13 THE FUTURE OF THE GLOBAL FINANCIAL SYSTEM

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LEARNING OBJECTIVE

After studying this chapter, you should be able to:

- Assess the Impact of Financial Crisis on Global Financial System
- Know the Changes Occurring in Global Financial System
- Understand the impact of Financial Crisis on Wealth Management Industry

KEY TERMS

This chapter features these terms which you should strive to do more research about:

Hedge Fund	Absolute Return Products	Private Equity Firms
Multilateralism	Systemic Financial Risks	Lines of Credit

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INTRODUCTION

The global environment remains very challenging and compels us to search urgently for solutions to the new problems. The multiple factors underlying the financial crisis evolved over many years, and it will take us years to work through the crisis and adjust to its long-term effects. The financial markets are forever changed, and as Financial Practitioners and Wealth Managers we must confront these realities with a broad and creative perspective that seeks to restore the conditions for economic growth.

The current financial crisis has triggered a fundamental review of the global financial system, in terms of regulation, the role of financial institutions, and the role of governments, and can be seen as an important inflection point. The world is seeing an unwinding of global imbalances, and after more than two decades of exceptional growth, financial institutions are now adapting to a new environment of tighter credit and lower economic growth, increased government intervention and a threat to the previous pace of globalization.

These challenges will require that international policymakers and market participants mount a coordinated global effort to find solutions. First, we must navigate through the current crisis in a manner that mitigates further economic damage, while helping to restore confidence and creating the conditions for renewed growth. Second, we must carefully identify the causes of the financial crisis and act responsibly to avoid a recurrence. Although it is difficult to consider future regulatory and market structure changes during a crisis, we must evaluate what went wrong and determine how to fix it.

With the onset of the current financial crisis, the world has seen an initial unwinding of global imbalances that were built up over the past decade. As the crisis continues to unfold – after years of expansionary monetary policies, financial deregulation and excessive credit utilization – a fundamental question emerges:

How might the governance and structure of the global financial system evolve over both the near-term and long-term?

As wealth managers it is very important for us to have a broad idea of the short term and long term changes in the global financial system so that we are better equipped to handle the effect of these changes on the wealth of our clients.

Let us Review these Possible Changes:

The future of the global financial system: Short Term View

After more than two decades of exceptional growth, financial institutions are adapting to a new environment of tighter credit and slower economic growth, increased government intervention and a threat to the previous pace of globalization.

- **Interventionist regulatory reform:** Global policy-makers have committed to a new regulatory framework that is expected to expand the scope of regulated entities, increase global regulatory coordination and constrain the growth prospects of incumbent financial institutions.
- **Back to basics in banking:** Banks of all types have begun the process of repairing their balance sheets through higher liquidity and capital ratios, coupled with reduced reliance on short-term wholesale funding. Re-regulated banks are likely to become more like utilities as they refocus on core competencies. Moreover, bank strategies are less likely to overlap as individual competitive advantages are reaffirmed.
- **Restructuring in alternatives:** Alternatives players have suffered in the current financial crisis, from both deleveraging and market turmoil. Recent hedge fund losses have called into question the durability of absolute-return products. Private equity firms have to balance steering levered portfolio companies through a severe downturn with the challenge of raising new capital to pursue upcoming investment opportunities when many among their investor base are severely limited in terms of capacity to commit capital.

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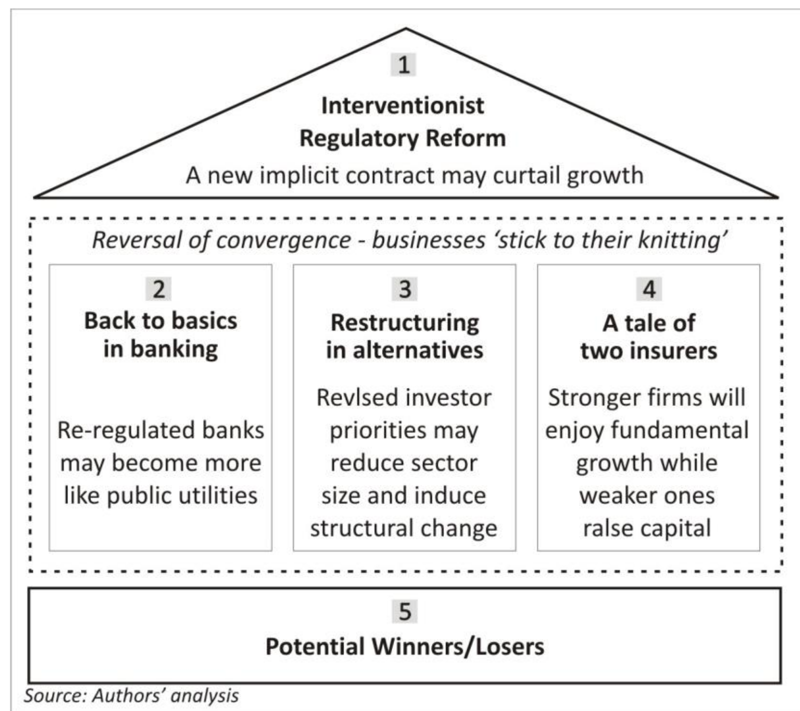
Meanwhile, many investors are shifting their attention to low-cost indexation strategies and "new beta" asset classes. As a result, "unconstrained" providers of capital – such as family offices and sovereign funds – may gain the upper hand.

A tale of two insurers: The fortunes of the insurance industry are broadly split between property & casualty versus life insurers on the one hand, and North America versus Europe on the other. While some organizations will be forced to focus on survival, many will be able to capitalize on the emergence of new acquisition opportunities, continued demand for retirement products and an increased use of traditional insurance products to hedge risk, thereby strengthening their underlying businesses.

SUMMARY NEAR-TERM OUTLOOK FOR WHOLESALE FINANCIAL MARKETS



Source: Authors' analysis

Long Term View: Over the longer term, a range of external forces and critical uncertainties will shape the future of the global financial system. There are various scenarios possible on the long term outlook for the Global Financial System. These scenarios go beyond simply extending current trends and explicitly take into account critical uncertainties, potential discontinuities and system dynamics. These scenarios can be used to support strategic decision-making and facilitate collaborative action.

Each of these scenarios take a myriad of underlying driving forces into account – such as the evolution of energy and commodity prices, global economic growth, fiscal policies, trade regimes, climate change, exchange rate policies, extremism, demographics and global wealth distribution.

Financial regionalism is a world in which post-crisis blame-shifting and the threat of further economic contagion create three major blocs on trade and financial policy, forcing global companies to construct tripartite strategies to operate globally.

Re-engineered Western-centrism is a highly coordinated and financially homogenous world that has yet to face up to the realities of shifting power and the dangers of regulating for the last crisis rather than the next.

Fragmented protectionism is a world characterized by division, conflict, currency controls and a race-to-the bottom dynamic that only serves to deepen the long-term effects of the financial crisis.

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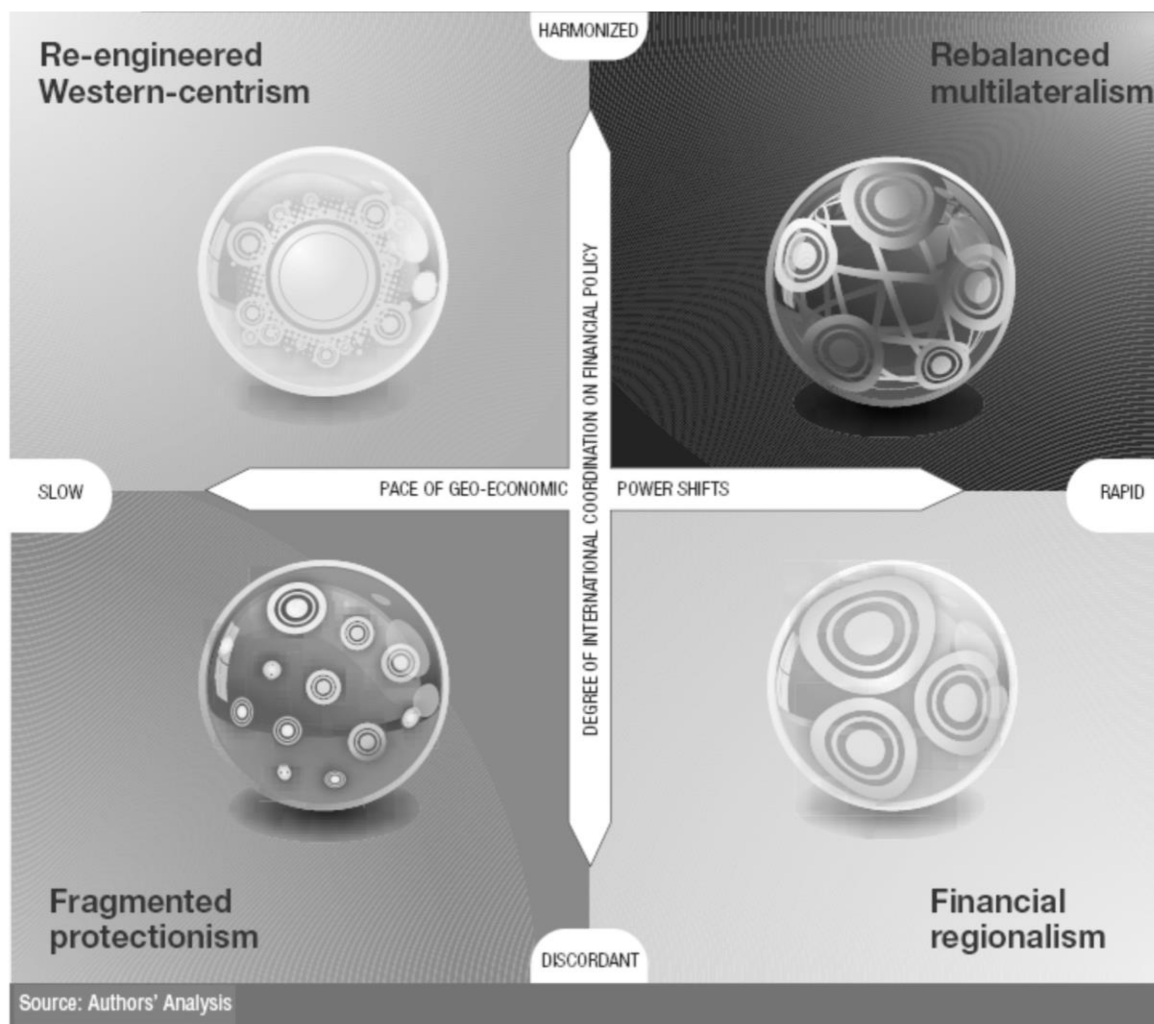
Rebalanced multilateralism is a world in which initial barriers to coordination and disagreement over effective risk management approaches are overcome in the context of rapidly shifting geo-economic power.

Each of these scenarios describes key forces and turning points that could fundamentally shape the governance and structure of the global financial system in the next decade. These scenarios are not designed to predict the future, but rather to explore the boundaries of the plausible, to stimulate strategic thinking and facilitate collaborative action between the various stakeholders.

FOUR SCENARIOS FOR THE FUTURE OF THE GLOBAL FINANCIAL SYSTEM



Source: Authors' Analysis

IMPORTANT CHANGES IN GLOBAL FINANCIAL SYSTEM

The financial crisis marks the beginning of a new chapter for the global financial system, characterized by three important changes.

They are:

1. Deleveraging and a global economic slowdown
2. Increased government intervention
3. A threat to the pace of globalization

1. **Deleveraging and a global economic slowdown:** Over the near-term, the process of deleveraging bank and household balance sheets will have significant implications for the financial services sector, chief among them being the placement of sustained stress on the global economy.

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The corrective actions of banks and investors have so far had the most prominent effects, as manifested in ongoing price declines across global credit and equity markets. The rising cost of credit and the negative economic outlook have forced many investors to dramatically reduce their use of leverage, resulting in large global sell-offs across almost every asset class. These market declines have lowered household expectations for wealth creation, resulting in lower debt and higher savings ratios.

The global downturn will have significant effects on the financial services landscape. In the near-term, slowdowns in the financial industry and in the real economy will mutually reinforce each other. With weakening levels of global consumption, economic growth will be limited, leaving financial institutions with fewer attractive lending and investment opportunities. Tighter credit standards and heightened risk aversion will make it difficult for businesses to finance their operations, resulting in further losses and bankruptcies. This will ultimately impact the value of existing bank assets, forcing further write-downs and credit contraction.

2. **Increased government intervention**: Once the extent of the financial crisis became more evident in mid-2008, most finance ministries, treasuries and central banks responded forcefully. These actions represented a new implicit contract between countries and their respective financial services sectors, in which governments will assume the risk from their national banking sectors in exchange for significantly increased levels of financial regulation and oversight. This latter side of the contract will take time for thoughtful design and implementation.

   Intervention so far has been broad-based and relatively consistent across the major economies. These measures have included negotiated bank acquisitions, outright nationalizations when buyers could not be found, emergency lines of credit, liquidity injection programs to liquidity injection programs to interbank loans, and the introduction or expansion of deposit insurance schemes.

   Intervention on such a massive scale has made it necessary for central banks to request special financing packages from their governments. As a result, national fiscal positions will be strained, raising the risk of sovereign defaults and the potential for IMF intervention.

   In the developing economies that have a greater reliance on external financial markets, the risks are even more significant, and include renewed pressures on inflation, currency devaluation, deterioration in foreign direct investment and a negative economic outlook.

   This expansion of national risk-taking has dramatically shifted the role of government within the financial services sector. Where the activities of governments and their agencies were previously focused on oversight, they have now become active players in the very markets they regulate. Government intervention will be felt acutely by the newly semi-nationalized financial institutions, which will face competing objectives from sovereign and private shareholders. At a time when private shareholders are expected to take a more activist role to bring these companies back to profitability, government shareholders could introduce new objectives that are misaligned with those of private investors.

   The assumption of risk by governments is expected to lead to the greater regulation of all financial entities benefiting from their programs to ensure that taxpayer funded investments are properly managed. This forms the second part of the implicit contract between governments and financial markets. Such regulation and supervision will have the dual objective of minimizing systemic financial risks and protecting businesses and households from market failures when they do occur. In contrast to the relatively consistent short-term response to market failures, the degree

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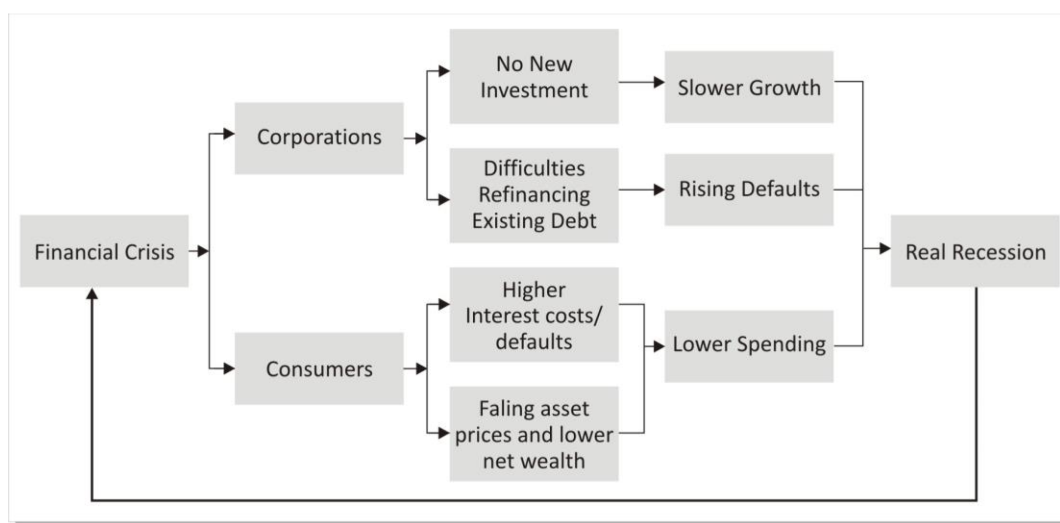
of change in regulation and supervision is expected to vary greatly by country, including the approach each takes to capital and liquidity management, compensation reform, regulatory oversight of the non-bank sector, and, to a lesser extent, the introduction of early warning systems and circuit breakers for systemic financial risks and increased coordination with foreign regulators.

As can be seen from the above figure there is a real danger of this financial crisis snowballing into a Global Economic Recession.

3. **Threat to the pace of globalization:** The expectation of a sustained global economic slowdown threatens the pace of financial market globalization and, thus, future growth opportunities for wholesale financial institutions. Financial globalization has allowed these firms to expand their operations into new markets in both the advanced and the emerging economies. This has been a boon for the industry, resulting in increased revenues, investment access and portfolio diversification.

FINANCIAL CRISIS AND REAL ECONOMY FEEDBACK LOOP



However, as damage from the financial crisis works its way through to newly open economies, the threat of increased capital controls becomes a distinct possibility.

Debates regarding the role of “hot money” flows in international financial crises, having already received significant attention in the wake of the Asian and Russian default crises may once again return to the forefront of public debate. As national governments investigate the conditions that led to the current crisis, arguments for limiting the exposure of domestic economies to external crises are also likely to regain their former prominence. Should national governments close themselves off and reinstate capital controls as a means of protecting their economies; these restrictions would significantly limit growth and investment opportunities for financial institutions. Such controls could potentially lead to higher debt costs – with supply/demand equilibriums differing greatly among regions – and might decrease the correlation of global asset returns.

EMERGENT POST CRISIS BUSINESS MODELS FOR INVESTMENT BANKING ACTIVITIES

1. **Scale Globals** will likely to be part of a small, super class of global liquidity providers. They will use their deposit-funded, fortress-like balnce sheets, global footprint and trading infrastrucuture to maintian or become major liquidity providers across markets and asset classes. Many of them will be universal banks, and will grow retail deposits and high net worth accounts to stablize their funding sources, but will reduce the amount of ring-fenced proprletary trading.

2. **Focused regionals** will likely recommit to regional franchises. They will dramatically reduce their capital commitments and balance sheets, will pick businesses where they identify a

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regional advantage, and will extract corporate and commercial cross-self synergies to dominate mid sized corporate and governemnt advisory and financing mandates. They will build secondary trading operations to support their advisory and primary issuance businesses and support small international teams that can help syndicate issues gloablly. As regional specialists, they may engage in a limited amount of proprietary trading where they have an information advantage.

3 **Private Banks** will recommit to their retaills, small business and high net worth client franchises. Like scale globals, they will emphasize deposit funding, but like focused regionals, they will significantly de-risk their trading businesses and seek to extract cross sell synergles for other banking products. They will maintain some presence in secondary markets to facilitate client transactions.

4. **Merchant Banks** may emerge and gain share in advisory and corporate finance as a greater number of institutions focus on domestic and retail markets and the scale globals look to serve only the largest intertional clients.

5. **Alpha risk takers,** such as hedge funds and private equity firms, may increasingly act as market makers on instruments where spreads have widened or arbitrage opportunities are present. Hedge funds with trading infrastruture are likely to move into select high margin sell side businesses (e.g. fixed income, credit, corporate finance). Private equity firms with established track records of aligning the interests of general and limited partners will be best positioned to attract fresh capital to invest in illquid markets.

IMPACT OF FINANCIAL CRISIS ON THE WEALTH MANAGEMENT INDUSTRY

Among the key issues wealth management firms face include:

- **Sub-optimal advisor productivity** due to time spent on increasing client demands for investment information. As client satisfaction and trust levels drop, advisors need to back up investment advice with comprehensive data on product performance, risk levels, fees and fit with the client's investment strategy. Without the right support tools to simplify access to data and report creation, gathering and presenting this information can become overhead that detracts from more productive activities.
- **Higher resource costs for attracting and retaining talent.** Having a skilled set of advisors on board is more important than ever, as firms strive to deliver on client expectations. However, rising industry demand for experienced advisors has made it increasingly challenging for firms to attract and manage high-quality talent. In addition, firms are grappling with attrition, as experienced advisors migrate to independent channels that offer higher payouts.
- **Changing regulatory regime.** Heightened regulatory scrutiny following the financial crisis is forcing firms to re-examine their hiring and training practices. Firms need to ensure that potential advisors have the necessary industry certification and qualifications. Targeted and effective delivery of training materials on new regulations, client communication guidelines and product information is a priority.

Financial Crisis has had a profound impact on the Wealth Management Industry. This crisis has proved again the importance of impact of changes Global Financial System on the wealth of individuals and corporate.

A wealth manager must strive to update themselves on the developments in the Global Financial Environment to analyse and understand its effect on client's Wealth.

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