



SMART Perceptions A View on the Year Ahead – 2008

Welcome to SMART Perceptions, in which our team of experts offer predictions for the financial services market in the year ahead. Whether your area of interest is banking, insurance, investment management, real estate or commodities, it is shaping up to be an intriguing 12 months.

The big story of 2007 has been the sub-prime crisis, a term few of us had heard before outside of a butcher's shop, but which is now truly embedded in popular vocabulary. The big question is: what next for the sub-prime saga? Should we adopt a half-full or a half-empty outlook? If half-empty, we might assume that the leverage created by structured transactions is such that we have only seen the beginning of the fallout. Many more hedge funds will be adversely affected, as will more banks. This will have a further knock-on effect on the domestic housing market and the insurance market, which will then feed through to the rest of the economy.

The half-full view, on the other hand, goes like this: the banks have seen their share prices being hit so hard anyway that they wrote off as much as possible of their potential sub-prime liability, to avoid giving the market further shocks. This way, they are likely to be able to write back some of it in future quarters. Having already introduced hiring and spending freezes earlier than normal in '07, the banks will start the New Year in reasonable shape, and their investment budgets for 2008 will remain strong. This, we believe, is the most likely scenario. It is just possible that the worst is now over.

Chris Tattersall, Managing Partner, SMART UK

New directions for the commodity boom

- With high and volatile oil prices, why be confined to derivatives when there is plenty of money to be made trading physical oil? Goldman Sachs, Morgan Stanley, Shell, BP and Exxon all reported good commodity numbers. At the same time, is it possible to make money operating a fleet of supertankers at \$40 a barrel? And what about the increasing regulatory burden (MiFID is the first proper piece of European legislation to hit commodity derivatives)? BarCap believes the risks are balanced in favour of trading physical oil and is doing so for the first time (the first European bank to do so). With oil looking set to average up to \$80 a barrel for 2008, we expect that other major European investment banks will soon follow BarCap's lead.
- High commodity prices and credit turmoil: there could be trouble ahead. For the many commodity players facing the credit crunch, it will be increasingly difficult to generate additional revenue trading 'traditional' products. Even so, there are a couple of paths they could follow to revive their fortunes. Either they start trading more complex and less liquid commodity products e.g. quantos and term trades, or they go back-to-basics with 'safer' commodity products such as following the latest Russian oligarch into gold related assets. They are not mutually exclusive, however, and we predict the volumes of complex transactions will increase substantially as will the price of safer commodities.
- As climate change business rises to the top of the agenda, what's next in CO2 emissions trading? Will the second and third phases of the EU Emissions Trading Directive be successful? Having survived its tumultuous first phase, the European Union Emissions Trading Scheme is now entering its 2nd phase. By allowing the auctioning of emissions allowances, we believe this 2nd phase will be successful and that most EU states will auction part of their allowances. Will Schwarzenegger follow suit? One thing's for certain – he'll be back!

Insurance horizons

- As our environmental conscience and consciousness grows, so will attempts to seek damages from the companies that permeate our everyday lives, such as utility companies. Although litigation against them has yet to succeed in the US, we would not be surprised to see similar suits over here. Likewise, the US trend to sue consumer product manufacturers may also find its way to the UK. Consumers will increasingly look to blame the effects of eating or drinking too much on others. Test cases in the US invoke public nuisance, addiction, deceptive trade practices and targeting minors. Although still in its infancy, this kind of litigation – as well as the debate about the insurability of such claims – is unlikely to go away.
- As asbestos product claims continue to mature and stabilise in the US, so defendants are learning new tricks to deal with them. Numerous defendants have re-categorised their asbestos claims from products to non-products so as to increase the insurance available and to avoid exhausting the product limit provisions in their commercial general liability policies. With many of the underlying insurance policies reinsured in the London market, we can expect an increase in arbitrations dealing with this issue.
- The credit crisis will force risk carriers to reassess their businesses and exit unprofitable or redundant lines of business, creating new run-off operations. Strategies to achieve this will focus more on the protection of the brand and reputation of the original carriers than just the mitigation of liability, which is the main consideration for legacy portfolios containing asbestos and environmental losses.
- Run-off globally will become a bigger business. Growth will originate from continental Europe and Bermuda, the latter driven by specific loss events, such as the hurricanes of 2005. It will also spark an increase in M&A activity from international capital providers. We expect to see run-off gain steady momentum in Germany, Austria, and Switzerland, especially as insurers reorganise their businesses in preparation for Solvency II.

Rebalancing of real estate

The accounting principle that “for every debit there is a credit and for every credit there is a debit” is also a natural law. Take the real estate sector: before the sub-prime crisis, the debit was low interest rates and easy money, whereas the credit was the domestic and commercial real estate markets in full throttle. Then the sub-prime crisis hit, giving rise to another debit and credit. The debit was higher interest rates, tighter funding controls and less finance available while the credit was a normalisation of prices, leading to better buy, rent or lease opportunities for those who had been financially prudent and not over leveraged. This in turn will give rise next year to another debit and credit. The debit is the property managers, banks and investment managers who have not overly leveraged are now actively planning to develop their real estate portfolios. The credit will be a requirement for improved effectiveness of systems, controls and internal and external reporting in order to better manage risk and better meet tighter compliance requirements.

Where now for CDO Derivatives?

- The financial services sector is not alone in feeling the brunt of the maelstrom in the credit markets. Institutions around the world have already written off billions of dollars to compensate for their inability to price trades accurately. We don't yet know the impact on UK Plc but it is likely that it too used the products in everyday treasury operations. We won't know for sure until the year end when the auditors have done their work. But one thing is certain: it is unlikely companies have yet disclosed the true value of the instruments on their books.
- Anyone looking to point the finger of blame could start with technology. If it weren't for Excel, we couldn't have created products of such complexity that only their inventors truly understood them. In addition, the enterprise risk models that are meant to help banks manage and monitor these risks do a poor job when markets do not conform to the past. Expect regulators to examine what levels of surveillance are required.

Transparency is the watchword

Banks' operating models will come under increasing scrutiny, both externally from regulators and internally from the board. The bottom line will be under the microscope to determine if it contains hidden exposures and transparency is likely to be the buzzword of the year. In practice, transparency means evaluating the whole value chain, including: initial financial instrument design; pricing; capture; mark-to-market or mark-to-model valuation; close-out; settlement and client reporting. Transparency means structured products should be reported on in such a way that their risk profiles can be reported under all market conditions. At its simplest, this can be making visible the links between the individual trade legs that go into a multi-legged instrument. For

example, being able to link through a single report, the spot, future and swap legs of a long-dated currency exchange rate fix trade. In terms of the technology required, the CFO will be looking to improve transparency through tools and techniques that borrow from the Rapid Application Development paradigm or Extreme Programming techniques, which provide structure in a fast-moving environment. Also the COO and CIO will be looking to simplify the complexity created by the explosion of applications built on end-user tools such as MS Excel and Access.

The leading banks will look to construct new operational frameworks that clearly lay out the terms and conditions inherent in using CDO and similar tools. Network audits will be undertaken to identify and categorise unauthorised applications. The business functions will have to be able to prove to the COO/CIO that no business critical solutions exist in the form of linked spreadsheets and desktop databases for which code and logic changes cannot be tracked. Expect to see creative tension between those wishing to enforce programming and development discipline and those who wish to unlock the flexibility of end-user tools.

US perspectives

In 2008, the full impact of globalisation will bear down on financial markets. We expect to see a raft of groundbreaking developments:

- US financial services firms operating globally will seek to increase shareholder value through growth. This growth will take the form of aggressive expansion through acquisitions in Western Europe, Eastern Europe and Asia. The aim will be to establish a presence in areas where economic growth is outpacing US markets. In addition, to create value, some larger firms will break up into smaller pieces which are worth more than the sum of their parts.
- Sources of liquidity will become more global, along the lines of the combination of the NYSE and Euronext.
- The speculative run-up in real property values in the US, fuelled by liquid credit markets, has only just begun to unwind and cause dislocation in world financial markets. "Mark to Model", which has replaced "Mark to Market" as the widely-used daily valuation method, has failed the test of adequately modelling the fast-moving deterioration of the real asset values that underlie complex hybrid financial instruments. Hedge funds, pension funds, endowments and corporate treasuries will begin to feel the impact in the second quarter. While the impact in 2007 has been limited to the underwriters of these mortgages, ultimately there will be contagion throughout the US and global economy. However, stagnant economic growth in the United States will be a short cycle. US markets adapt quickly and business as usual will commence towards the end of 2008.
- Offshoring activity, which has been frenzied in the last 10 years, will begin to wane as the supply of high quality labour begins to flatten and the wage differential between the United States and offshoring locations shrinks. A weakening dollar will accelerate this. European firms will look to near-shore to locations such as Hungary and Ireland.
- There will be a continued drive towards internationalisation of financial accounting standards. IFRS will be the ultimate reporting standard for public companies as US firms gradually pull back on a dual GAAP/IFRS reporting model.

And finally...

- The FSA will announce a dramatic increase in its shoe-leather budget half way through the year as its inspectors doorstep every hedge fund to check they have implemented MiFID. They might need to increase the tissue budget too when they realise how few actually have!
- Northern Rock, after being taken over by Richard Branson's Virgin Group, will add "& Roll" to its name, and the branches will be redesigned to resemble record stores of the 1970s. Mike Oldfield (of Tubular Bells fame) will write a new theme tune for the bank, which will, of course, go to number one in the charts. Deposits will flow in and Sir Richard will be lauded across the land.
- The UK Parliamentary review of the audit industry will confirm that nationalising the audit industry was not a joke. The private health insurance industry will receive so many stress-induced claims from Big Four audit partners that the government will consider nationalising them as well.