The year ahead

Following last year's meltdown of the financial system, Bernard Madoff's $50 billion pyramid fraud, and various other disasters to have hit the industry, many people are justifiably asking what's in store for us in 2009? **Neil Ainger** canvasses some opinions from various industry representatives, consultancies, trade bodies and vendors

Last year will undoubtedly be remembered as one of the most turbulent in recent financial history, with the fall of Lehman Brothers, Bear Stearns and other august names all of whom were caught in the financial meltdown that affected the world in September and October, claiming the independence of HBOS, Bradford & Bingley and many other institutions, many of whom, such as RBS, are now effectively in government hands.

Commenting on the turmoil of recent months at the inaugural Economist City Lecture in January, Lord Turner, the chairman of the Financial Services Authority (FSA), said that he believed the "originate and distribute" model of financial lending had a role to play in the future, but needed to be reformed, with less complexity and opacity moving forward. He added that over the last decade the scale of proprietary trading had created risks, and that financial innovation had in many cases delivered minimal economic value and increased the dangers of financial instability. Lord Turner also outlined the issues that he would deal with in his review of the regulation and supervision of the banking system, which is due to be published in March. Three key long-term regulatory initiatives intended to reduce the probability and severity of future financial crises are:

- New approaches to capital adequacy, entailing more capital held against risky trading strategies and counter-cyclical capital requirements to build up adequate buffers during good economic times, which can be drawn on in bad times
- A new liquidity regime focused not just on individual firms' liquidity but also on market-wide risk
- Ensuring that financial activity is regulated according to its economic substance, not its legal form.

These aims, and how they will be achieved, will be outlined more fully in the Turner report in March, but it is clear that much debate about how to respond to the credit crunch in terms of future regulation still rages – the decision not to renew the short-selling ban, for instance, has caused dismay among some commentators.

Regulatory changes are not the only things that we can expect to see in 2009 however, as the increased prevalence of risk is also likely to come to the fore; the necessity of identifying indebtedness in the retail banking and mortgage markets; the challenge new market structures, such as the introduction of the Single Euro Payments Area (SEPA) Direct Debit scheme; and the need to provide instant Return on Investment (RoI) for any technology projects undertaken, will also be evident in 2009. FST gauged the opinion of a few industry players as to what lies ahead:

Q. What are your predictions for the year ahead and how do you see the financial services sector, and its regulation, use of technology, risk procedures and so on, changing during 2009?

Philippe Carrel,
Executive Vice-President, Risk Management, Thomson Reuters

The massive liquidity injections and the Keynesian economics embraced by the UK and US should begin to bear fruit by the second quarter of 2009. At this point firms will reconsider their doom and gloom strategies and the markets may pick up again. This will last until the side-effects of monetary expansion appear. As market sentiment may swing from deflation to growth to super-inflation, we should expect very high volatility and unpredictable correlations throughout 2009.

To meet these challenges, and better seize the inflexion points, risk managers must become excessively pragmatic. Conventional methodologies inspired by Basel, lead firms to aggregate risks by business line, then model enterprise-wide exposures to allocate capital. The cross-market correlations however and the extreme volatility we are expecting demand a much more direct response. Firms will therefore aggregate exposure by risk factors, as opposed to business units. Attention will focus on extreme and worst case scenarios, as opposed to loss distribution models. Risk managers will be empowered to take preventative action. Micro-hedges will prevail on enterprise-wide capital allocation.

This radical departure from the previous approach requires a re-engineering of the data and information workflow. Root-risk factors need to be identified and their 'betas' need to be calculated. The granularity of the approach and the level of cross-asset integration depend on whether risks remain hedgeable under worst case scenarios. This should lead to a return to micro-hedging. Risk reporting structures will be simplified to make business managers more directly responsible and accountable for their hedges. Alerts and emergency procedures will replace the lengthy risk committee escalation processes that have been prevalent.

The financial industry is undoubtedly going through testing times. The outlook will start improving only when risk management techniques have undergone a complete revolution.

Gary Scott,
Director at DecisionMetrics, part of the credit reference agency, Callcredit Information Group

The fallout from the credit crunch has prompted a recession and within consumer credit the crisis has highlighted a need for lenders to rethink their credit policies. There is a business maxim that in difficult times the best companies cut back early, only to return early with new processes prepared for better times. Credit risk professionals will have to reassess their scorecards and credit risk policies in 2009 to ensure they are prepared to lend again in 2010, when an economic upturn is expected. Minimising risk to preserve capital will no longer be a main concern. But as current risk models are likely to have been built in a benign environment, based on data from 'good times' in 2005/2006, will they be robust enough to make responsible lending possible?

There is little doubt that the lending landscape has now changed forever. Lending policies primarily focused on the propensity to pay, based upon historic performance, must now make way for a more balanced assessment with equal consideration being given to both affordability and intention to pay, in addition to traditional credit risk procedures. Over the next 12 months, identifying the trends emerging in post-credit crunch Britain will be key. Adapting scorecards using data that reflects recent consumer behaviour together with the integration of indebtedness and fraud indices in credit policies is essential if lenders are to be ready for the upturn in 2010.

Callcredit Information Groups' own research suggests that today's over-indebted consumer may not fit the typical stereotype of a low paid, blue collar worker in their thirties. Instead they are likely to be 45 to 55-years-old, middle class home owners, living in affluent suburban areas. Would current lending policies predict that these consumers are stretching their credit commitments? It is often the case that the most over-indebted consumers haven't missed a payment and are unlikely to be identified within current risk models. Daily, dynamic risk segmentation, driven by customer behaviour, built into revised risk models and used in partnership with affordability data, will be most effective in enabling lenders to keep profitable customers in future, as well as be more responsive to customers sliding into over-indebtedness.

Neil Johnson
Policy manager, Building Societies Association

The depressed state of the UK housing market remains of concern, particularly the difficulties facing first-time buyers, which is slowing the market. Unlike many of their competitors however, building societies remain in the fortunate position of still being able to lend because they generally have healthier capital ratios, thanks to the less risky nature of their business [those societies that demutualised and followed a different, more aggressive, business model, such as Northern Rock, have run into trouble –Ed].

Although fund raising has been difficult in the wholesale money markets, our members reliance upon the retail market for funding has meant that they have been well placed to weather the storm. Indeed, while the wholesale markets have closed, UK building societies have seen record inflows of capital into them from savers. But despite this, the prospects for the property market remain poor. Although 46 per cent of respondents to December's BSA Property Tracker survey felt that now was a good time to buy property, 58 per cent felt that a lack of job security would prevent them from doing so, demonstrating that as mortgage rates have lessened, it is concerns about the wider economy that are now keeping buyers out of the market and prices depressed. So although people recognise that the price falls that have characterised the last 18 months of the UK property market mean that there may be bargains out there – and now might be a good time to move – it is clear that worries about the wider economy mean any large scale recovery in house prices in 2009 is unlikely.

Edith Rigler
Director of Business Development, VocaLink

At a time when the European banking community faces unprecedented regulatory change, the global economic crisis could not have come at a worse time. In this increasingly competitive market it is critical that retail banks retain customers by offering innovative profitable products and services. However operating under the toughest financial climate in decades and faced with growing public scrutiny, can banks achieve this objective?

We are currently witnessing a bewildering number of events in the market. In boardrooms around the world, retail banks are being forced to review their investment spend and their cost base at a time when SEPA Direct Debit and Payment Services Directive (PSD) compliance is imminent. Historically, banks have preferred to manage their payments operations in-house, but with increasing legislation there has been a growing trend of outsourcing functions which are non-core, require continuous investment in technology, or are resource-intensive. In 2009 we believe there will be an acceleration in the number of banks willing to consider this business model.

With consolidation and mergers on the increase, regulatory compliance is an expensive, time-consuming business. Outsourcing the integration process rather than building in-house has become an attractive option, allowing banks to focus on their core business and customer propositions. This year may also see a growing trend in smaller banks looking for alternative solutions. In the past they have outsourced part of their payments business to larger banks but in view of the current climate may be tempted to look elsewhere. With risk management high on everyone's agenda, payments processing is a specialist business and potential partners must be chosen with care. Sweden's national payments scheme, BGC, provides an example of this new thinking. They recently contracted with us here at VocaLink to implementing an outsourcing agreement that will see us our technology platform and economies-of-scale to process Swedish payments cheaply, while they concentrate on developing new products and improving services at the front-end. This could be a model others follow as the payments landscape changes in 2009 with the advent of the Single Euro Payments Area Direct Debit scheme.

- For more 2009 predictions please go to our website at www.fstech.co.uk