By making a comprehensive examination of trends, risks, and opportunities, managers of financial institutions would be better equipped to face the uncertain future. Unfortunately, there was little time as the global financial crisis took hold to act on the findings presented in *The Future of the Global Financial System: A Near-Term Outlook and Long-Term Scenarios*.

Today, the issues addressed in that report are still very much live and indeed can be found daily on the front page of the world's newspapers, and feature prominently in policy, academic and practitioner debates. They are also re-examined in chapter one of this report. Furthermore, over a year later, many aspects of the financial architecture are being questioned. Some will ultimately be reaffirmed, while other areas will be torn down and rebuilt in the hopes of creating a more durable and socially beneficial financial system. In light of the ongoing public debate, chapters two and three of this report aim to advance the dialogue on two pressing issues – government management and resolution of investment stakes in financial institutions, and the critical importance to all financial institutions of restoring the trust lost through the crisis.

While the insights presented in the body of this report focus on the long-term repercussions of action (or inaction), in the spirit of avoiding the myopia that many say paved the way for the crisis that nearly brought the financial system down upon itself, we conclude with a look not so much at the challenges faced today, but rather at some challenges we may face in the future.

In fact, even as we interviewed the financial services experts regarding the content of the preceding chapters, time and again conversation turned to the uncertainties of the future[17]. Through that process, two categories of potential challenges to the financial architecture stood out as major areas of common concern – both highly uncertain and of great potential impact. The first are 'new' asset bubbles which could pose significant systemic economic risk. The second are structural flaws in the financial architecture that create fundamental instability in the system.

Asset bubbles

Aside from the potential double-dip scenario resulting from eventual withdrawal of government support of the financial and real economy, the current evolution of the financial architecture suggests two potential sources of asset bubbles.

Carry trade

The first bubble scenario involves the unwinding of the large carry trade best described by Nouriel Roubini in his FT opinion piece from late 2009[18]. The carry trade began as cheap access to government provided liquidity combined with quantitative easing and asset purchases by the US Treasury to encourage investors to take on massive short dollar positions in order to make leveraged investments in riskier assets. While the broad array of assets held by these investors creates the illusion of diversification, each of the long positions is supported by the same leveraged bet on a weak dollar – not on the fundamentals of the assets themselves. When the US Federal Reserve begins to rein in liquidity, all of these positions will be simultaneously impacted. The bursting of this bubble could be particularly damaging as asset price erosion (as investors unwind what are otherwise uncorrelated positions to cover their dollar positions) and investor performance degradation reinforce each other in a rapid and self-reinforcing downward cycle.

17 Several of these risks and many others are discussed in detail in the World Economic Forum's "Global Risks 2010: A Global Risk Network Report" available at www.weforum.org/grr
18 Nouriel Roubini. Financial Times. 11/1/2009. "Mother of all carry trades faces inevitable bust".

Sovereign debt

The second potential bubble also results from a combination of seemingly beneficial and rational government and investor responses to the crisis[19]. Specifically, as governments look to finance asset purchases and stimulus programs, they have issued significant new sovereign debt. That debt, in turn, has been picked up by financial institutions looking to clean up their balance sheets – replacing CDOs and mortgage debt with 'safer' sovereign debt. However, with no end in sight to rising fiscal debts (particularly in the US and UK), and with governments unable to continue increasing their borrowing indefinitely, devaluation of sovereign debt (at least in some geographies) seems an inevitability. Whether that devaluation is slow and moderate or fast and severe will determine the extent to which it creates a shock to the financial system.

Structural flaws

A common sentiment amongst industry experts is that future asset bubbles are a near certainty. The questions are simply in which assets the bubble will build, and how air can be gently let out of the bubble to prevent systemic disruption. A second source of instability, however, is less discussed, less understood, and far more uncertain. This instability stems from structural flaws in the financial architecture. Some flaws revealed in the current crisis are being addressed in its aftermath, including: gaps in oversight of certain types of financial institutions, limited coordination leading to international regulatory arbitrage, insufficient techniques for measuring and monitoring risk, compensation norms that encourage excessive risk taking, etc. However, just as well-reasoned and well-intentioned reactions to the crisis risk creation of asset bubbles, they may also build new structural flaws into the system architecture.

In particular, there are three structural flaws that risk being built into the financial architecture as policy makers, regulators and practitioners redesign and rebuild coming out of the crisis.

Return to Business As Usual

According to many experts, a failure by industry to internalize the lessons from this crisis, even operating under a reformed regulatory regime, will mean eventual return to imprudent underwriting and investment and continuation down a frightening path of more frequent and higher magnitude financial crises. That is, simply remembering the past will not be enough to avoid repeating it. In chapter two we discuss a few of the more prominent historical financial crises. The similarities are striking – investment in overly risky real estate loans, an excess of greed facilitated by incentive schemes that reward short-termism, and a regulatory/oversight system unable to detect the structural weakness until too late. As the financial system grew larger and more interdependent, the fundamental drivers of financial crises haven't changed. The stakes have simply gotten higher.

If, following this crisis, industry leaders do not balance profits with prudence, many warn that the next crisis may be worse. As this past crisis demonstrated, even with innovative regulations (e.g. Basel II), financial institutions can still find new sources of leverage, new risky assets, and new ways to accelerate compensation. Similarly, even a better coordinated set of regulators with more staff can choose to be more lenient once the financial sector returns to growth and the scrutiny of the general public is directed elsewhere. The financial sector did not develop subprime mortgages, CDOs and SPVs in order to destabilize the system. But, industry leaders and regulators alike could have sought deeper understanding of these innovations and the new risks they brought with them. Ultimately, the right attitude, behavior, and oversight to enforce them will be needed to avoid repeating, and amplifying the mistakes of the past.

19 Gillian Tett provides an overview of this scenario in, Could Sovereign Debt Be The New Subprime? FT, 11/22.

Excessive regulation

Even as the vast majority of interview participants recognize the need for governments to play an active role in repairing the global financial architecture, many warn that regulators should be wary of an excess of regulation. The dangers of too little regulation are quite clear, even if more obvious in hindsight. The risks and implications of over-regulation are perhaps less defined and longer-term. However, they are certainly just as significant and include depressed growth and stifled innovation.

Historically, financial services has been an important contributor to economic growth – both directly through its contribution to GDP and indirectly through provision of risk transfer and transformation. Greater regulation, while aimed at creating a more stable system and enhancing consumer protection, could have the side effect of restricting industry growth in the future. Regulators therefore face a trade-off between stability and consumer protection on the one hand, and growth and competitiveness of the domestic financial sector on the other. At the time of writing, several major markets (primarily the UK and France) were contemplating "one-off" taxation on bank bonuses of as much as 50%. There are reasonable arguments for imposing such a tax – both the existence and profitability of most banks are due to some form of government support (whether direct investment or provision of cheap sources of liquidity). At the same time, some experts see such a tax as setting a dangerous precedent. Financial services profits are always dependent to some degree on government and central bank policy (e.g. interest rates have dramatic effects on industry profits). And while there may be room (or in fact need) for policies that ensure taxpayers are made whole for expenses they incurred to protect financial institutions, there is a fine line between equitable measures and punitive ones. Many in industry encourage that regulators consider the implications of their actions on the ability of and incentive for the financial sector to contribute to long-run economic growth.

Beyond GDP contribution, the ability of financial services firms to continue to innovate in the new regulatory regime should be an important consideration. Industry leaders point out the positive innovations of the past decades that accompanied those that are more stigmatized (e.g. CDOs and SPVs). Online banking and brokerage, mobile banking, exchange traded funds and reverse mortgages only exist due to innovation in part made possible by the ability of primary and secondary market providers to take on new risks without undue government restrictions. Making the financial sector 'safer' is a daunting challenge for regulators. However, overshooting away from too little regulation towards too much could do long-term and possibly irreversible damage to the industry and, by extension, the customers that they serve.

Homogeneity and tunnel vision

The collapse of Long Term Capital Management in 1998 focused attention squarely on the systemic risks posed by hedge funds. In the ensuing 10 years, little attention was paid to risk in more traditional financial institutions such as investment banks. In 2008, with the collapse of Lehman Brothers, we face the prospect of increased scrutiny on subprime mortgages, securities, and originate-to-sell business models. With planned and already realized changes in regulation and business practices in these areas, it is highly unlikely that the next crisis will come from any of these sources. As we emerge from this crisis, in addition to learning lessons from the past, a greater adaptability and sense of 'creativity' will be required if we are to prevent the next crisis.

Experts note two threats to the adaptability and creativity necessary to prevent future crises. First, oversight of financial institutions, like those institutions themselves, has historically experienced significant cyclicality. Regulators build staff and capabilities during periods of turbulence, and often lose institutional knowledge and rapid response abilities during periods of calm. This pro-cyclical behavior, just as in the private sector, heightens systemic risk by increasing the likelihood that needed resources will not be available in times of crisis. That both financial institutions and some regulators diverted resources away from prudent risk management during low-risk periods was perhaps a significant driver of the crisis. Many suggest that to prevent the next crisis, both public and private sector actors should take advantage of periods of calm to enhance risk management capabilities.

Similarly, financial services leaders recognize that a mindset shift is called for in private sector business practice around risk management. Much has been written about tail risks or so called “black swans”, but some bears repeating. Regulators can encourage business resiliency, but only practitioners can build truly resilient businesses. One key component to doing so will be more creativity in risk management. Prior to this crisis, few imagined that such a broad array of historically uncorrelated assets would become near perfectly correlated in a crisis. In the United States, a nationwide decline in real estate prices was a generally discarded scenario. And there was little discussion of the ability of a single bank failure to catalyze a systemic crisis. To prevent the next crisis, practitioners should stretch their creativity in preparing for the future. Scenario planning can be an effective tool here. But no tool can substitute for a culture that encourages the questioning of dominant thinking and rewards prudent risk management over short-term profit orientation.

Conclusion

As the global financial system recovers from the crisis, it faces a myriad of potential perils but also many potential opportunities. The immediate challenges include resolving government interventions, restoring trust lost through the crisis, and navigating a macroeconomic and competitive environment in flux. At risk are billions of dollars of taxpayer investments, and the long-run stability, and economic and social contribution of the global financial system. Success will mean a more resilient financial system, a financial system geared more directly towards serving the needs of its customers, a more balanced and coordinated international regulatory regime, a resumption of beneficial innovation, and a profitable and growing industry.

Rebuilding the financial architecture will not be easy, nor will it be quick. We hope the ideas presented in this report will assist the stakeholders to the financial system -- from policy makers to CEOs to taxpayers -- as they redesign and rebuild a better global financial architecture for the benefit of all.

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Senior Project Adviser

Julia Hobart, Partner, Oliver Wyman

The project team would like to thank all interview and workshop participants for sharing their time and insights. These individuals were (in alphabetical order):

Interview and workshop participants

Doyin Adeyinka, Acorn Petroleum Plc
Ahmed Al Dailami, Abu Dhabi Investment House
Saud Hasan Al Nusuf, Vision 3
Talal Al Zain, Bahrain Mumtalakat Holding Company
Yarom Ariav, Ministry of Finance of Israel
Andre Baladi, International Corporate Governance Network
Elena Barmakova, Fontvieille Capital Inc.
Richard Barrett, Barrett Values Centre
Denis Bastin, Oliver Wyman
Alan Batkin, Eton Park Capital Management LP
Douglas G. Bergeron, VeriFone Holdings Inc.
Terry Berland, Russell Investments
Andreas Beroutsos, Eton Park Capital Management LP
Mario I. Blejer, Banco Hipotecario SA
John Bovenzi, Oliver Wyman
Frank Brosens, Taconic Capital Advisors
John Bryant, Operation Hope
René Buholzer, Credit Suisse
Max Burger-Calderon, Apax Partners LLP
David Carruthers, Data Explorers
Miles Celic, Prudential Plc
Kai Chen, Canadian College of Acupuncture and Oriental Medicine (CCAOM)
Mathews A. P. Chikaonda, Press Corporation Ltd
David Clarkson, Oliver Wyman
Abby Cohen, Goldman Sachs
John Colas, Oliver Wyman
Clint Corver, Barrett Value Centre
John Coyle, Permira Advisers Ltd
Hans Dalborg, Nordea
John Dalla Costa, Centre for Ethical Orientation
Bruno de St. Florent, Oliver Wyman
Peter DeBoer, Standard & Poor's
Christopher Delong, Taconic Capital Advisors LP
Volker Deville, Allianz SE
Michael Drexler, Barclays Capital
Jack Ehnes, CalSTRS
Mohsen Fahmi, Moore Capital Management
Robert Fauber, Moody's Corporation
Stephen Fitzgerald, Goldman Sachs
Richard L. Folsom, Advantage Partners LLP
Aldo Fozzati, Fozzati Partners
Robert Friedman, The Blackstone Group
Philipp Freise, Kohlberg Kravis Roberts & Co.
Fu Xingyu, Xinhua News Agency
Matt Furman, The Travelers Companies Inc.
Amir Gal-Or, Infinity Group/Infinity I-China
Thomas Garside, Oliver Wyman
Mary Gentile, Giving Voices to Values
Hendrik H. Gienow, Eurohypo AG
Mack Gill, SunGard
Rafael Gil-Tienda, Marsh & McLennan
Ralf Gruss, Apax Partners LLP
Sunil Gulati, YES BANK Limited
Clarence Hahn, Alix Partners
Jennifer Hill, University of Sydney
Daniel M. Hofmann, Zurich Financial Services
Yoshito Hori, Globis Group
Ken Howery, Founders Fund LLC
Jukka Jäämaa, Moventas Oy
Stefan Jaecklin, Oliver Wyman
Robert Jagiello, National Bank of Poland (NBP)
Rashad Y. Janahi, Abu Dhabi Investment House
Jiang Yuanfu, China National School of Administration (CNSA)
Michael J. Johnston, Capital Group Companies Inc.
Scott E. Kalb, Korean Investment Corporation
Clint Korver, Crescendo Ventures/lecturer on Ethics at Stanford
Andrea Kramer, Hamilton Lane LLC
Margery Kraus, APCO Worldwide Inc.
Kun Ma, China Academy of Traditional Chinese Medicine (CATCM)
Andrew Kuritzkes, Oliver Wyman
Sir Andrew Large, Deputy Governor Bank of England (2002-2006)
Ed Lebar, BrandAsset Consulting
Josh Lerner, Harvard Business School
James Z. Li, E. J. McKay & Co. Inc.
Li Hang, National Development and Reform Commission
Lim Cheng-Teck, Standard Chartered Bank
Simon Longstaff, St James Ethics Centre
Gerard Lyons, Standard Chartered
Spyros Makridakis, INSEAD
David Marchik, The Carlyle Group
Glen T. Matsumoto, EQT Partners Inc.
Wael Mattar, Abu Dhabi Investment House

Paul Mattera, Liberty Mutual Group
Robert H. McCooey, The NASDAQ OMX Group
Gregg Medcraft, Australian Securities and Investments Corporation
Ken Mehlman, Kohlberg Kravis Roberts & Co.
Michael Menhart, Munich Re (Münchener Rück)
Ilian Mihov, INSEAD
Eric Mindich, Eton Park Capital Management
Daniel R. Mintz, Olympus Capital Holdings Asia
Edward Moynihan, Oliver Wyman
Mo Yu, National Development and Reform Commission
David Moloney, Oliver Wyman
Robert Monks, Lens Inc.
William W. Morton Jr, WL Ross & Co. LLC
Valerie Mosley, Wellington Management Company LLP
Narv Narvekar, Columbia Investment Management Company
Robin Niblett, Chatham House
Stephen G. Pagliuca, Bain Capital
Clare Payne, Macquarie
Donna C. Peterman, The PNC Financial Services Group Inc.
Michael Poulos, Oliver Wyman
Steven Rattner, Counsellor to the US Secretary of the Treasury (February-July 2009)
Emmet Rennick, Oliver Wyman
Phil Robin, MasterCard Worldwide
Scott Robinson, Oliver Wyman
Christopher Rodrigues, International Personal Finance
John Romeo, Oliver Wyman
Michael Roux, RI Group
Anupam Sahay, Aviva Plc
Mahmud Samandari, EBBF
Alberto Sanchez, Grupo Santander
Sanusi Lamido Sanusi, Central Bank of Nigeria
Taisuke Sasanuma, Advantage Partners LLP
John Schubert, Commonwealth Bank Australia
Paul Schulte, Nomura International (Hong Kong) Limited
Sheryl Schwartz, TIAA-CREF - Financial Services for the Greater Good
Leo Shapiro, Royal & SunAlliance Insurance Group Plc
Gregg Sherrill, Tenneco Inc.
Robert Shiller, Yale University
Randall Shuken, MasterCard Worldwide
Donal Smith, Data Explorers
Michael Smith, Oliver Wyman
Nicole Souffront, Standard & Poor's
Janet Spencer, Oliver Wyman Delta
Richard Steeves, Synergy Healthcare Plc
Joseph Stiglitz, Columbia University
Peter Stringham, Young & Rubicam Brands
Nicholas Studer, Oliver Wyman
John Studzinski, Blackstone
Takeo Sumino, Nomura Holdings America Inc.
Wayne Swan, Treasurer of Australia
Davide Taliente, Oliver Wyman
John Tan Ming Kiu, Standard Chartered Bank
Richard Thaler, University of Chicago Graduate School of Business
Stephan Theissing, Allianz SE
Tian Ning, Zhejiang Panshi Information Technology Co. Ltd
Deborah Traskell, State Farm Insurance Companies
Andrew Turnbull, Oliver Wyman
Phin Upham, Clarium Capital Management
Wang Ran, China eCapital Corporation
Wang Zhizhong, Tianjin Materials and Equipment Group Corp.
Manfred Wennemer, Opel Treuhandbeirat
Barrie Wilkinson, Oliver Wyman
Clark B. Winter Jr, SK Capital Partners
Mark Wiseman, Canada Pension Plan
Wu Ying, CTC Capital
Rupert Younger, Oxford University Centre for Corporate Reputation
Barbara Yu, Eton Park Asia Limited
Giuseppe Zammarchi, UniCredit Group
Michael Zeltkevic, Oliver Wyman
John Zhao, Hony Capital Ltd
Lixing Zou, China Development Bank

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Project Team

This report is a joint effort of the World Economic Forum's Centre for Global Industries and selected Industry Partners. The content is based on input from over 150 senior executives in the financial sector, policy-makers, regulators and academics. The report has been developed by the following people:

Core Team and Authors

Max von Bismarck, Director and Head of Investors, World Economic Forum USA
Nicholas Davis, Associate Director, Scenario Planning, World Economic Forum
Ben Hoffman, Senior Engagement Manager, Oliver Wyman
Carsten Reimund, Senior Manager, Mergers & Acquisitions, Allianz
Bernd Jan Sikken, Associate Director and Head of Project Management, Centre for Global Industries, World Economic Forum
Hanno Strube, Deputy Global Head of Corporate Communications and Strategic Marketing, Allianz Global Investors

Production - Editing and Creative Design

Helena Halldén, Editor, World Economic Forum
Nancy Trachet, Associate Director, Editing, World Economic Forum
Kamal Kimaoui, Associate Director, Production and Design, World Economic Forum
ekze.ch, Geneva

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