



2010 Financial Services – Capital Markets Industry Perspective

It's been a roller-coaster year. From a frightening nadir in March when the Dow Jones Industrial Average touched 6,500 and the financial world seemed truly on the verge of collapse, it progressed to a 50 percent run-up in stock prices through the summer and into the fall, and was followed by the inevitable hand-wringing and worries that the recovery had come too far too fast. Capital providers ran to the sidelines as they perceived credit risks creating liquidity risks that would result in declining asset values. At times, it has all seemed a little surreal.

In fact, 2009 has been a crucial period of transition – a bridge from the tumultuous financial crisis to a more stable, though changed, future. It is still unclear exactly what this future will look like, but the broad outlines of this competitive landscape are coming into focus. In the post-crisis environment, both capital markets and wealth management firms have a vital need to recalibrate risk and reestablish trust. On the institutional side, well-capitalized global firms that entered the crisis with robust risk management have quickly emerged from the downturn and are posting near-record profits (and bonus payouts). On the retail side, the need for trust is reflected in high-net-worth individuals' desire for transparency – in pricing, product structures, providers, and performance – and sensitivity to potential conflicts of interest. Firms that are perceived to be offering objective advice from trusted advisors and conflict-free platforms are flourishing.

To understand the institutional story, one must appreciate that the leading firms are not just big; they have also shown good judgment based on rigorous analytics, solid risk management, and a commitment to their long-term value proposition. They have emerged from the crisis with strong balance sheets and the confidence of the market. These firms are now positioned to leverage their global scope, culture of sturdy risk management, and product innovation capabilities to push forward and explore new opportunities – even with all the tumult and scrutiny on Capitol Hill. These firms are not waiting to see what politicians decide about their industry. They are creating new products that fit their risk and capital profiles and that deliver results to clients and shareholders. Given their performance through the crisis, they are confident they can explain their new financial products and packaging to regulators if called upon to do so tomorrow.

Consider that derivatives such as credit default swaps were the bogeyman of the financial crisis. Yet billions of dollars of these securities have been sold since the summer with hardly a whisper of popular or government discontent. Exotic products are not going away. Far from witnessing the death of financial engineering, the industry is being schooled on the continued importance of product innovation—coupled with smart risk management.

Today, the entire industry, including even those firms that already managed risk relatively well, is newly focused on risk management. Evidence of this is the growing clout of chief risk officers as risk management is embedded into companies' operations. As part of this new culture, the credit review and underwriting process is fundamentally changing. Many financial institutions no longer outsource risk management to credit rating agencies and bond insurers; in our view, these businesses have been diminished by their poor performance in assessing the impact of the economic downturn on the firms and securities they rated.

Better risk management has a direct impact on the performance and scale of these global players. As they demonstrate their acumen, they gain both the market's confidence and greater access to capital, which allows them to grow even bigger. As they increase in scale and scope, they move to the center of the information flow, which in turn creates enormous opportunities in securities trading, relationship building, and more.

Concern about risk is a dominant theme among individual investors as well. And it is not just market and interest rate risk, but, for the first time for many, provider risk. Triggered by the collapse of Lehman Brothers Inc., investors now want to discern the strength of the firms holding their assets under custody or management, and are demanding more security and transparency. This intense desire for transparency is also causing discomfort among hedge fund managers and those who undertake proprietary trading.

But above all else, individual investors today are seeking relationships with people they trust. This development has significant implications for customer relationship management, and so far registered investment advisors (RIAs) and commercial banks are benefiting over traditional full-service brokerage firms. Consider the rapid growth in the number of registered advisors and in assets under management. In 2008, US\$108 billion in assets shifted into the RIA channel, while \$18 billion left the big brokerage firms. This shift is being driven both by clients switching some investable assets to RIAs and by the fact that some advisors at traditional full-service brokerage firms are going independent and taking their books of business with them.

Wirehouse advisors turning independent is a relatively new phenomenon propelled by several factors. First, big brands aren't providing the advantages they once did – in fact, the association with a major name can make it harder for an advisor to gain a client's trust. In the past, a big brokerage house with ties to an investment bank had both a research advantage and a new-issue advantage over RIAs, but now that research is available from many sources online and there are fewer new issues, these advantages have been substantially reduced.

Finally, advisors are making the move to the RIA channel because their clients want them to – they want objective advice from a trusted third party with whom they have a personal bond. Investors are turning to traditional advisors and, increasingly, to online social networks for this objective advice. In other words, personal relationships, which today can extend to the social network, are becoming more important than the financial institution behind the advisor. Indeed, there's no clearer testament to the primacy of the personal relationship over the institutional relationship in today's wealth management business than that these small, independent RIAs with no brand recognition are actually gaining market share on big brokers.

Wealthy customers increasingly view the commission-based sales approach with suspicion; it is another reason they are abandoning big brokerage firms. In contrast, they perceive large banks as a safer haven for their money. With multiple customer touch points (private banking, branch-based brokers, retail, small business, community banking), banks are better positioned than brokerage firms to leverage existing relationships to build a broader and deeper level of client engagement.

In conclusion, we see risk management and trust building as the primary near-term drivers of growth for institutional and retail capital markets firms. The fundamental function of capital markets firms remains – to connect the owners of capital with the users of capital. But the crisis has created broad doubt as to whether the global financial system is up to this task. Firms that quickly establish their ability to manage risk at the product, client, counterparty, and firm level will be rewarded with growth opportunities from their clients and shareholders. Along the way, firms must satisfactorily answer some basic questions for clients, shareholders, and regulators: Are you providing advice that has the best interests of your clients in mind? Do you provide product transparency? Does your firm know how to manage risk? Is your firm truly safe?

We hope you find these insights helpful as you consider your organization's strategy for 2010 and beyond, and we welcome the opportunity to further discuss them with you.

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