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FINANCIAL SERVICES INDUSTRY

SUBPRIME AND CREDIT CRISIS WEIGHS HEAVY

2008 Edition

The financial services industry has witnessed its greatest challenges since the Great Depression, due to the bursting of the housing bubble and the resulting credit crunch. Within a period of weeks, venerable institutions have been brought to their knees by dysfunctional credit markets and the punishing stock market. The U.S. and European governments, as well as Japan, have pumped liquidity into the system and taken on direct capital investments in these financial behemoths, in an effort to stabilize credit markets and prevent a global economic meltdown.

The impact of the credit crunch has been severe, and devastating in many cases, as the basic structure of the industry has transformed. A pre-Glass-Steagall financial world has emerged, one with large diversified financial institutions, providing services from commercial banking to investment banking, and most likely with broader regulatory oversight. The Treasury Department has introduced a new regulatory proposal, which empowers the Federal Reserve to oversee the stability of financial markets and financial institutions across-the-board. The next president and Congress are certain to consider such overhauls to the regulatory framework, with substantial changes sure to come.

An Advisen Industry Analysis Report

Table of Contents

Section			Page
I.	Industry Overview		1
	a.	Consumer Finance Segment	2
	b.	Capital Markets Segment	3
	c.	Diversified Financial Services Segment	6
	d.	Economic Indicators	9
	e.	Top Players	14
II.	Business Environment		16
	a.	Extreme Government Measures to Stem the Credit Crisis	16
	b.	Tectonic Shifts on Wall Street	21
	c.	Proposed Broader Regulatory Authorities	23
	d.	Lower Cardholder Credit Lines Dampening Spending	24
	e.	Credit Crisis Retarding the Momentum of Deals	25
	f.	Organizational Restructuring amid Financial Troubles	26
	g.	Credit Crunch Causes a Wave of Lawsuits	27
	h.	Other Significant Trends	28
	i.	Summary	29
III.	Business Initiatives and Risks		31
	a.	Strategy Initiatives	31
	b.	Marketing and Sales Initiatives	33
	c.	Governance Initiatives	34
	d.	Compliance Initiatives	36

Industry Overview

The financial services industry has witnessed its greatest challenges since the Great Depression, due to the bursting of the housing bubble and the resulting credit crunch. Within a period of weeks, venerable institutions have been brought to their knees by dysfunctional credit markets and the punishing stock market. The U.S. and European governments, as well as Japan, have pumped liquidity into the system and taken on direct capital investments in these financial behemoths, in an effort to stabilize credit markets and prevent a global economic meltdown.

The industry comprises complex networks of organizations, which primarily deal with management of money and create conditions for investors and corporations to flourish in the market. The growth of other sectors is closely dependent on this industry as it is a prime source of liquidity and thereby ensures the overall prosperity and economic stability. This multi-trillion dollar services industry comprises companies varying a great deal in size and their offerings as well. The industry grouping is widely branched out to include companies providing varied services, preventing a simple categorization of this industry.

The U.S. financial sector is the third-largest sector of the economy after manufacturing and real estate, and accounts for nearly one-tenth of the total U.S. GDP. It is also a major contributor to the tax base and quality jobs. The U.S. financial services structure is the most sophisticated and efficient globally. It follows the federal and state regulatory structure to oversee and supervise all financial activities. Over the decades, U.S. financial firms have flourished under this regulatory framework and have also gained substantial global presence and dominance. Of the top 10 global financial services firms in terms of revenue, four are U.S.-based banks, including JP Morgan Chase, Goldman Sachs and Morgan Stanley that are the largest in terms of global market share.

The housing crisis, declining corporate profits, rising oil prices, increasing interest rates and geopolitical uncertainties have led to unfavorable and weak financial markets over the past year. Investment banking and brokerage companies have witnessed a decline in their revenues due to trading losses and decrease in underwriting activities. Also, many foreign markets have outperformed U.S. stock markets luring U.S. investors to invest overseas. But it is the subprime mortgage crisis, and the subsequent credit crunch, that has loomed large over this industry, with most players taking substantial write-offs, and threatening the very existence of stalwart firms like Lehman Brothers (now defunct) and Bear Stearns (now part of JP Morgan Chase).

Up until the recent credit crisis, reforms in the financial sector such as the Gramm-Leach-Bliley Financial Services Modernization Act had lent the sector more stability and efficiency, but certainly not nearly enough to deal with the tidal forces of the crisis. The Act came in effect in 1999 and removed barriers that limited competition and introduced regulations for financial conglomerates offering a wide range of services ranging from banking and insurance to securities broking and asset management. The Sarbanes-Oxley Act of 2002 laid down strict guidelines for accounting firms and auditors to adhere to, which resulted in more transparency. Another major reform was introduced by the previous New York State Attorney General Eliot Spitzer who brought changes in financial markets by issuing guidelines that restricted manipulative practices adopted by companies operating in the market. The Bankruptcy Abuse Prevention and Consumer Protection Act, which came into effect in 2005, is another step toward minimization of losses occurring to financial services companies. The Act empowers financial services firms by making it difficult for individuals to file for Chapter 7 bankruptcy. Certainly further regulatory reforms will be implemented as a result of the subprime mortgage crisis, and Treasury Secretary Paulson has proposed a new regulatory structure.

The financial services sector had been among one of the fastest growing sectors in the U.S., at least before the recent meltdown of profits. Along with traditional activities in brokering and equities dealing, derivatives and debt instruments trading and dealing, and the rise in personal incomes have acted as revenue drivers for the industry until this year. Investment advice services to individuals and corporations have resulted in additional revenue for players, particularly in the consumer finance segment. The U.S., which boasts the largest population of high-net-worth individuals having total assets in excess of $10 trillion, offers significant opportunities for players operating in the market. With the rise of the aging and retiring population in the U.S., many companies are targeting this demography and offering innovative retirement products and services. Along with U.S.-based players, many non-U.S.-based players, such as Barclays PLC, Deutsche Bank and UBS, are also leveraging their active presence in the U.S. and taking advantage of these opportunities.

Consumer Finance

Market Definition

The segment primarily comprises companies providing personal loans, indirect financing, including lease and sales financing, credit cards issuers, pawn shops and pay day loan providers. The segment excludes companies dealing in mortgage lending. Companies under this classification provide unsecured loans to individuals for both commercial and personal purposes. They operate in the subprime category and provide loans to individuals with bad credit history. This feature differentiates them from other banks and credit unions.

Market Size and Growth

According to statistics released by the Federal Reserve, the total consumer credit outstanding in the U.S., which covers most short- and intermediate-term credit given to individuals and excludes loans secured by real estate, reached $2.56 trillion at the end of 2007, as compared with $1.7 trillion at end-2000, representing a CAGR of 5.7%. The total consumer credit outstanding for 2008 Q1 stood at $2.54 trillion, an increase of 5.8% as compared with $2.40 trillion in the same quarter of 2007.[1] The increasing level of outstanding consumer credit is a direct indicator of strong fee and interest revenue growth for players operating under this segment. However, since achieving the peak of 8.1% in 2002, consumer credit outstanding growth has slowed down in the U.S. During 2005 and 2006, growth for consumer credit dampened further because of a sudden rise in interest rates.

Figure 1: U.S. Consumer Credit Outstanding (%) by Type of Holder – 2007

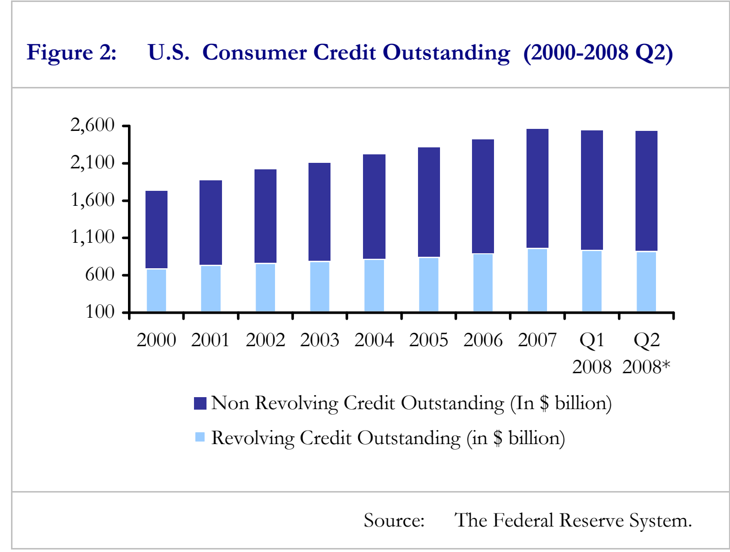
Finance companies 23%
Credit Unions 9%
Federal government and Sallie Mae 4%
Savings institutions 4%
Nonfinancial business 2%
Pools of securitized assets 27%
Commercial banks 31%

Source: The Federal Reserve System.

* Preliminary figures provided by Federal Reserve.

[1] Statistical Release, Consumer Credit, Federal Reserve (July 2008).

In 2007, commercial banks were the major originator of consumer credit with 31% contribution to credit outstanding, amounting to $804.1 billion, followed by finance companies and credit unions with a contribution of 23% and 9%, respectively. In 2007, of the total credit outstanding, the share of revolving credit stood at $969.5 billion, while the remaining 62% valued at $1,587.1 billion was made up of non-revolving credits, including automobile loans and all other loans not included in revolving credit, such as loans for mobile homes, education, boats, trailers, or vacations.[2] Approximately, 80% of the total consumer credit outstanding for banks and saving institutions was debt outstanding of credit card holders. Credit card debt outstanding of banks stood at $612 billion in 2005 and projected to reach a value of $775 billion by 2010 at a CAGR of 4.83% for the period spanning from 2005 through 2010.[3] In the U.S., the credit card market is highly consolidated and the top six players hold approximately 80% of the market.[4] The market for debit and credit cards is expected to be driven by both the increase in the number of accounts and higher purchase volumes. Up until the current financial woes resulting from the credit crisis, credit card spending by bank customers was expected to rise significantly from the historical figures. The spending for the same was expected to reach $2,157 billion at the end of 2010, at a CAGR of 9.46% for the five-year period spanning 2005 through 2010.[5] However, the Census Bureau will probably need to scale these projections back given the likelihood of much tighter credit for years to come, particularly in the subprime areas of this segment.



Capital Markets

Market Definition

Establishments in this segment undertake activities, including trading, brokerage, strategic advisory, portfolio management, asset management and investment advice. They primarily work as intermediaries, either to provide or manage capital, thereby satisfying financial goals of institutions and individuals. Companies operating under the segment can broadly be classified into three distinct categories. The first set includes investment banking and brokerage companies that provide services, such as underwriting of bonds and stocks to raise capital, trading and broking of stocks, bonds, derivatives and commodities, as well as companies engaged in strategic advisory services. The second set comprises asset management firms, including companies that professionally manage large pools of money from individuals and institutions with an aim to satisfy a common investment goal. Firms under this sub-segment manage various funds, such as open-ended, closed-ended, unit investment trusts and face certificates. The third set includes companies classified as diversified capital markets, which provide more than two services and

[2] Statistical Release, Consumer Credit, Federal Reserve System (July 2008).
[3] Banking, Finance, & Insurance: Payment Systems, Consumer Credit, Mortgage Debt, The 2008 Statistical Abstract, U.S. Census Bureau (2008).
[4] Annual Report, CapitalOne (2008).
[5] Banking, Finance, & Insurance: Payment Systems, Consumer Credit, Mortgage Debt, The 2008 Statistical Abstract, U.S. Census Bureau (2008).

drive a majority of their revenues collectively from both of them with no significant proportion coming from only one service.

Market Size and Growth

In 2006, the total revenue of companies engaged in securities, commodity contracts and other financial investment activities stood at $499.2 billion as compared with $406.3 billion in 2005, representing an increase of 22.8% on a year-on-year basis. For the period spanning from 2000 through 2006, the total revenue of these companies increased at a CAGR of 4.4%, with a significant amount of decline witnessed in years 2001 and 2002.[6]

Figure 3: U.S. Security Brokerage and Investment Banking Revenue by Segment (2000-2006)*

Source: U.S. Census Bureau.

A majority of the revenue came from securities and commodity contracts intermediation and brokerage, which contributed $365.6 billion in 2006 as compared with $293.1 billion in 2005. Companies operating under this category are inclusive of securities brokerage, commodity contracts dealing and brokerage, and investment banking and securities dealing.[7] In 2006, an increase in underwriting activities along with intense mergers and acquisitions in many sectors propelled the segment, thereby accounting for a majority of the 29% rise in revenue of investment banking as compared with 2005. However, the performance of investment banks deteriorated in 2007 amid the weakening housing sector and falling financial markets. The decline in revenue was attributed to trading losses, write-offs and slowdown in underwriting and advisory activities. Corporate underwriting activities that touched $3.34 trillion in 2006, fell off by 9.78% in 2007 to $3 trillion. Revenue for all leading investment banks declined, by more than 30%, in 2007, with the exception of Goldman Sachs. Before the credit crisis evolved, projections called for a flat 2008, and for investment banking revenue growth at 6% to 11% year-on-year until 2012.[8] Such projections should undoubtedly become more modest in light of recent events.

Figure 4: U.S. Securities, Commodity Contracts and Other Financial Investment Activities (2006)

Source: U.S. Census Bureau.

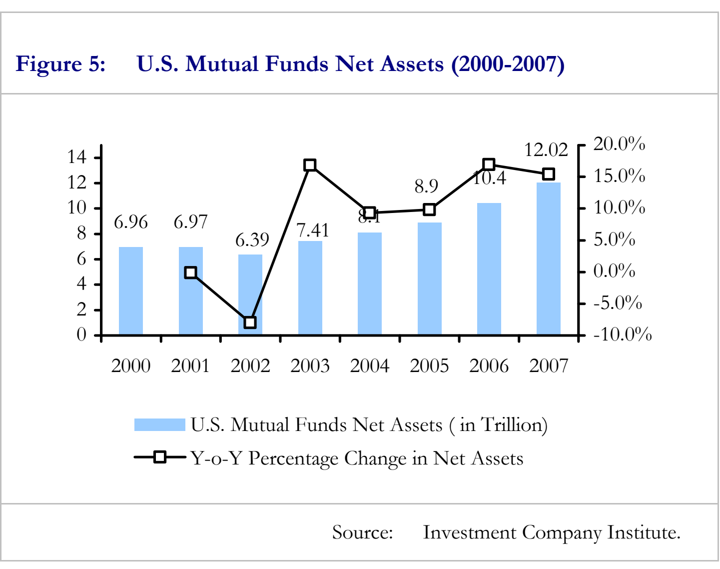
Revenue from other financial investment activities has also grown significantly over the decade, with contribution coming from both portfolio management and investment advisory services. In 2006, while revenue from portfolio management services reached $107.1 billion, revenue from investment advisory services touched

[6] Data, 2006 Service Annual Survey, U.S. Census Bureau (March 2008).
* Includes Revenues from Investment banking and securities dealing and Securities brokerage only, Excludes revenues derived from Commodity contracts dealing and brokerage.
[7] NAICS Industry Data, 2006 Service Annual Survey, U.S. Census Bureau (November 2007).
[8] Market Report, Investment Banking and Capital Markets, BCG (February 2008).

$26.4 billion.

The mutual funds market, which is an essential part of this segment, has also witnessed a constant rise in net assets from 2003 onwards. The total asset base of mutual funds reached a record high of $12.02 trillion by the end of 2007, as compared with $7.0 trillion in 2000, representing a CAGR of 8.1% from 2000 to 2007 and an increase of 72.6% since 2000. With assets in excess of $12 trillion at the end of 2007, U.S. mutual funds accounted for 46% of the global market valued at $26.2 trillion.[9]

Figure 5: U.S. Mutual Funds Net Assets (2000-2007)

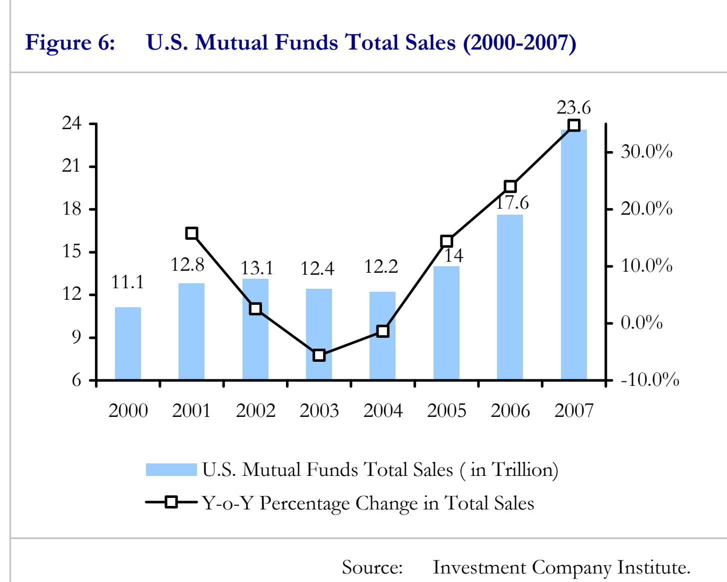


Source: Investment Company Institute.

In 2007, the total net sales of mutual funds increased to $23.6 trillion. Between 2000 and 2007, the net sales of mutual funds increased at a CAGR of 11.4%. As the sales of mutual funds increased, the income earned by banks from sales and servicing of these funds as well grew by 4.5% to $4.33 billion in 2007 as compared with $4.14 billion in 2006.[10]

Of all the mutual funds, equity funds contributed the most to the asset base, followed by money market funds and bond funds. The remaining was contributed by hybrid funds, also known as fund of funds. Equity funds continue to be the most preferred form of investment and thus constituted 54% of the total net assets held by U.S. mutual funds. Equity funds were followed by taxable money market funds, which are less risky and offer assured returns. Money market funds grew in demand during the latter half of 2007 following disruptions in credit markets. The share of money market funds, bond funds and hybrid funds stood at 25.8%, 14% and 10.9%, respectively.[11] According to Investment Company Institute, in 2007, 8,029 mutual funds were operational holding approximately 299 million shareholder accounts. About 59% of the total number of mutual funds was equity oriented followed by 25% of bond funds.

Figure 6: U.S. Mutual Funds Total Sales (2000-2007)



Source: Investment Company Institute.

[9] Recent Mutual Fund Trends, 2008 Investment Company Fact Book, icifactbook.org (2008).
[10] Press Release, Bank Mutual Fund and Annuity Income Up 4.6% in First Nine Months of 2007 Over Year-Ago, BankInsurance.com (December 2007).
[11] Review, 2008 Investment Company Fact Book, Investment Company Institute (2008).

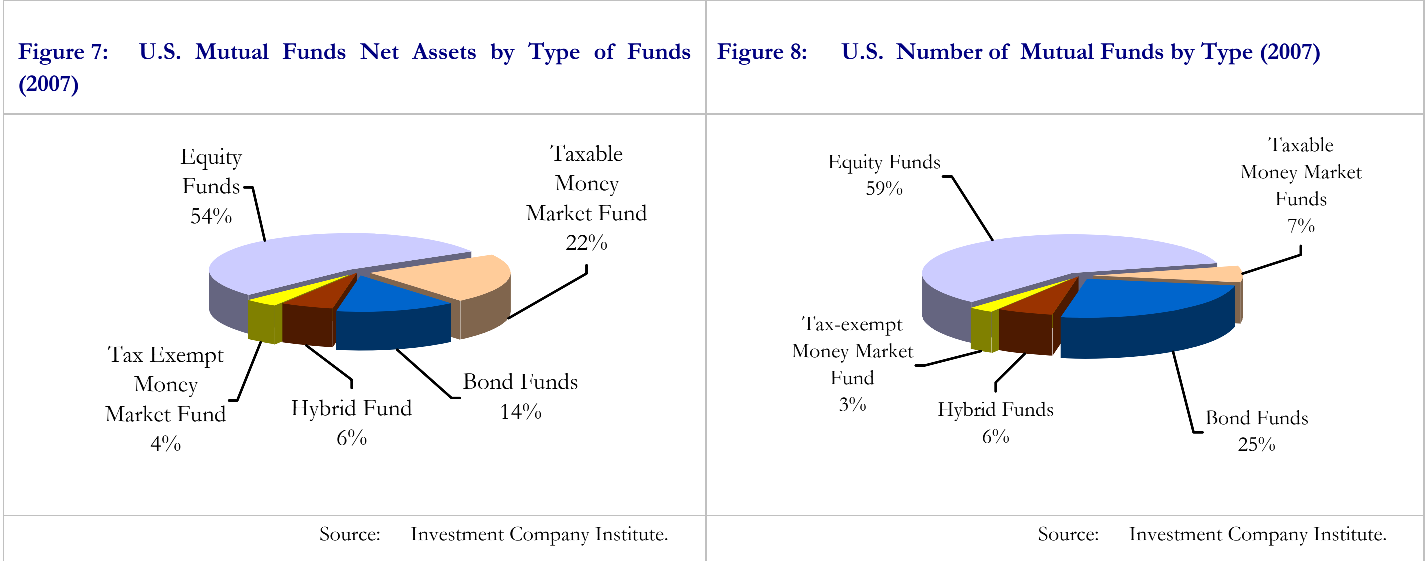


Figure 7: U.S. Mutual Funds Net Assets by Type of Funds (2007)

Source: Investment Company Institute.

Figure 8: U.S. Number of Mutual Funds by Type (2007)

Source: Investment Company Institute.

Diversified Financial Services

Market Definition

This segment includes establishments engaged in providing financial services, such as financial advisory firms, investment research companies, stock exchanges and credit rating companies. Many companies involved in a variety of diversified financial activities, such as banking, insurance, financial advisory, but not particularly dominant in one line of business are classified under this category as well. Another set of companies in this segment have operations in a specialized business line, such as stock and commodity exchanges, credit agencies, and investment research and investment advisory companies. For these companies, a majority of their revenue is derived from one particular area of expertise and specialized activity.

Market Size

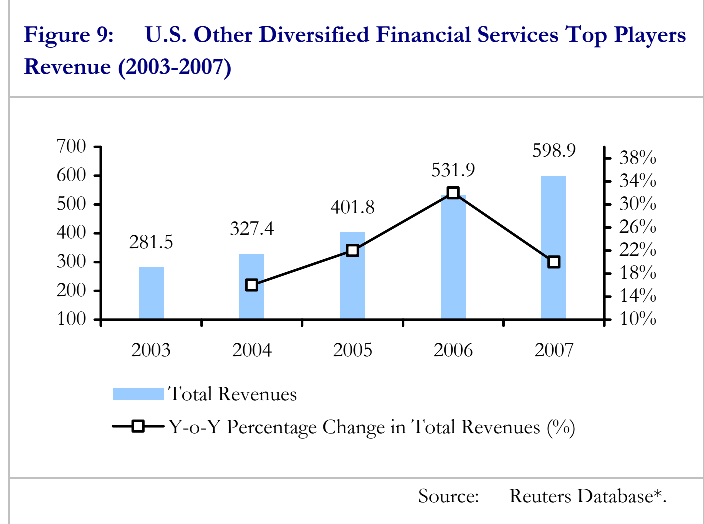
The total revenue generated by the top 10 players in the diversified financial services segment in 2007 was $674.5 billion as compared with $310.6 billion in 2003. Revenue of these companies witnessed a steady growth with a CAGR of 21% for the period 2003 through 2007. Over the 2003 to 2007 period, the maximum growth in revenue was experienced in 2006 when it jumped to $531.9 billion from $401.8 billion, representing an increase of over 32% on a year-on-year basis.

Among the top 10 players in this segment in 2007, CitiGroup stood first with $124.5 billion in total revenue, followed by Berkshire Hathaway ($118.0 billion), Goldman Sachs ($88.0 billion), Morgan Stanley ($85.0 billion), JP Morgan Chase ($71.3 billion), and Merrill Lynch ($62.0 billion).

Currently, players in this segment are adversely affected due to the slump in the financial sector. The total net incomes of the top 10 companies reported a net decrease of 39.3% in 2007 as compared with 2006. CitiGroup, the biggest player in this segment, witnessed an 83.2% decline in its net income from $21.5 billion in 2006 to $3.6 billion in 2007. Although the company witnessed record performance in international consumer, global wealth management and transaction services business segments, the markets and banking business that deals in securities

and banking witnessed significant write-downs in the subprime market and credit losses resulting in the net fall of the reported income.

Figure 9: U.S. Other Diversified Financial Services Top Players Revenue (2003-2007)



Source: Reuters Database*.

JP Morgan Chase, which has operations in a total of six business segments catering to both the wholesale and retail markets, reported an increase in both the net income and net revenue. Although, the net income of three of the segments, namely investment banking, retail financial services and card services declined, the record net income posted by treasury and securities services, commercial banking and asset management resulted in the overall rise in the net income reported for the year 2007. The main reason for the decline in the net income through retail financial services, card services and commercial banking was the increased loan losses provisions. The impact of the financial crisis was felt less by the company because of the diversity of its operations as compared with other financial institutions. The company also benefited from the organic growth in retail financial services with rising deposits and mortgage originations. JP Morgan Chase acquired Bear Stearns in March 2008, as the Federal Reserve brokered a deal to save the ailing investment bank from its poor investments in mortgage-backed securities.

Merrill Lynch witnessed the worst-ever performance in its history in 2007. Although the company had stable revenue growth in wealth management and equity market operations, it met huge losses in the global markets and investment banking division. Losses in global markets and investment banking reached $16.3 billion at the end of 2007. Reported losses under the division in the U.S. were $17.3 billion, indicating the company's profitability outside U.S. operations.[12] Merrill Lynch's residential mortgage-related net losses reached $4.19 billion at the end of 2007. Merrill Lynch also witnessed an increase in expenses by way of higher communications, technology costs, and an increase in brokerage and exchange fees in addition to restructuring expenses from the acquisition of FirstRepublic Bank. Due to their spiraling problems related to mortgage-backed securities, Merrill Lynch agreed to be acquired by Bank of America.

Morgan Stanley & Co. Inc., which has operations in institutional securities, global wealth management group and asset management segments registered a net loss of $8.6 billion from trading activities. However, total revenue reached $85.3 billion at the end of the fiscal year 2007, representing an increase of 20.6% from the figures reported for the fiscal year 2006.[13] But net revenue reduced slightly from $29.4 billion for the fiscal year 2006 to $28.0 billion in 2007, primarily due to a rise in interest expenses by more than 40.1%. The bank's net income for the fiscal year ending November 2007 declined to $3.21 billion, a decrease of 57% from $7.47 billion a year ago. The company wrote down $9.4 billion of its mortgage-related securities in 2007 Q4, including complex mortgage-related products, commercial mortgage-backed securities and non-performing loans. The write-downs continued in 2008 Q1 and the firm recorded losses of about $1.2 billion, half of which were related to U.S. subprime exposures. Morgan Stanley's weak position resulting from its holding of mortgage-backed securities, in conjunction with dysfunctional credit markets preventing it from borrowing further, caused the company to accept a $9 billion cash investment, for a 21% stake in the firm, from Mitsubishi UFJ Financial Group.

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* Except for Fidelity Investments which is Privately Held.
[12] Annual Report 2007, Merrill Lynch & Co., Inc. (2008).
[13] United States Securities and Exchange Commission, FORM 10-K, Morgan Stanley (2008).

Unlike many other players in this segment, Goldman Sachs Group that specializes in investment banking, asset management, and trading and securities transaction services registered growth in both revenue and net income. The company recorded total revenue of $87.97 billion in the fiscal year ended November 2007, an increase of 26.8% over 2006. The net income of the company stood at $11.41 billion in 2007 from $9.4 billion in 2006, registering an increase of 21.4% over 2006. [14]

Berkshire Hathaway Inc., because of its holding in the number of diverse business activities was less impacted as compared with its counterparts in 2007. The company is primarily active in insurance businesses conducted on both a primary basis and a reinsurance basis, along with many other holdings. Berkshire Hathaway, which has a total of 76 operating businesses with primary focus on insurance activities, witnessed an increase of 18% in the net income, from $11 billion in 2006 to $13 billion in 2007. In 2007, the company made a profit of $3.37 billion from insurance underwriting business, a decrease of 12.1% from 2006.

Although, for 2007, revenue growth in corporate finance and advisory, fixed income and equity trading flattened for almost all players in the U.S., growth in the Asia Pacific region was unaffected by the credit crunch and was driven primarily by the appreciation of local currencies.

Exchanges

Exchanges, by facilitating the trading of securities and commodities form an important part of the diversified financial market. Traditionally, stock exchanges were considered as the central markets where stocks were traded through competitive bidding. However, with increased information technology (IT) usage, its traditional face is changing rapidly. The biggest stock exchanges of the U.S. in terms of market capitalization are — the NYSE Group, NASDAQ and American Stock Exchange (AMEX). The total market capitalization of these three exchanges collectively reached $19.92 trillion in 2007, of which 78.6% or $15.65 trillion was contributed by the NYSE. It was followed by NASDAQ, which contributed 20.1% to the total market capitalization values. The domestic market capitalization of these three stock exchanges grew at a CAGR of 3.93% over the period 2000 through 2007, from $15.21 trillion in 2000. In terms of values of shares traded on exchanges, the NYSE reached a record of $29.91 trillion in 2007, much ahead of any other exchange in the world. NASDAQ and AMEX recorded trade worth $15.31 trillion and $0.7 trillion, respectively, for the entire year. The volume of shares traded on the NYSE reached a record of 698.7 trillion shares in 2007, rising by 18.8% from the figures reported in 2006. The volume of shares traded on NASDAQ reached 543.6 billion, representing an increase of 7.6% from the figures reported in 2006. On the contrary, the number of shares traded on AMEX stood at 11.7 billion, representing a significant decline of 34% from the figures reported in 2006. [15]

All the above-mentioned exchanges experienced a growth in the number of IPOs and proceeds as well. The NYSE maintained its leading position in terms of IPOs with the number reaching to 154, which was 13 more than the previous year and raised proceeds of $20.46 billion. The NASDAQ witnessed the listing of 83 IPOs in 2007, as compared with 70 in 2006. The exchange raised $34.28 billion from the proceeds of these IPOs. AMEX witnessed the highest growth in terms of volume with 59 IPOs listing in 2007 as compared with 25 in 2006. Also, the amount of proceeds raised from these IPOs increased by more than 400% to reach $10.4 billion in 2007 from $2.5 billion in 2006. A significant factor contributing toward the growth in the number of IPOs was the increased interest shown by non-U.S. issuers. Of the total 56 IPOs listed by non-U.S. issuers, a majority were listed on the NYSE. Non-U.S.

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[14] Company Profile, Reuters Database

[15] Statistics, Exchange Data, world-exchanges.org.

issuers contributed $13.8 billion from 33 IPOs on the NYSE, accounting for 82.5% of the total proceeds and 58.9% of the total volume of such issuers.[16]

Credit Rating Agencies

Credit rating agencies (CRAs), another marker area of this highly diversified segment, play a key role in financial markets by bringing transparency during information exchange between lenders and investors. With the emergence of Basel II, the role of CRAs has expanded further. CRAs are broadly divided into the categories of recognized and non-recognized. The top Nationally Recognized Statistically Rating Organizations (NRSRO) are A.M. Best., Dominion Bond Rating Service (DBRS), Fitch Ratings, Egan-Jones Ratings Company, Moody's and the Standard and Poor's Division of McGraw Hill. The entire credit rating market in the U.S. is estimated at approximately $6.5 billion and is experiencing a double-digit growth rate. With nearly 43% of the market share, Standard and Poor's is the largest among the players, closely followed by Moody's with 35% market share. Among the smaller players, Fitch has a relatively larger share at 21%.[17] There is little competition between players operating in the market, primarily because of NRSRO designation required to operate in the market. However, after the Credit Rating Agency Reform Act of 2006, the competition is set to increase. Under the new Act, credit agencies now do not require SEC designation by NRSRO, but can operate after registering themselves with SEC as a statistical rating organization, a registration which is much easier to obtain as compared with currently required NRSRO certification.

Most of these agencies have been under fire from their failure to recognize the risks associated with mortgage-backed securities backed by subprime mortgages.

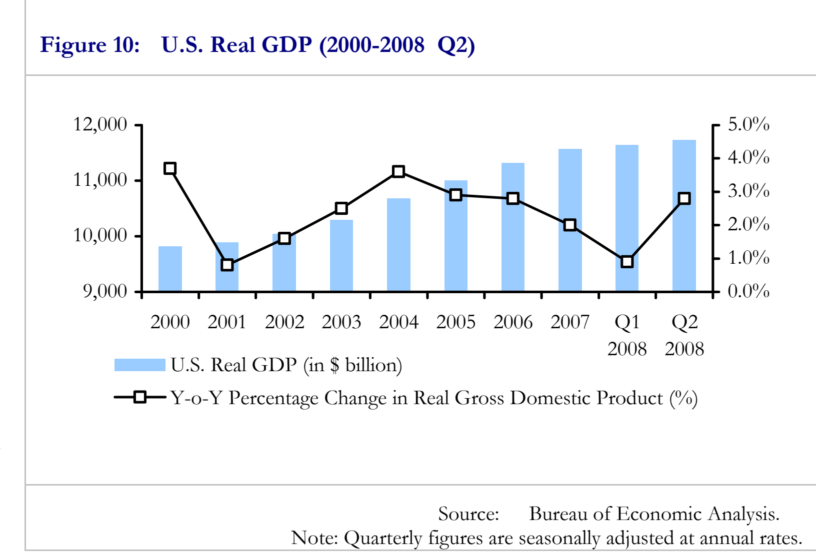
Economic Indicators

The credit crunch has come to define the state of the industry since mid-year, as the industry's business activities have all but shut down during the panic. But even before the panic, slow economic growth, the decline of the residential mortgage market, credit tightening and the subsequent decline in consumer sentiments have led financial markets and investment banks' profits to dip sharply for the last couple of quarters. With leading banks in the U.S. writing down significant amounts of mortgage loans and witnessing a reduction in trading revenue, the financial condition of traditional mainstays of the U.S. capital market and financial services firms has been steadily deteriorating. Some segments of the industry are also influenced by residential building activities, including new housing units under construction and expenditure on improvement and repair activities. This is especially true for investment banks as they are highly active in securitization of mortgages. The number of IPOs also impacts the state of the industry, investment banks and stock exchanges in particular, as significant proportion of investment banks' revenues is driven by IPO underwriting fees. Along with IPOs, M&A activities are also a good indicator of the revenue stream of investment banks, as these firms collect a large chunk of their fees from advising on mergers and acquisitions.

[16] Analysis and Trends, 2007 US IPO WATCH, PriceWaterHouseCoopers (2008).
[17] Companies Summary, Corporate Overview, OneSource Database.

After the recession of 2001, yielding 0.8% real gross domestic product (GDP) growth in the U.S., the economy remained sluggish in 2002 with 1.6% GDP growth. But the economy picked up in 2003 with 2.5% GDP growth, and more importantly grew robustly in the second half. GDP continued its strong showing in 2004, up 3.6%, and was tempered a bit through most of 2005 at a moderate 2.9% rate, but was respectable despite Hurricane Katrina. GDP continued its moderate pace for 2006 overall, at a 2.8% growth rate. But growth slowed after a brisk first quarter due to the slumping housing market, with the third and fourth quarters coming in at 0.8%, and 1.5%, respectively. Then the slumping housing market continued as resurging gasoline prices impacted consumer spending in the first quarter of 2007, causing GDP to come in at a microscopic 0.1%. Strong corporate investment and consumer spending, along with the effects of the weak dollar on growing exports, brought strong GDP growth for the second and third quarters of 2007, both coming in at a solid 4.8%. But the weak housing market and higher gasoline prices caught up with consumer spending in the fourth quarter, causing GDP to shrink at a -0.2%, bringing overall 2007 growth to a less than moderate 2.0%. The weakness continued in 2008, with first quarter growth continuing at an anemic 0.9% rate, but the second quarter growing at 2.8% due to one-time tax rebates and growing exports.[18] The emergence of the credit crisis and financial market meltdown has certainly damaged the economy to a degree that the probability of avoiding a recession is quite small.

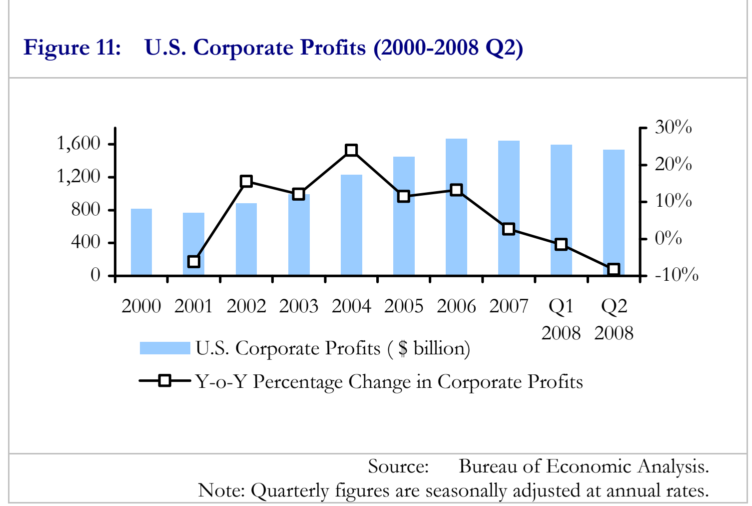
Figure 10: U.S. Real GDP (2000-2008 Q2)



Source: Bureau of Economic Analysis.
Note: Quarterly figures are seasonally adjusted at annual rates.

The recession of 2001 caused corporate profits to fall to $767.3 billion, from $817.9 billion in 2000. However, in 2002, corporate profits rebounded to $886.3 billion, and continued to grow in 2003 to $993.1 billion and in 2004 to $1.23 trillion. The strong growth continued in 2005, touching $1.45 trillion, and in 2006 reaching $1.67 trillion, although profits were off in Q4 at $1.64 trillion. Profits were down a bit in 2007, to $1.64 trillion. The first half of 2007 saw profits climb to $1.67 trillion in 2007 Q2. But the second half displayed shaky results in corporate profits, off slightly to $1.61 trillion in Q4. The first half of 2008 continued with weakening profits, coming in at $1.53 trillion in Q2, which was 8.3% below a year earlier.[19]

Figure 11: U.S. Corporate Profits (2000-2008 Q2)



Source: Bureau of Economic Analysis.
Note: Quarterly figures are seasonally adjusted at annual rates.

Personal income in the U.S. has risen over the years. It recorded a 5% to 8% growth in the late-1990s, followed by a slowdown in 2002, registering 1.8% growth to reach a figure of $8.9 trillion. Personal income grew moderately in 2003 at 3.2%, but accelerated in 2004, registering a 6.2% growth to touch $9.7 trillion. It grew robustly in 2005 and 2006 at 5.9% and 6.6%, respectively, to reach $11 trillion in 2006. Personal income registered impressive growth

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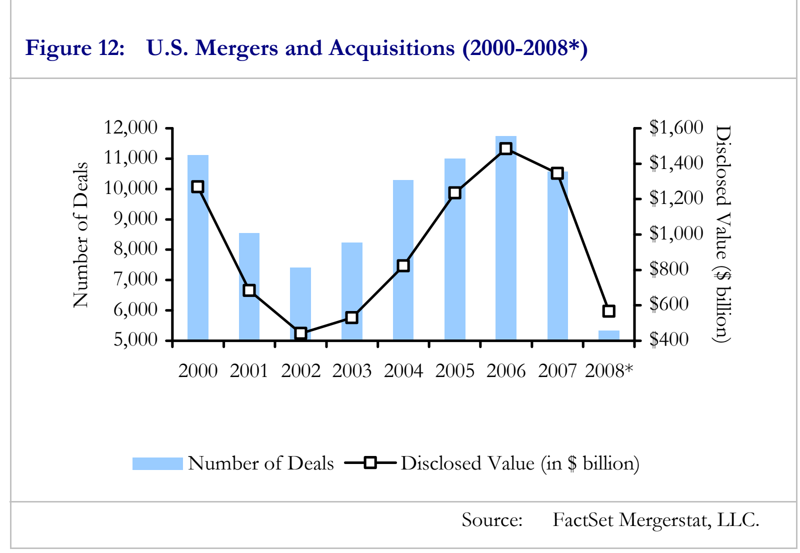
[18] Bureau of Economic Analysis.
[19] Bureau of Economic Analysis.

figures in 2007, reaching $11.7 trillion in 2007 Q3. Continuing this positive growth trend, personal income touched $11.9 trillion in 2007 Q4 and on an annual basis grew by 6.2% over 2006. In 2008 Q1, personal income in the U.S. increased marginally to reach approximately $12 trillion. For the second quarter of the current year, personal income was up slightly and reached $12.2 trillion.

Consumer confidence reflects the consumers' inclination to spend or save and therefore is an indicator of the overall state of the U.S. economy, as consumers do not purchase high-value items without considering their financial stability in the future. After a couple years of decline, the U.S. Consumer Confidence Index started to increase in mid-2003, reaching 96 by January 2004. The index then rose to the 100 to 110 range, where it remained until 2007. But since mid-2007, the index has been on a steady slide as continued high gasoline prices and the weak housing market hurt consumer confidence. This has brought the index down to about 90 to end 2007. In 2008, the downward slide continued, and at a faster pace, falling down to 51.0 for June, but up slightly to 59.8 in September, remaining at a weak level.[20] The recent trend represents the first consistent slide in consumer confidence since mid-2003, most likely indicating further belt-tightening among consumers to counter higher fuel prices and less access to credit due to the housing slump and credit crisis.

Figure 12: U.S. Mergers and Acquisitions (2000-2008*)

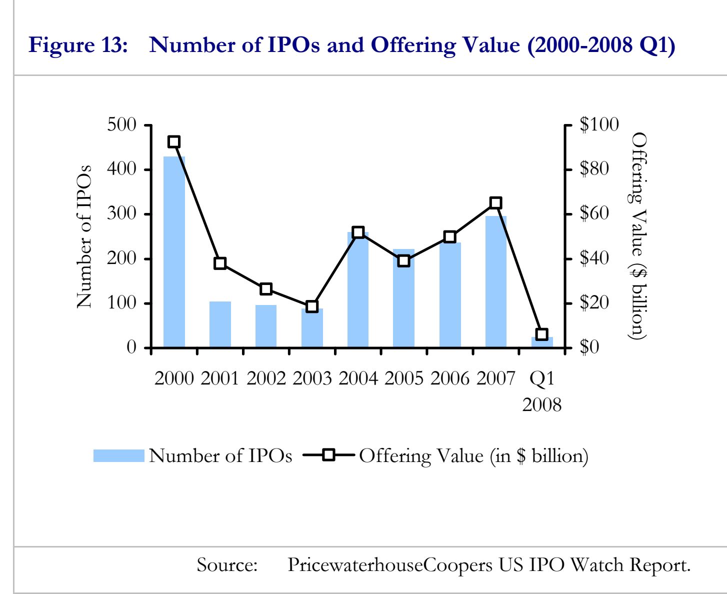


Source: FactSet Mergerstat, LLC.

The volume and value of deals, involving U.S. companies, including privately held, publicly traded and cross-border transactions, increased steadily until 2006 since it reached the bottom value in 2002 for the decade. In 2006, the aggregate value of such deals even surpassed the values achieved during Internet boom years and touched a figure of close to $1.5 trillion. However, 2007 witnessed the decline in the figures, which although remained relatively high at $1.34 trillion. For the full year 2007, 10,574 M&A deals were announced as compared with 8,545 deals announced in 2001, representing a CAGR of 3.6% over the period 2001-2007 and an increase of 23.7% since 2001. Although the figure increased over the period, the number of deals y-o-y in 2007 decreased by 10%. The deal value decreased to $1,287.3 billion in 2007 as compared with $1,484.3 billion in 2006, representing a decline of about 13.3%.[21] Weak equity markets, the sinking U.S. dollar, slumping consumer confidence, the upcoming U.S. presidential elections have compounded the problems of tight credit markets in 2008 and deal making is expected to remain affected for the entire 2008. For all such deals in 2008, Goldman Sachs Group, Inc. was the financial advisor for a maximum number of deals, followed by JPMorgan Chase & Co. and Morgan Stanley. The Switzerland-based UBS AG was the next most active player, while ORIX Corporation, Citigroup Inc., Merrill Lynch & Co. Inc., Lehman Brothers Holdings Inc., Credit Suisse Group and Lazard group were the other players among the top 10.[22]

[20] The Conference Board.
[21] M&A Activity: U.S. and U.S. Cross-Border Transactions, FactSet Mergerstat, LLC (December 2007).
[22] Ibid.

Figure 13: Number of IPOs and Offering Value (2000-2008 Q1)



Source: PricewaterhouseCoopers US IPO Watch Report.

Although, the turmoil in the credit market adversely impacted the pace of M&As during the second half of 2007, the number of IPOs as well as the offering value continued at a robust pace, but fell off in early 2008. In 2007, the total IPO activity volume was $65.1 billion, also the highest since 2000 when it stood at $92.6 billion. For the period 2001-2007 offering values of IPOs grew at a CAGR of 9.4%. In 2007, the total proceeds grew by 30.4% on a y-o-y basis. Although, financial sponsors-backed IPOs continued domination, 2007 additionally saw a surge in special purpose acquisition company (SPAC) IPOs and increased interest shown by non-U.S. issuers. Non-U.S. companies raised a total of $16.7 billion through 56 IPOs in 2007, which were double the number as well as the volume in 2006. Similarly, the number of SPAC IPOs increased from 18 in 2006 to 49 in 2007. After sustaining growth over the decade, 2008 started on a weak note under the challenging environment aggravated by volatility in the equity market.[23]

Mixed signs for future growth are seen in the U.S. Leading Economic Indicators. The index increased significantly in 2003 and 2004, and remained fluctuating though flat through most of 2005. It declined in mid-2006 due to the weakening housing market but eventually rebounded to the 2005 levels. It was mostly flat through mid-2007, but fell for the remainder of the year, ending the year at 102.6. The trend has mostly continued in 2008, down 0.5% in January and 0.2% in February, flat in March, up slightly by 0.1% in April, down 0.1% in May, flat in June, and plummeted 0.7% in July and 0.9% in August, while recovering slightly by 0.3% in September, coming in at 100.6.[24] Although it still remains marginally on the positive side, indicating a possibility of modest future growth, the steady drop-off since mid-2007 is also a sign that the falloff in consumer confidence can lead to further sluggish growth, and more likely a recession given the effects of the credit crisis.

General Economic Overview The onslaught of weakening corporate profits, the falloff in consumer confidence, and the slump in the housing market caused by years of growth in residential property prices that have outstripped income growth, have restricted consumer credit and reduced consumer spending. The housing market will continue to slump and dampen consumer spending through at least early 2009. Although the economy was strong enough to absorb the direct losses from the sub-prime mortgage collapse, the effect it has had on global credit markets has caused restricted credit across-the-board, including seemingly unrelated commercial loans, having a cascading effect on financial institutions and causing a credit crunch. In addition to the Federal Reserve lowering interest rates, both the Federal Reserve and the Treasury Department have taken a series of unprecedented steps in an attempt to end the credit crisis. In 2008, the changes on Wall Street, and throughout the banking system, represent tectonic shifts; permanently changing the financial landscape. (See the “Business Environment” section for a further explanation and analysis.)

After this credit crunch and panic is overcome, other problems are of immediate concern. Given that high budget deficits and lower interest rates have substantially weakened the value of the dollar, and oil prices remain high, inflation has become a real fear. This limits the ability of the Federal Reserve to lower interest rates in response to

[23] Analysis and Trends, 2007 US IPO Watch, PriceWaterhouseCoopers (2008).
[24] Bureau of Economic Analysis.

weak consumer spending. The Federal Reserve might even need to raise interest rates at the expense of economic growth to ward off inflation. Furthermore, high oil prices divert more consumer dollars toward gasoline and heating bills, which further weakens consumer spending in other areas. On the bright side, the economic fallout from the credit crisis appears to have eased oil prices and inflation fears for the meantime. The end result is at best a sluggish economy over the coming year, with a recession most likely already occurring, as the credit crisis has already inflicted further damage to the economy beyond the effects of the housing market falloff.

For the financial services sector, a sharp retraction in business will ensue as a direct result of the credit crisis. Sluggish growth at best is expected over the coming year, after the immediate effects of the financial panic have subsided.

Top Players

The following tables list the leading players in the U.S. financial services industry, as of mid-2008, or before the fallout from the credit crisis.

Top U.S. Personal Credit Institutions (as of mid-2008) – by Revenue[25]

Company Name	YOI*	Headquarter	Lines of Business	FYE**	2007 Revenue ($ mil)
American Express Company	1850	New York, NY	Business services, depository banking services, investment advisory services, security broker and dealer, life insurance carrier	Dec	31,634
GMAC LLC	2006	Detroit, MI	Financial services	Dec	30,927
HSBC Finance Corporation	2003	Prospect Heights, IL	Consumer finance, commercial finance and insurance. Sub. of HSBC Holdings.	Dec	25,082
Capital One Financial Corporation	1994	McLean, VA	State and federal credit card, banks and automobile and other motor vehicle financing	Dec	19,001
Ford Motor Credit Company LLC	1999	Dearborn, MI	Vehicle financing	Dec	18,587
SLM Corporation	1997	Reston, VA	Education loans	Dec	10,532
Toyota Motor Credit Corporation	1982	Torrance, CA	Variety of finance and insurance products for automobiles. Sub. of Toyota. Revenue for FYE March 2008.	Mar	8,878
Discover Financial Services	2007	Riverwoods, IL	Electronic payment services, consumer financial services	Nov	6,434
AmeriCredit Corp.	1988	Fort Worth, TX	Automobile financing	Jun	2,543
Nelnet, Inc.	1997	Lincoln, NE	Education loans	Dec	2,073

[25] Advisen company information.
* YOI denotes Year of Incorporation and ** FYE denotes Fiscal Year End.

Top U.S. Diversified Financial and Capital Market Firms (as of mid-2008) – by Revenue[26]

Company Name	YOI*	Headquarter	Lines of Business	FYE**	2007 Revenue ($ mil)
Citigroup Inc.	1988	New York, NY	Financial services	Dec	157,333
Bank of America Corporation[1]	1884	Charlotte, NC	Financial and other related services	Dec	119,190
JP Morgan Chase & Company[2, 6]	1824	New York, NY	Financial and other related services	Dec	116,353
The Goldman Sachs Group[3]	1998	New York, NY	Investment banking, security broking and dealing, securities underwriting	Nov	87,968
Morgan Stanley[3]	1997	New York, NY	Financial services, investment banking, security broking and dealing, securities underwriting	Nov	85,328
Merrill Lynch & Co., Inc.[1]	1820	New York, NY	Securities and commodities broking and dealing, investment banking, securities underwriting	Dec	62,675
Lehman Brothers Holding Inc.[4]	1850	New York, NY	Securities broking and dealing. Declared bankruptcy in September 2008.	Nov	59,003
Wachovia Corporation[5]	1908	Charlotte, NC	Financial and other related services	Dec	55,528
Wells Fargo & Company[5]	1872	San Francisco, CA	Diversified financial services, including banking, insurance, investment, mortgage and consumer finance	Dec	53,593
Prudential Financial, Inc.	2001	Newark, NJ	Insurance, investment management securities and other financial products and services to individual and institutional customers	Dec	34,500

[1] Bank of America acquired Merrill Lynch in September 2008.

[2] JP Morgan Chase acquired the balance sheet of Washington Mutual after the savings and loan failed.

[3] Goldman Sachs and Morgan Stanley are the remaining two independent investment banks, but have applied with the Federal Reserve to transform into bank holding companies, allowing them to hold retail deposits.

[4] Lehman Brothers declared bankruptcy in September 2008. Its North American capital markets businesses were purchased by Barclays for $1.75 billion, and its Asian operations were acquired by Japan's No. 1 broker, Nomura Holdings, for $225 million. Nomura also purchased the European and Middle East operations.

[5] Wells Fargo announced they would purchase Wachovia in September 2008 for $15.1 billion.

[6] JP Morgan Chase acquired Bear Stearns, with a $30 billion line of credit from the Federal Reserve, for $1 billion.

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[26] Advisen company information. All firms have operations in various sub-segments of capital markets through holding companies and subsidiaries. This list represents the top firms before the fallout from the credit crisis, but after the demise of Bear Stearns.
* YOI denotes Year of Incorporation and ** FYE denotes Fiscal Year End.

Business Environment

The financial services industry has been severely impacted by difficult conditions in the U.S. housing market, leading to a global credit crisis. This crisis has led to tectonic changes to the face of this industry, having long-term impacts on business models. Even before the credit crisis escalated, the industry faced major setbacks, such as declining profitability, mounting non-current loans and loan loss provisions, rising delinquency rates and increasing foreclosures. These factors have resulted in the increase in credit card defaults as card provider companies have started reducing credit limits to minimize bad debt outstanding. The nature of M&As has also changed significantly with the rise of distressed M&A activities as the liquidity crunch deepens and the credit market tightens. As companies are hit hard on profitability and revenue, cost cutting has become the priority. Amid all the financial trouble, even large companies have either announced mass reduction in workforces or outsourcing their jobs to low-wage destinations. Investment banks are also being hit by a number of lawsuits filed against them alleging the selling of complex financial products without properly informing buyers, in addition to a plethora of shareholder lawsuits filed against directors and officers.

Extreme Government Measures to Stem the Credit Crisis

The basis for the unprecedented moves by the Federal Reserve and Treasury Department has its underpinnings in research conducted by Federal Reserve Chairman Ben Bernanke. Ben Bernanke spent the lion's share of his career studying the causes of the Great Depression. He found that the underlying reason for the initial fallout had its roots in a protectionist wave that made its way into government policies around the world, and the culmination of these policies followed a period of a bubble-forming irrational exuberance in stock prices allowed by mostly unregulated markets. But after the initial collapse in stock prices, a series of government missteps, or lack of steps in some cases, turned what would have been a recession into a depression. The government missteps included raising taxes, cutting spending, and raising interest rates. Perhaps more important were the government inactions.

After the stock market plunged, panic set in, and over the next few years thousands of banks failed. Most banks that failed were originally financially sound, but the mere fear that others feared a bank collapse caused a run on banks. The lack of an FDIC-style insurance program resulted in this panic to spread like a contagion across the entire banking system, having a devastating impact on credit markets of the time. Chairman Bernanke found that the collapse of local banks caused a loss of knowledge, as local bankers knew their local businessmen, and understood who were good risks and good managers. For about a decade after the collapse of many banks, when local businessmen had good ideas for new businesses, no banker had enough knowledge to assess risks, so most loans were denied, preventing an economic resurgence normally seen during recessions.

The underlying causes of the current credit crisis differ: years of excessive amounts of credit available from government-sponsored agencies like Fannie Mae and Freddie Mac, government debt, and loose monetary policy; and a bubble-forming irrational exuberance in the real estate market. Both cases have in common the lack of regulations around certain markets, but instead of the stock market it was the derivatives and mortgage markets that inflated the bubble. The common point of greatest and most immediate concern for Chairman Bernanke was the panic-mentality setting in among financial institutions. Although the mere existence of the FDIC successfully prevented a bank run at the retail level, the mere lack of knowledge as to which financial institutions held an exorbitant level of risky mortgage-backed securities prevented these institutions from lending to each other. The fact that such a credit crunch was forming caused more panic because this market scenario places all financial

institutions at greater risk, even those previously unharmed by the collapse of mortgage-backed securities. Ben Bernanke couldn't stand by and see history repeat itself, perhaps unfolding a decade of economic suffering.

Then Treasury Secretary Henry Paulson enters the scene. As the former CEO of Goldman Sachs, the only investment bank to dump its positions in mortgage-backed securities before the collapse, this former Wall Street executive is a hard-charging man of action. He speaks with a sense of urgency, expecting those that work for him to swiftly attack opportunities, yet be smart and versatile in the pursuit. His personality alone makes its impossible for him to remain inactive in such a time of crisis. The combination of Ben Bernanke's conceptual understanding of financial markets and knowledge of the Great Depression, and Henry Paulson's hands-on know-how of the gears that make the financial business world work, led to a series of aggressive actions.

Some say that the Federal Reserve and Treasury Department waited up to a year too long, and should have taken action sooner, but the political will of Congress to approve such measures before the point of panic is doubtful given the considerable opposition to the $700 billion rescue plan. Still others, from the fringes of both political parties, feel the need for such actions is exaggerated, and will encourage more risky behavior in the future. But the actions taken are indeed aggressive, and are in uncharted territories for government officials. Never before have government regulators expand so broadly beyond commercial banking, let alone take ownership stakes in such a wide array of institutions.

Major steps taken by the Federal Reserve and Treasury Department, as well as other shifts in financials markets, in 2008 include:

- In March, the Federal Reserve offered large commercial and investment banks loans through the discount window, with funds available up to $400 billion, with some risky mortgage-backed assets used as collateral in an attempt to avoid a panic and the associated cash-hoarding mentality. But not all mortgage-backed assets met the requirements.

- Also in March, the Federal Reserve, with much consultative assistance from Treasury Secretary Henry Paulson, facilitated the buyout of troubled Bear Stearns, a major investment bank, by JP Morgan Chase for $1 billion, and supported the transition with a $30 billion line of credit. This move was meant to promote stability of financial institutions.

- Regulator concerns persisted for financial institutions, as the housing market and house prices continue to fall. In September, the Treasury Department created a conservatorship for the takeover of the two largest mortgage finance companies in the U.S., Fannie Mae and Freddie Mac, which was approved by Congress. These companies, which investors assume the government would bail out in emergencies due to their government-sponsor enterprise statuses, have been hit hard by the mortgage foreclosure crisis. The two mortgage giants had grossly overstated their mortgage asset values, and no signs of improvements of the housing market in the near future to alleviate the situation. Most agree that the very structure of these institutions, with privatized profits and socialized risk, has led to companies that were hungry for profits at any risk, as their accounting procedures hid this risk. The mortgage foreclosure crisis merely exposed this Achilles heel. The takeover was necessary because they control the majority of mortgages ($5.3 trillion), and if these institutions fail to purchase mortgages, then the mortgage market would collapse and the housing market would follow. Furthermore, many banks hold debts in these institutions, in turn impacting the financial health of the industry. In other words, the implicit government backing gave a financing advantage to these companies, creating two monsters that became too big to fail, necessitating more government backing.

As the Treasury Department injects funds in the two mortgage giants, a new class of preferred shares is created, giving the government prime shares over existing common and preferred shares. A line of credit was also approved, making it easier for the companies to secure financing at favorable rates. A total of $200 billion was approved for backing both institutions. Eventually, Secretary Paulson would like to sell off most of the assets of the two companies to shrink their size, and disentangle them from any implicit or explicit government backing, since it was the original implicit government backing that allowed these two institutions to grow disproportionately large. However, this decision will fall in the hands of the next administration, with Congress likely to want a say.

- A week after the fallout of the mortgage giants, investment bank Lehman Brothers announced that they will file for bankruptcy, and unwind the company's assets. Also, Bank of America announced plans to purchase the behemoth investment bank Merrill Lynch for $50 billion. The Federal Reserve and Treasury Department declined to intervene to save Lehman Brothers, but helped in negotiating the buyout of Merrill Lynch. The government's decision against saving Lehman Brothers has since been seen as a mistake by most given the panic that ensued. Regulators correctly estimated that the size of its assets and the degree its trading activities were entangled with global trading was manageable. But they underestimated the effect of freezing the accounts held for other investors, most notably for hedge funds and the panic it caused among their investors. As a result of bankruptcy proceedings, parts of Lehman Brothers ware later sold to Barclays and Nomura.

- A few days later, the government showed that its unprecedented moves were not over, as the Federal Reserve gave a bridge loan to troubled insurance giant AIG allowing them to borrow up to $85 billion over two years, and in exchange the government would receive warrants worth 79.9% of the company. This loan is contingent upon AIG selling most of its assets over the two-year period to pay off the loan, the Federal Reserve retains veto authority over assets sales, and the loan has an interest rate of three-month LIBOR plus 8% (i.e., 11.4% given LIBOR rates at the time). AIG sold credit-default swaps for mortgage-backed securities, and its growing liability for them as the market for these assets fell caused their collateral calls to grow, prompting AIG's credit ratings to fall, and in turn causing higher collateral calls. As the credit markets seized, AIG was fast moving toward default despite having profitable insurance businesses. The plan provides AIG with time to sell assets outside of a "fire sale" scenario, and it hoped to avoid the associated financial panic and cash-hoarding that could ensue if AIG were to declare bankruptcy, particularly among all investors in credit default swaps that AIG previous sold.

- Although the AIG bailout might have avoided some panic, it was clear shortly after that most financial-institutions were in fact hoarding cash, and a complete market meltdown could soon follow. Many believe the failure of Lehman Brothers contributed significantly to the crisis as many hedge funds had accounts tied up in the bankruptcy proceedings, causing a panic of hedge fund managers. In late September, the Treasury Department proposed to Congress a $700 billion rescue plan that would give the Treasury Department that authority to purchase troubled illiquid mortgage-related assets from financial institutions.

- While Congress negotiated the rescue plan in late September, other changes in the financial world occurred. The remaining two pure large investment banks, Morgan Stanley and Goldman Sachs, announced that they were applying with the Federal Reserve to act as a holding company that could own a commercial bank. This represents the final blow to pure investment banking, as large banks recognize that they need deposits or risk being too highly leveraged, particularly in a world with more restricted credit. This also underscores that Goldman Sachs and Morgan Stanley are well aware of the threat posed by the all-encompassing banks

of JP Morgan Chase and Bank of America, joining Citigroup already with extensive investment banking operations.

- Also in late September, as Congress debated the rescue plan, the Federal Reserve brokered the sale of Washington Mutual's assets and deposits, the largest saving and loan in the U.S., for $1.9 billion to JP Morgan Chase, avoiding an FDIC bailout of its depositors. A few days later, the Federal Reserve brokered what would have been Citigroup's acquisition of Wachovia's banking operations for $2.16 billion and assume $53 billion in debt, and would have had the FDIC absorb losses over $42 billion that might result in Wachovia's $312 billion pool of existing loans in exchange for $12 billion in preferred stock and warrants in Citigroup. But days after, in early October, Wells Fargo swooped in with a $15.1 billion offer, and no FDIC assistance. Citigroup protested in courts, so the Federal Reserve, concerned with volatility in the banking industry, attempted to broker a deal to split up the branches. Citigroup dropped out in early October due to the size of bad assets it would need to assume. Since this deal being pursued by Citigroup would have given it a national exposure to retail deposits, which it significantly lags Bank of America and JP Morgan Chase, the new dominance of large institutions that provide both investment and commercial banking services is underscored. This dynamic was always the norm outside of the U.S., as only in the U.S. did the Glass-Steagall Act separate investment and commercial banking. Now Wells Fargo is on par with such deposits.

- In early October, the $700 billion rescue plan was passed, but altered from its original form. The money would be disbursed in parts: $250 billion, followed by $100 billion at the discretion of the president, and the Treasury can request the remaining $350 billion at any time, as Congress would need to act to deny it to block the payment. The idea is that the Treasury would buy these illiquid assets from financial institutions that do business in the U.S., and potentially reselling them at higher prices in the future, as the government might even turn a profit. As a taxpayer safeguard, if the program has lost money after five years, the president must submit a plan to Congress to recover those losses from the financial industry, presumably in new fees and taxes. Furthermore, the Treasury would receive warrants in companies as part of its compensation to allow the taxpayers to benefit from the risks they are undertaking, but the Treasury Secretary would have wide latitude regarding the level of stake needed. Two types of asset purchases will occur: purchases through auctions where the lowest offer is purchased; and direct purchases of distressed debt from troubled institutions. Executive compensation for sellers of these assets would meet restrictions, but differ depending upon the type of seller. Sellers of assets through auctions and who sell more than $300 million in assets would be barred from making new executive contracts that provide "golden parachutes" in the event of bankruptcy. Sellers of assets directly to the Treasury would be barred from such lucrative executive severance packages as long as the government held a stake in the firm, and would agree to mechanisms for the government to recover any performance-based compensation that was based on inaccurate or fraudulent earnings data.

- The week after the rescue plan was announced, credit markets remained tight. Although the plan was yet to be implemented, commercial paper market were frozen, which are funded mostly through money market funds and provide short-term financing to fund operations of corporations. Unable to borrow from these usually very liquid markets, corporations have been forced to borrow at higher rates, leading to jobs cuts and capital investments reductions. So the Federal Reserve announced that it would lend directly to corporations, bypassing banks, in an effort to support the commercial paper market. Furthermore, expanding its Term Auction Facility by $600 billion, originally set up in December 2007, the Federal Reserve announced that it is providing up to $900 billion in short-term collateralized cash loans available to banks,

for 24-day and 84-day periods, through the end of 2008, in an effort to encourage short-term lending. This is meant to re-awaken short-term lending by banks and unclog the credit markets.

- The day after these announcements, with banks remaining reluctant to lend to other banks, concerns rose over the ability of the rescue plan to ease fears by merely purchasing mortgage-backed assets because uncertainty remains regarding the level of exposure for both the institutions that participate and those that refuse assistance. Uncertainty seems to rule the day in such panic-driven times. The Treasury Department announced that it is considering direct cash injections into financial institutions with the $700 billion rescue plan, and in return receive an ownership stake through warrants. The plan provides the authority to do so, and the hope is that direct investments will instill confidence in financial institutions with government backing.

- On the same day in early October, the Federal Reserve announced that it would lend an additional $37.8 billion to AIG, in exchange for investment-grade fixed income securities as collateral, for certain AIG domestic life insurance subsidiaries. This move was meant to help AIG secure funds needed to meet collateral obligations for its troubled securities lending operations, which was accounting for much of its borrowing from the original $85 billion lending plan instead of using it to fund core businesses. The securities lending operations lent securities to short sellers in exchange for a fee and cash collateral, and this collateral was reinvested in longer-term instruments such as mortgage assets. The plunge in the value of those assets and the collapse of credit markets made it impossible for AIG to borrow against those instruments to repay its counterparties upon the return of the securities. This additional loan will fund these counterparty obligations, freeing up the entire $85 billion to secure core businesses and meet collateral obligations, while the company sells off assets of the company and repays its debt to the Federal Reserve.

- By mid-October, the Federal Reserve sought to ease fears from Mitsubishi UFJ Financial Group about its $9 billion cash investment in Morgan Stanley. It helped to re-negotiate the terms, allowing for a greater share of its investment in preferred shares yielding 10%, with a lower strike price. Without explicitly making guarantees, Treasury officials hinted that it would salvage Morgan Stanley from any possible bankruptcy event, and Mitsubishi UFJ Financial Group's share would not become diluted along with other shareholders.

- The day after, the Treasury Department announced its specific plan to invest some of the $700 billion rescue plan in financial institutions. It entails investing $250 billion, with about half of that amount going to the top-nine institutions, in exchange for 5% yielding preferred shares, moving up to 9% if kept after five years, as well as warrants totaling 15% of the amount invested. According to the terms of the rescue plan, executives of all of these firms must forego golden parachutes. The top-nine firms received approximately half the amount, including: Bank of America ($25 billion - $5 billion for Merrill Lynch); Citigroup ($25 billion); JP Morgan Chase ($25 billion); Wells Fargo ($25 billion); Goldman Sachs ($10 billion); Morgan Stanley ($10 billion); Bank of New York ($2-to-$3 billion); and State Street Bank ($2-to-$3 billion).

  On the same day, the Federal Reserve announced that it would insure all non-interest bearing business deposits, mostly used for making payrolls, above a new $250,000 FDIC limit for interest-bearing deposits. It also would back all new senior debt issued by banks for three years. All of these moves are meant to encourage banks to start lending to each other again, and to businesses. They come as European governments injected $2.5 trillion into their banks, effectively nationalizing all major European banks.

- In October, as money market funds remained under stress, the Federal Reserve announced a program, called the Money Market Investor Funding Facility, with JPMorgan Chase. Under the program, JPMorgan Chase will set up five special-purpose vehicles (SPVs) that purchase certificates of deposits, bank notes and commercial paper with a maturity of 90 days or less remaining, from money market funds as needed to meet redemptions. The Federal Reserve will lend up to $540 billion at the discount rate (at 1.75% at the time of the announcement) for the purchase of up to $600 billion of assets, with the remaining $60 billion financed by commercial paper issued by the five SPVs to the money market funds selling their assets. The program is expected to last through April 2009.

Tectonic Shifts on Wall Street

The falloff of the housing market, and the collapse in the value of associated mortgage-backed securities, has caused a systemic crisis and credit crunch, global in proportions, and never seen since the Great Depression. Venerable firms are now defunct or acquired, while others sit on the brink of collapse and holding on due to the support of the Federal Reserve and Treasury Department. Some of the major changes to industry participants in 2008 follow:

- March – JP Morgan Chase acquired Bear Stearns for $1 billion.

- September – Lehman Brothers filed for bankruptcy. Barclays acquired its North American capital markets businesses, and Nomura Holdings acquired its Asian, European and Middle East operations.

- September – Bank of America acquired investment banking giant Merrill Lynch for $50 billion.

- Mid-September – Goldman Sachs and Morgan Stanley, the remaining independent large investment banks, applied to the Federal Reserve to act as commercial banking holding companies.

- Late-September – As Washington Mutual failed, the Federal Reserve brokered the sale of its assets and deposits to JP Morgan Chase for $1.9 billion.

- October – Wells Fargo acquired the ailing bank Wachovia for $15.1 billion, beating Citigroup's bid.

- Mid-October –The Treasury Department revised its $700 billion rescue plan, and decided to use $250 billion of the funds to directly inject capital into banks and other financial institutions.

- Mid-October – The Federal Reserve and Treasury Department helped to broker the final agreement by Mitsubishi UFJ Financial Group to invest $9 billion into Morgan Stanley.

These moves represent more than mere M&A activities and changes in tactics; as they are fundamental structural changes to the foundation of the industry. The structure of separate investment and commercial banks was borne of a Depression-era regulation, the Glass-Steagall Act, requiring both activities to operate separately. As investment banking activities became deregulated starting in the 1980s, they also became more competitive, and the margins for traditional investment banking service like brokerage and IPO issuance became thinner. Investment banks felt the need to become more leveraged and take greater risks with bets on the market to maintain their high level of return-on-equity that they became accustomed to.

This strategy worked as long as one boom followed the other, including the stock market booms in the 1980s and 1990s, and the real estate bubble in the 2000s. For example, even though per share IPO issuance fees dropped, the total pie mushroomed in the technology-boom in the late 1990s. When this market fell off, the real estate bubble opened the door for mortgage-backed securities issuance and investing. The Glass-Steagall Act was repealed in the late 1990s, allowing for commercial and investment banks to merge, but, other than Citigroup and Salomon Smith Barney, these types of mergers mostly did not occur. As the good times rolled, investment-banker hubris prevented them from assuming that they needed the safety of deposits as a form of financing. Short-term credit markets became evolved enough that financing would always be available, or so the argument went.

When the housing market fell, and the value of mortgage-backed securities plummeted, the most highly leveraged investment banks with the largest bet on these assets, such as Lehman Brothers and Bear Stearns, took the biggest hit. Their debt was owed short-term, and their assets bets were long-term and illiquid. The threat of these assets plummeting further caused credit markets to tighten, tipping these firms to failure, even though most believe the intrinsic value of these securities were worth more than the fire sale prices they are trading at. The collapse of these firms then caused credit markets to completely freeze, with banks unwilling to lend to each other.

It is important to note, despite popular opinion and media hype, that the repeal of Glass-Steagall was not a cause of this credit crunch, in fact it is saving the day. The underlying cause was mushrooming credit markets fueled by the quasi-governmental roles of Fannie Mae and Freddie Mac, with socialized risk, along with high deficits and loose monetary policies. The abundance of credit caused housing prices to spike, which in turn encouraged speculators, and prompted sub-prime mortgage brokers to offer mortgages to those that couldn’t afford the terms, causing a housing bubble. The lack of regulation for new types of mortgages (such as sub-prime), and for investment banks in dealing with new and complicated derivatives, allowed the problem to escalate into a global panic.

So it wasn’t the repeal of Glass-Steagall that caused the problem, as mergers between investment and commercial banks mostly did not occur until the credit crisis began. After considering the underlying cause of loose credit, it was the lack of regulations for new instruments that is at the heart of the problem. This relates to regulations on the amount of risk financial institutions could incur in these assets with ballooning-liability potential, and to regulations on issuing these complex securities without a proper assessment of risk (particularly in regard to the inflated credit ratings issued by ratings agencies). The lack of mortgage-issuing regulations also shares in the blame.

The repeal of the Glass-Steagall Act is in fact allowing for many of the mergers that are rescuing institutions, such as Bank of America acquiring Merrill Lynch and JP Morgan Chase acquiring Bear Stearns. This type of institution is seen as the model of stability, heralded as the future of large financial institutions, seen in Goldman Sachs and Morgan Stanley applying for commercial banking licenses. Citigroup, with the weakest position in deposits among its commercial banking counterparts (i.e., JPMorgan Chase and Bank of America), is anxious to acquire deposits. Their bidding war over Wachovia, losing out to Wells Fargo, even with a large portfolio of troubled assets, underscores the desire to obtain safe retail deposits, which Wachovia had an abundance of.

These fundamental changes happening to the U.S. financial services industry reflects the world pre-Glass-Steagall, which is the same model that most other developing countries have followed all along, as they have been unburdened by such regulation. The shift will also mean more comprehensive regulations of all financial activities and of all financial players, as politicians will seek to avoid such a catastrophe again.

Proposed Broader Regulatory Authorities

Regulatory reforms seeking to modernize and consolidate financial services sector regulations were already under consideration even before the credit crisis emerged in the summer of 2007; however the pace of introducing the reforms has increased since the collapse of the investment bank Bear Stearns in March 2008. The debate over the Treasury Secretary Henry Paulson's proposal has gained momentum since then, even though passing of new regulations look opaque ahead of the presidential elections. The current proposal seeks to consolidate the ambit of banking and securities regulators into a set of three overseeing authorities responsible for banks and brokerage firms, including hedge funds and private equity firms as well.

The Treasury recommends a merger of the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to oversee securities and futures trading. However, those who oppose the proposal argue that while it will strengthen the Federal Reserve Board in fixing issues in financial markets and institutions, it will also result in more freedom to highly unregulated secondary or derivative markets. In addition, the merger of the SEC and the CFTC may result in lesser control over stocks, bonds and commodities exchanges as well as investment banks.[27] The Treasury has also proposed changes to reconcile regulations related to broker-dealers and investment advisers offering similar services to retail investors. Under the proposed plan, the Treasury also recommends investment advisers to be regulated under the same laws applicable for broker-dealers. Despite fundamental similarity of acting as intermediaries between investors and securities markets, both broker-dealers and investment advisers are currently regulated differently under different securities laws. While broker-dealers are subject to the Exchange Act, investment advisers are subject to the Investment Advisers Act, also known as the Advisers Act.

In order to distinguish the regulations for retail transaction businesses and wholesale transaction businesses, Paulson has proposed the creation of three regulators focused exclusively on financial institutions and two other key authorities, namely a federal insurance guarantee corporation and a corporate finance regulator. The proposal, if implemented, will bring massive changes in terms of the role played by the Federal Reserve, as it will be given additional responsibility of preventing financial problems from developing into crises, along with its current role of promoting economic stability. The Federal Reserve will have the additional right to review the books of investment banks along with other financial firms.

Regulatory changes are also being discussed relate specifically to mortgage brokers, credit rating agencies, and credit-default swaps. Mortgage brokers are currently regulated by a hodge-podge of state laws, but fiduciary requirements at the federal level are being considered regarding clear disclosures of terms to consumers, determinations of affordability for these consumers, and minimal client information provided about mortgages sold. Federal regulators are sure to scrutinize credit rating agencies more closely to assure independent standards are followed. Many states, such as New York, have indicated that they will start to regulate certain credit-default swaps as insurance contracts, with minimum collateral requirements. But federal regulations are likely to avoid the same hodge-podge scenario that has plagued regulatory efforts overseeing mortgage brokers.

This being a presidential election year, most of these proposals, if not all, will not be approved by Congress any time soon. The opportunity to use these issues as a political football is too tempting. But the next president and Congress will certainly need to handle the issue of greater regulatory oversight, particularly over mostly unregulated complex derivatives, such as credit-default swaps and mortgage-backed securities.

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[27] Article, US Treasury plan shields Wall Street speculators, World Socialist Web Site (April 2008).

Lower Cardholder Credit Lines Dampening Spending

Consequences of the financial downturn experienced by industry players are also being felt by consumers using credit cards. In a move to protect themselves from massive losses similar to subprime mortgages, banks and consumer card companies are trying to reduce their exposures to customers more likely to default. As a result, companies are reducing credit limits, along with hikes in interest rates and offering fewer balance transfers. Card companies, including Washington Mutual, HSBC, Wells Fargo, JP Morgan Chase & Co., Citigroup Inc., and those which have already taken heavy hits on mortgage-related losses and are expecting further losses in that segment, have lowered their credit limits to counter rising defaults. American Express is cutting on the credit provided to customers currently holding subprime mortgages or in some way related to the real estate market. Chase Card Services is following steps toward borrowers particularly in the states of California, Arizona and Florida where home prices are the most affected.[28]

FICO credit score – a measure of creditworthiness – has also been impacted because of lowering of credit limits, causing a proportionate increase in credit utilization rates. Until recently, home equity lines of credit (HELOCs) were the major source of revolving credits to consumers and the biggest competitors of credit card companies. However, the recent plunge in HELOCs due the collapse in housing and mortgage markets have left consumers searching for other sources of liquidity. Therefore, credit cards, which provide an easy source of revolving credit, have become more popular in recent months. Credit card usage, which experienced a growth of 2% to 3% from 2004 to 2006, has increased to approximately 8% on a y-o-y basis for recent months. However, credit card usage is more frequent as compared with other lines of credit, thus results in the accumulation of higher balances on cards. Consumers are faced with a number of economic scenarios simultaneously – falling home prices, rising commodities costs and a weak job outlook, which may lead to payment default.[29] Credit card delinquencies in the U.S. have already seen a bit of an increase, rising to 4.51% in 2008 Q1 from 4.38% at the end of 2007, higher than the five-year average delinquency for bank card loans of 4.4%.[30] Rising delinquency rates, along with increased card usage reported in recent months, is expected to push charge-off levels higher in the near future.[31]

However, the current scenario is ideal for debit card processers, as consumers are swiping more of their debit cards than credit cards. MasterCard and Visa are getting the maximum benefit from the use of debit cards. Both MasterCard and Visa reported double-digit growth in gross dollar volume for debit cards as compared with only small increases for credit cards. Also, experts believe that the slowdown in credit card spending is short term and over a longer period, growing revenue will continue to be generated from credit cards.[32]

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[28] News Article, U.S. banks trimming limits for many on credit cards, International Herald Tribune (June 2008).
[29] News, Banks trim borrowers' credit limits, thenewstribune.com (August 2008).
http://www.thenewstribune.com/business/story/400441.html
[30] Article, Loan Delinquencies Increase; Trend Likely to Continue, The Wall Street Journal (July 2008).
[31] Testimony, Vice Chairman Donald L. Kohn, Board of Governors of the Federal Reserve Systems (June 2008).
[32] Article, Use of debit cards is growing, baltimoresun.com (August 2008)

Credit Crisis Retarding the Momentum of Deals

Fuelled by the availability of financing on easy terms, the financial services sector inclusive of asset management, banking, insurance and other financial services achieved record levels in M&A activities during the first half of 2007. However, the credit crunch that started in the second half of 2007 dampened the pace of deals. This downward trend in deals continued in the first half of 2008 as well. Despite the significant decline in the latter half of 2007, the year saw a total of 1,033 transactions in the financial sector, including both disclosed and non-disclosed, an increase of 4% from 993 deals in 2006. Although, slightly less but relatively strong, deal values for disclosed deals were $163.9 billion in 2007 as compared with $189.2 billion in 2006. The decline in values is primarily associated with the decrease in the value of mega deals having transaction value of above $1 billion. The number of such mega deals surged to 34 in 2007 as compared with 26 in 2006, but the cumulative value stood at $122.6 billion, 17% less than $147.6 billion reported in 2006. The investment banking segment, which was worst affected due to subprime crisis, witnessed a decline of over 32% in deal volume for 2007.[33]

Aided by the weakening dollar, non-U.S. players are increasingly acquiring U.S. based players. In 2007, non-U.S. players spent over $64.5 billion to acquire financial services firms in the U.S., representing an increase of 240% over $19.0 billion in 2006. Also, the gross value of $64.5 billion is close to two-fifth fraction of the total financial services deal value, a significant jump from 2006's contribution of 10% and 2005's 7% contribution.[34] Badly affected by the unfavorable events in the financial services space, deal activity in the U.S. financial services sector has slowed down significantly. For the first half of 2008, a total of 375 financial services deals were announced, including both disclosed and non-disclosed – a decline of 29% in deal volume from the same period last year and 26% less as compared with that reported in the second half of 2007. However, non-U.S. acquirers continued their strong presence in the U.S. financial services space for the first half of the current year and were further encouraged by favorable currency exchange rates. During the earlier half of the current year, the numbers of deals involving non-U.S. acquirers stood at 37, a slight decrease from 40, the figure reported for the corresponding period in 2007.[35]

In 2008, when most of the banks are seeking to extract capital while assessing the impact of the credit crisis, consolidation activities are on hold. A surge is expected in consolidation activities once asset qualities settle and fair values of the target institutions are known. Contrary to the banking segment in the U.S., deal values in asset management, including hedge funds, private equity and mutual funds rose to $35 billion in 2007, up 112% from $16.5 billion in 2006. The number of mega deals also increased from only two in 2006 to nine in 2007. However, the credit crisis did not impact any IPO activity in the industry. While the top 10 IPO deals were broadly spread across all industries in 2006, financial services IPOs dominated in 2007 with five deals aggregating $10.3 billion or 64.0% of the top 10 deal value. Contributing to this growth was the $4.1 billion IPO of Blackstone Group, almost double the volume of the largest IPO of MasterCard in 2006.[36]

Experts believe that market volatility is the key factor hampering M&A activities in the industry. While some institutions find themselves engaged in resolving their internal issues after the economic downturn, others will try to acquire companies with dipping share prices. As a result, most acquirers may find themselves being acquired. However, the rising interest from non-U.S. acquirers will keep the market busy, particularly with most institutions valued at a discount. Furthermore, proposed changes in the regulatory environment and long-term move toward adopting Basel II norms are expected to impact M&A activities. While the proposed changes will increase regulatory

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[33] Report, Transactions in a volatile environment, PriceWaterHouseCoopers (2008).
[34] Ibid.
[35] News Report, Sovereign funds and private equity step up with capital for cash strapped banks, PriceWaterHouseCoopers (July 2008).
[36] Analysis & Trends, 2007 US IPO Watch, PriceWaterHouseCoopers (2008).

requirements imposed on financial firms, it may also fuel the pace of M&A, as smaller firms will look to reduce compliance cost through mergers.

Organizational Restructuring amid Financial Troubles

The credit crisis and recent write-downs by large financial institutions have created a need for reduction in cost, which should be carried out without compromising on values. Organizational restructuring is one area where cost-cutting methods cannot only be applied, but can also be quickly executed as compared with other cost reduction methods. Since a major proportion of the operating expenses is related with compensation and benefits of employees working in the industry (42% for the top 10 investment banks), companies are looking to reduce on staff-related expenses. The financial and insurance services companies have already laid off or discharged 263,000 people in the U.S. in the first half of 2008. The finance and insurance industry collectively laid off or discharged 510,000 employees in 2007, a 64.5% increase over 2006, and 87.5% more than the figure in 2005.[37]

In April 2008, Merrill Lynch announced that it would lay off 4,000 employees. The job cuts were announced after the company witnessed losses in the third straight quarter. Morgan Stanley announced the second round of layoffs in May 2008, which included some of the award-winning analysts. The company also announced to further eliminate 1,500 jobs taking the total number to 4,000 such cuts starting from June 2007. The number also represents nearly 10% of the total workforce of the 47,000 employees. The company is focused toward cutting on fixed costs and not the number of jobs; therefore, more number of jobs may be eliminated to bring down fixed costs.[38]

Morgan Stanley will cut jobs across all the business divisions except brokers who rely on commission and generally leave on their own in case of unfavorable market conditions.[39] JPMorgan Chase, which bought Bear Stearns, is reducing its own employees to accommodate the latter's staff. According to New York State Department of Labor, JP Morgan will be reducing its headcount by 4,000 from its own staff. Of the 4,000 cuts, about 2,000 employees will be vacating jobs for those holding the same position at Bear Stearns. The remaining workers could be terminated because of a slowdown in business activities.[40] In terms of laying off jobs, Citigroup leads the pack and announced further job cuts approximating 9,000 in April in addition to 4,200 cuts announced in 2007 Q4. A majority of the job cuts at Citigroup were a part of restructuring. The company also plans to exit some of its unprofitable businesses in the consumer banking and securities division. In June 2008, Citigroup Inc. announced that it will continue to cut more jobs in trading and investment banking for the ongoing year as part of its reported plan to slash about 10% of its investment bank division globally.

Following the purchase of American Stock Exchange by the owner of the NYSE, NYSE Euronext, numerous job cuts are expected. As both the exchanges overlap in terms of their trading businesses, the NYSE is likely to retain only about 100–120 of the total of 380 AMEX employees. The remaining 260–280 employees are expected to be phased out over the next 12 months, once the deal is completed. Of the total of 260–280 employees, some are expected to stay at the NYSE for a period ranging from three months to one year after the completion of the deal.[41]

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[37] Databases & Tables, Mass Layoff Statistics, Bureau of Labor Statistics (August 2008).
[38] Newswires, Morgan Stanley lays off senior analysts, efinancialnews.com (May 2008).
[39] News, Layoffs Loom at Morgan Stanley, JPMorgan, Lehman, cnbc.com (May 2008).
[40] Expansions and openings July2007- August 2008, New York State Department of Labor.
[41] Ibid.

Among the other players in the market, such as Goldman Sachs and the Switzerland-based UBS, have either announced or already started trimming their workforces. Others, such as now-defunct Lehman Brothers, have already issued large layoffs, which will undoubtedly continue for the units being bought out through bankruptcy selloffs.

Credit Crunch Causes a Wave of Lawsuits

The credit crisis has also brought increased lawsuit filings against big banks. Apart from individuals and organizations, some cities have sued banks holding them responsible for the recent subprime crisis. In January 2008, the city of Cleveland filed a lawsuit against 21 banks, including Deutsche Bank, Goldman Sachs, Merrill Lynch and Wells Fargo, alleging them of originating the subprime and foreclosure crisis in the Ohio city. The city officials claimed that investment bankers continued to buy subprime mortgages from lenders, "securitize" them and then sell them to investors. A similar complaint was filed in February 2008 against Merrill Lynch by the State of Massachusetts blaming it for fraud and selling of complex financial products such as collateralized debt obligations (CDO), which eventually lost the entire market share.[42]

The growing number of subprime mortgage and related federal filings picked up pace toward the end of 2007, and accelerated in 2008. The number of such cases filed in federal courts reached 170 for the first three months of 2008, up by 85% from the previous quarter, which was already the busiest in these terms in recent times. Of all the cases filed, securities fraud accounted for 26%. Among the total of 44 such cases filed, eight were related to ARS, for which values are timely reset through an auction process. However, ARS had become impossible to sell since late-January, as investment banks stopped shoring up auctions that were being abandoned by investors.[43]

As state and federal regulators started investigations about the alleged role of investment banks and regulatory pressure mounted, banks decided to buyback the ARS in the end of July and the first half of August 2008. Citigroup was the first to announce the buyback of $7.5 billion worth of ARS from retail investors over the next three months starting August while another announcement came from the Merrill Lynch confirming that it would buy back $12 billion of ARS starting next year January 15. Merrill expects there would be $10 billion of such holding by the time it begins its buy back. Following this, Morgan Stanley also announced its ARS repurchase plans. Morgan Stanley expects to buy $4.5 billion of such securities from retail clients starting from the end of September 2008.[44] However, New York's attorney-general turned down Morgan's response of buy back such securities stating it as "too little, too late".[45]

The number of subprime-related cases filed in federal courts continued to spiral throughout 2008. According to Advisen's MSCAd lawsuit database, as of September 2008, over 400 cases were filed in total, excluding borrower suits. These lawsuits have been filed against mortgage brokers and lenders, investment banks, companies investing in securities backed by subprime mortgages, and others involved in the subprime mortgage origination and securitization process. Losses to directors & officers liability (D&O) insurers are projected to be $3.6 billion, spread over accident years 2007 and 2008. Losses to errors & omissions (E&O) insurers are projected to be a very similar number – approximately $3.8 billion. D&O losses will fall most significantly on large publicly traded financial

[42] Article, Let the Lawsuits Begin: Banks Brace for a Storm of Litigation, Web of Debt (July 2008).
[43] Subprime Mortgage and Related Litigation, First Quarter 2008 Update: Reaching New Heights (April 2008).
[44] Press Release, Morgan Stanley to Repurchase Auction Rate Securities, Reuters (Aug 2008).
[45] News Release, Morgan Stanley ARS buyback offer rejected, ft.com (August 2008).

institutions, but E&O losses will be far more widely distributed, with insureds ranging from small mortgage brokers to the largest global financial services companies.[46]

Other Significant Trends

Payroll Costs

The largest cost incurred by the industry is salaries and other employee compensation, driven by intense competition for the most talented employees. The annual bonus component, which has soared in recent times, further inflates payroll expenditure. In some of the segments such as investment banks, salaries and other employee compensation account for just under half of the total expenditure, excluding annual bonuses.[47]

With steady employment totals, handsome bonuses were handed out in 2005 Q4 and figures were even larger in 2006 Q1. In 2006 Q1, private sector investment banking and securities dealing in the U.S. witnessed average weekly wages of $8,367, well above that of any other industry. The numbers for the same were even larger among the other Wall Street giants and securities brokerage firms. The total quarterly wages for the investment banking segment were in the range of $6 billion to $18.9 billion for the latter period of 2005 and early-2006, nearly 10-times higher than national average wages.[48] Since upper echelons of all segments of the industry enjoy extremely high earnings, keen competition for jobs in the industry is a constant. This makes managing the pool of talent vital for banks, which means distinguishing those who are responsible for primarily generating their revenue.

Investment in Technology

The financial sector is ahead of other sectors in terms of adopting IT because of reasons, including capturing rapid and accurate data, and sharing and processing data across multiple locations. Furthermore, investment in technology is important to improve reliability and security, and to offer innovative products. The rise of the Internet and availability of private high-speed networks have revolutionized trading of securities and commodities, almost completely automating the transaction process. The evolution of online trading has resulted in a sudden rise in the number of online trading firms. In order to remain competitive, many full-service brokerage firms have also started offering online trading to their customers. The advancement in technology usage has changed the basic nature of jobs in the industry and some companies, particularly those engaged in securities trading, resemble more of IT companies with most employees working in computer-related occupations.

Despite the global downturn in financial markets, spending on IT has continued to increase. The U.S. Census Bureau estimated the total expenditure on IT equipment and software by the finance and insurance sector at $48.29 billion for 2006, an increase of 9% over 2005. With the exception of the technology sector, all other sectors spend less on IT equipment and computer software as compared with the finance and insurance sector.[49] According to a recent published report by Celent, global information technology spending by financial services institutions was estimated at $342.1 billion in 2007, an increase of 5.9% from the figure estimated in 2006. Furthermore, IT spending in the North American securities and investments segment stood at $35.4 billion in 2007, which is

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46 Advisen's MSCAd lawsuit database and Advisen's projections.
47 OneSource Industry Classification System, Investment Services, OneSource (2008).
48 Issues in Labor Statistics, Wages and bonuses in investment banking, U.S. Bureau of Labor Statistics (August 2007).
49 Information and Communication Technology Survey, Summary of Findings, U.S. Census Bureau (March 2008). http://www.census.gov/csd/ict/xls/2006/SUMMARY%20OF%20FINDINGS.pdf

expected to reach $38.2 billion at the end of 2009, as reported by Celent. However, the projected figure is substantially lower than the historically achieved growth rate because of the credit crunch and economic uncertainty, which has forced these institutions to take thrifty approaches toward overall spending. Market players, particularly operating in the consumer finance segment, require secure, reliable IT systems and sophisticated software programs, often vital for numerous functions. Since suppliers of such products and services are generally large multinational companies, and since not many exist, companies are usually reliant on just one supplier for such inputs. Switching from one supplier to another is not always an option for companies as it requires spending capital on training staff to use new systems.

Constantly Evolving New Products

Since companies offer little differentiation among fee-based services offered by industry players, established players rely heavily on their reputation of effectiveness to attract customers. In order to produce high margins, new products and services are constantly invented by players in different segments of the industries. However, since patenting these products and services is not usually practiced; they are often copied quickly by competitors. Contrary to the investment banking segment, consumer finance companies offer products and services that can be fairly differentiated based on parameters, such as interest rate, repayment period and type of loan. A large range of available products provide customers an opportunity to choose the best one suited for individuals. The rise of alternative funds, such as the evolution of outcome-oriented funds, is driving revenue growth for asset management companies, while traditional funds have not lost ground as well. In the last few years, the average annual growth rate of outcome-oriented funds is double as that compared with traditional funds.[50] Furthermore, as the baby boomer population is nearing retiring age, the importance of financial planning has taken the lead in the priority order, providing an opportunity, at least for some, if not for the entire industry. In the consumer finance segment, players specializing in one product area, or nimble niche market, are already creatively analyzing data, markets and past performance to target high-return segments, often overcompensating for their lack of scale efficiencies enjoyed by the largest companies.[51]

Summary

The financial services industry has been experiencing a historic crisis phase since the credit crunch evolved. The industry is presently under substantial pressure because of the decline of housing markets, which started in 2007 and is expected to continue well into 2009. The impact of the credit crunch has been severe, and devastating in many cases, as the basic structure of the industry has transformed over the course of weeks. A pre-Glass-Steagall financial world has emerged, one with large diversified financial institutions, providing services from commercial banking to investment banking, and certainly with broader regulatory oversight coming soon.

As subprime mortgage losses continue to mount in 2008, the impact of the same has not remained limited to commercial banks but has spread to other financial firms as well. A series of disturbing events in the financial services sector has retarded deal activity in the U.S. financial services market. For the current year, significantly lesser number of deals has been announced in the industry. Similarly, after a robust year of initial public offering

[50] Current Trends, Investment Companies, Business Info Bytes (March 2007).
[51] Report, Consumer Finance, PriceWaterHouseCoopers.com (2006).
http://www.pwc.com/extweb/pwcpublications.nsf/docid/B7211334B7FB5418852571230078948F/$FILE/cfuWinter06.pdf

(IPO) activity in 2007, the number of IPOs has declined in the U.S. in the first half of 2008. Uncertainty in the U.S. market has resulted in the adoption of thrifty approaches by companies planning to go public.

Firms are implementing various options to counter challenges arising in the market. Job cuts, as a part of the restructuring plan that started in 2007, have continued so far, and although such planned job cuts are happening across all industries, financial services firms top the list. Since a major proportion of operating expenses in the industry is tied to compensation and benefits of employees, firms are looking to slash jobs in a hurry. Even the largest of the firms in the industry, such as Citigroup, Bank of America, JP Morgan Chase, and many others, have repeatedly announced job cuts from their current workforce. Other firms with more severe fates, such as Bear Stearns and Lehman Brothers, are witnessing even more severe cuts. The problems of investment banks are not limited to this; regulators have alleged that brokerage firms have misled investors and sold highly illiquid auction rate securities projecting them as safe and cash equivalents. Other regulatory actions are certain regarding their treatment of mortgage-backed securities. An increased number of lawsuits have already been filed against a number of investment banks, as well as other financial players such as mortgage brokers, alleging them of misrepresenting their products.

However, the Federal Reserve and the U.S. Treasury Department have taken extreme measures to resolve the current crisis. In addition, the Treasury Department has introduced a new proposal, which empowers the Federal Reserve to oversee the stability of financial markets. The proposal includes merging the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) to oversee securities and futures trading. Under another important restructuring clause, other financial supervisory bodies will be replaced by only three large agencies. However, any corrective measures taken by the Federal Reserve and government agencies will only reflect in the medium-to-long term and the industry is expected to continue to operate under immense pressure in the current year.

Business Initiatives and Risks

Recent historic changes to the financial services industry portend certain business initiatives that players in this industry must consider for both growth and mere survival. Pursuing, and not pursuing, these initiatives come with risks to companies in the industry.

Business initiatives for the financial services industry fall across four different high-level categories: strategy, marketing and sales, governance, and compliance. Strategy initiatives reflect the need for consolidation in a world of tighter credit. Market and sales initiatives stress selling new products to new markets. Governance business initiatives underscore the reality that financial firms need to impose stricter self controls on their own risk. Compliance initiatives deal with the complex web of regulations, and the strong likelihood of broader regulations.

Strategy

A tidal wave of large-scale acquisitions, for both whole companies and parts of bankrupt companies, swept across Wall Street as the credit crisis unfolded: Bank of America acquired Merrill Lynch; JP Morgan Chase purchased Bear Stearns; Barclays and Nomura picked apart the remains of Lehman Brother's empire. The assumed outcome of the Gramm-Leach-Bliley Act (i.e., the repeal of Glass-Steagall), which is the combination of commercial and investment banks, is finally being realized; unfortunately it took an economic calamity to push investment bankers into this role. It has become clear that most of the large players involved in investment banking activities will hold the long-term and safe liabilities of deposits, after years of stretching their return-on-equity margins with short-term leverage. This will require continued acquisitions for both investment banks seeking out the safety of deposits, and for commercial banks looking for an opportunity to tap into the growth potential of investment banking activities. Although rolling insurance operations into the mix has not met with much success, this area remains a potential opportunity, particularly those seeking to offer their commercial clients insurance brokerage services.

Goldman Sachs and Morgan Stanley, the remaining independent investment banks, have applied for commercial banking licenses. Even if both offer deposits, these activities are likely to remain small. Goldman Sachs plans to offer deposits to wealthy individuals, complementing their wealth management business, and to seek out longer-term financing terms through strategic alliances. Mitsubishi UFJ Financial Group's 21% investment in Morgan Stanley is also seen as the seed of a long-term partnership with this Japanese financial giant that owns one of the largest global commercial banks, the Bank of Tokyo-Mitsubishi.

Consumer credit firms can use both acquisition and alliances to branch out into the banking and insurance realms, such as Capital One expanding into retail banking. The reverse is also occurring, such as Bank of America purchasing troubled mortgage financing giant Nationwide. Credit and loans are in effect high-class commodities, or at least they are in the eyes of most customers. No one seems to care where their mortgage money comes from, or which bank provides their credit cards, as long as they are getting the lowest interest rates and fees for which they qualify. Acquiring a going concern, or partnering with one, and avoiding start-up costs is usually preferable if a company wants to expand into a new product or geographic area, as it is unlikely that a home-grown product will blow away the competition.

Being that the core of investment banking and consumer credit services are commodities, these areas have become more competitive, and this competition is largely coming from overseas. But just as non-U.S. firms are competing in

the U.S., all firms need to expand globally to serve clients in an increasingly global business environment. This is particularly true in developing countries, where opportunities abound with mushrooming middle classes and businesses. However, in many of these countries, such as China, growth is limited for those not willing to play by their rules of partnerships and acquisitions. Global expansion is also critical for cost savings initiatives. Many tasks, such as back-office work, trading, and sales, could be done more inexpensively by machines than by people. But many banks are also trying to spend more wisely on technology, in part by moving information technology and back-office jobs to countries such as India.

Consumer finance is a business in which many companies have enjoyed success by carving out niches, becoming specialists in a well-defined area, and developing a reputation for service, price, and quality that makes customers in that niche seek them out. Concentrating resources and going after clearly-defined target markets often result in economies of scale, permitting the company to undercut the prices of generalists offering the same or similar products and services. Of course, deciding which specializations to pursue, given current and projected future consumer financing needs, and developing a staff with expertise in those areas, is the key to profitability in niche marketing.

Components of Strategic business initiatives include:

- Pursue growth through acquisitions;
- Pursue growth through partnerships and alliances;
- Pursue growth through global expansion; and
- Increase focus on niches.

The following tables outline risks associated with these Strategic business initiatives.

Strategic	Operational
• Failure of acquisitions, joint ventures, or alliances • Disruptions from divestiture of assets • Ineffective business model/positioning strategy • New geographic initiative leads to regulatory and political exposures • New product/service fails in the market	• Inefficient operations render initiative unprofitable • Customer satisfaction suffers from poor service and support • Inadequate information processing systems create inefficiencies • Production/service quality suffers from low employee morale

Financial	Hazard
• Currency fluctuations cause earnings volatility in home currency • Decline in credit rating • Exposure to financial market volatility through investments • Improper hedging techniques cause exposure to market volatility	• Theft/fraud by employees • Lawsuits arising from performance or non-performance of professional services • Lawsuits from shareholders arising from errors or omissions of directors or officers

Marketing and Sales

The Gramm-Leach-Bliley Act opened the door for commercial banks to get into investment banking, and vice versa. As investment banking is generally more profitable than commercial banking (at least it is in a good market), banks are garnering an increasing share of this business. Their strategy for winning this new business is often to provide clients with credit facilities, which investment banks traditionally have not done. This is somewhat disconcerting for investment banks, as some clients are now demanding credit in return for mergers and acquisitions, and underwriting engagements. Investment banks will likely have to offer credit services if they are to compete.

Investment banks that combine with commercial banks will not only have this advantage of credit facilities, but also will reap the benefit of a more stable capital-base during hard times such as the current credit crisis, with customer deposits in tow. But investment banks who remain mostly independent, like Goldman Sachs and a plethora of medium- and small-sized investment banks, and are able to obtain the needed credit through alliances, might find their flexibility as a result of being leaner as a competitive advantage. It is the investment banks that have the underwriting expertise and access to potential investors, and market conditions often require both a steady and versatile hand at the wheel. Furthermore, large corporations don't necessarily want one-stop shopping for commercial and investment banking needs. Rather, they tend to choose the "best of breed" in each product or service category. Regardless of the service areas offered, any firm of significant size needs to seize the opportunities offered in developing countries, with particular attention given to China and India.

The wealthy will be with us always, and what a relief that is to every firm connected to financial services. Money needs to be invested, sheltered, protected, and hopefully multiplied, regardless of the state of the economy and the winds of war. Firms in this industry are focusing their formidable resources on the needs of wealthy private investors, offering financial guidance and sophisticated solutions to simplify their clients' lives and more importantly, make these clients even more money. High-net-worth individuals do not reside exclusively in the U.S., and firms are making an effort to reach the wealthy wherever they may have a home, or homes.

Components of Marketing and Sales business initiatives include:

- Grow revenue through increased penetration of existing markets with new products and services;
- Grow revenue through penetration of new markets with existing products and services; and
- Grow revenue through penetration of new markets with new products and services.

The following tables outline risks associated with these Marketing and Sales business initiatives.

Strategic	Operational
• New product/service fails in the market • Product obsolescence • New geographic initiative leads to regulatory and political exposures • Inadequate or ineffectual allocation of resources	• Inefficient operations render initiative unprofitable • Inadequate support causes products/services to fail • Customer satisfaction suffers from poor service and support • Inadequate information processing systems create inefficiencies

Financial	Hazard
• Large capital investments cause cash strain • Inadequate capital investments restrain future growth • Inadequate cash flow to support daily operations	• Lawsuits arising from contract disputes • Lawsuits arising from performance or non-performance of professional services • Lawsuits by shareholders arising from errors or omissions of directors or officers

Governance

After the dust settles from the credit crisis, much will need to change for financial services firms regarding governance and risk management. Many firms took on too much risk in one type of asset, and financed it with too much short-term leverage. Mortgage-backed securities were considered safe investments because they spread out the risk of defaults across many mortgages. However, most firms never independently assessed the risks of their investments, relying solely on the opinions of ratings agencies, which in turn relied on the guidance of Fannie Mae

and Freddie Mac, with socialized risk structures. Both rating agencies and investors need to have independent assessments of risk.

All players assumed that housing prices would continually rise, so almost no one considered the impact on the value of all mortgage-backed securities in a housing-market correction scenario. Furthermore, perhaps every firm in this industry under-estimated the cascading effect on credit markets under such a scenario, and the impact it would have on these mortgage-backed securities. The cascading effect started with failing firms causing panic, causing a credit crunch, causing more panic and more failing firms, leading to fire-sales of the very mortgage-backed securities that started the cycle. The same is true for credit-default swaps, the instruments that brought previously-vibrant AIG to its knees. AIG took on a level of potential liabilities through these swaps that, when housing prices fell somewhat significantly, the impact of its collateral calls associated with these swaps, in conjunction with its inability to raise financing in a credit crunch, mushroomed beyond the worth of the entire company.

When all is said and done, it was the lack of serious risk management procedures, even at their most rudimental levels, that led to the downfall of so many financial giants and the credit market meltdown that followed. Derivatives are part of the offerings of the financial services industry, which help firms reduce risk and raise financing. But these relatively new and unregulated products are more complicated than their plain-vanilla counterparts of yesteryear. The problem is not only on the asset side, but assessing the level of leverage, and the length of terms, is part of the risk equation as well. Risk management systems, and governance practices backing these systems up, are crucial for survival, and need to be seen as more than mere cost-centers. Governance structures that include the designation of risk management officers or committees, reporting to the Board level, should be considered. Regulations around these issues are sure to come, and those with proactive systems will find themselves ahead of the curve.

Components of Governance business initiatives include:

- Change the governance model of the firm; and
- Restructure the organization/streamline bureaucracy.

The following tables outline risks associated with these Governance business initiatives:

Strategic	Operational
• Ineffective business model/positioning strategy • Business initiative damages company's reputation • New product/service fails in the market • New geographic initiative leads to regulatory and political exposures	• Inefficient operations render initiative unprofitable • Oversized overhead renders initiative unprofitable • Inadequate information processing systems create inefficiencies • Breakdown of internal controls

Financial	Hazard
• Decline in credit rating • Counter party default on settlements • Inadequate cash flow to support daily operations • Exposure to financial market volatility through investments • Improper hedging techniques cause exposure to market volatility • Off-balance sheet liabilities and commitments larger than expected	• Lawsuits by shareholders arising from errors or omissions of directors or officers • Lawsuits arising from performance or non-performance of professional services • Lawsuits arising from contract disputes • Theft, robbery or fraud by third parties

Compliance

With Wall Street being casted as the "bad guys" in this credit crisis saga, and people on Main Street angered by the prospects of using taxpayer-money to bail out the banks that helped caused this problem, regulatory changes are certainly in the making. The "bad guy" image is mostly deserved, particularly for certain people who took excesses of risk seeking the upside without regard for their fiduciary duties on the downside. But others in the financial services industry off Wall Street, such as small mortgage brokers pushing unaffordable mortgages on unsuspecting consumers, have had their hand in these problems as well.

So broader regulations are in the cards for all financial players, from stricter term declarations from mortgage brokers, to safer capital requirements and leverage limits for investment banks, to more due diligence for credit rating agencies, to more consultative liabilities on all that issue derivatives. Similar to Secretary Paulson's proposal, the reach of the Federal Reserve will most likely expand well beyond its current domain of commercial banks, and oversee financial activities across the board. Greater transparency of investments and liability structures will become a centerpiece of new regulations, for both investor confidence and regulatory oversight purposes, especially for future times of crisis. Furthermore, with the strong possibility of large Democratic majorities in both houses of Congress, regardless of the winner of the Presidential election, executive compensation regulations will likely come to the fore, and especially for Wall Street firms.

Scandals of recent years have brought about dramatic changes in the legal and regulatory environment in the financial services industry. The New York Stock Exchange proposed new corporate governance rules. U.S. regulators mandated CEO and CFO certification of corporate financial statements. Law enforcement agencies began aggressive enforcement actions aimed at misconduct. Congress passed the Sarbanes-Oxley Act in an attempt to strengthen confidence in U.S. corporations, corporate accounting, and financial markets. As part of settlement agreements, investment banks have agreed to wide-ranging changes, including physical and financial separation of

research from investment banking, increased disclosure on research material, and the provision of independent, third-party research. So a changing regulatory landscape is far from new for this industry, but changes to come could dwarf these changes of the recent past; probably not seen since the Great Depression.

The specifics of the new regulations might vary, but they will most certainly become more complex and more strictly enforced. As the prime conduits for raising capital and investing, investment banks and securities firms can expect to be under the regulatory microscope, particularly in the aftermath of the credit crisis. They must remain vigilant about complying with the myriad federal and state laws and regulations regarding disclosure, avoiding conflicts of interest, and adhering to accounting standards.

With emotions high, and many with politicians looking for populist red-meat to serve their respective constituencies, some regulations are likely to pass that have nothing to do with the crisis but provide for a snappy bumper sticker. Industry players must take part in the political process through lobbying efforts to ensure reasonable regulations that will strengthen the stability of financial markets and firms. New regulations should provide a strong foundation that won't crush the creativity that serves corporate and retail clients more effectively.

Components of Compliance business initiatives include:

- Review appropriateness of accounting standards;
- Lobby governments to achieve desired regulatory outcomes; and
- Review compliance procedures to ensure compliance to regulations.

The following table outlines risks associated with these Compliance business initiatives.

Strategic	Operational
• Business initiative damages company's reputation • New geographic initiative leads to regulatory and political exposures	• Compliance procedures breakdown creates liability exposure • Lack of training causes misuse of company assets • Breakdown of internal controls • Inadequate support cause products/services to fail

Financial	Hazard
• Improper financial statement disclosures and accounting standards • Decline in credit rating • Lack of access to capital markets (equity and fixed income) • Inadequate cash flow to support daily operations • Off-balance sheet liabilities and commitments larger than expected	• Theft/fraud by employees • Lawsuits by shareholders arising from errors or omissions of directors or officers • Lawsuits arising from performance or non-performance of professional services

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