Worldwide Credit Crisis: The Contagion Spreads to Europe and Asia/Pacific

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PERSPECTIVE #

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IN THIS PERSPECTIVE

FinSightsAdvisor

FinSights Advisor is a weekly perspective on the financial services industry. It provides financial institutions with timely guidance about maximizing one's technology investments. This week's issue examines how the credit crisis that began in the United States has affected Europe and the Asia/Pacific region, with implications for the banking landscape and the regional economies.

In the last week, more banks in Europe had to be rescued as regulators worldwide continued to lose ground against the accelerating panic. Final passage of a controversial $700 billion bailout package in the US failed to stem the slide, as investors reacted with dismay to uncoordinated efforts by European regulators and continued bank failures. Credit tightening has begun to affect businesses and consumers, slowing the growth rate of economies worldwide and tipping some of them into outright recession.

While the Asia/Pacific region was originally thought to be somewhat insulated from the US crisis, it is becoming clear that the interconnections are much deeper, particularly with so many IT service providers based in India feeling the impacts from abroad. As US businesses are cut off from cheap credit, they are cutting back in all areas, and this will directly hurt A/P manufacturers and service providers.

Background

It was a chaotic week in the worldwide financial markets, as regulators scrambled to keep ahead of events and markets continued to deteriorate.

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United States:

- A $700 billion proposal from the US Treasury department to allow it to buy distressed securities from banks operating in the US was approved on Friday, October 6, after having been previously rejected on Monday, September 29, sending the Dow Jones industrial average down more than 770 points in one day. Following the addition of more than $110 billion in additional spending initiatives and other "sweeteners", a successful vote in the US Senate was followed by final approval in the US House of Representatives. However, this did not have the desired effect on the US stock market, with the Dow opening sharply lower and trading below 10,000 for the first time since 2004.

- On Monday, September 29, Citigroup announced a federally-sponsored bid to buy Wachovia Bank's retail banking assets at a price of only $1 per share, with the Federal Deposit Insurance Corporation (FDIC) agreeing to cover all loan portfolio losses over $42 billion, in return for $12 billion in preferred stock and warrants. Then on Friday, October 3, Wells Fargo announced a surprise agreement to acquire all of Wachovia (Citigroup would have left the asset management division independent) for $15.1 billion in stock. Citigroup responded by persuading a state judge to issue a temporary restraining order on the basis that Wachovia had agreed not to discuss merging with any other bank until October 6th. The legal battle could drag on for some time, as Wachovia's condition deteriorates.

- Acting on powers given it in the bailout bill, the Federal Reserve announced on Monday, October 6 that it would begin paying interest on commercial banks' reserves and expanded the amounts it would loan to commercial banks, up to a total of $900 billion by year's end.

Europe:

- Fortis was partially nationalized by the Dutch, Belgian and Luxembourg governments with a capital injection of 11.2 billion euros ($16.3 billion). BNP Paribas, of France, subsequently agreed to buy the Dutch and Belgian portions for 14.5 billion euros ($20 billion), making it the largest European bank.

- Bradford & Bingley was nationalized in the United Kingdom (the government has injected 1.8 billion pounds to cover loans) and the Spanish bank Santander agreed to buy the mortgage lender’s deposit book and branch network for about 600 million pounds ($1.1 billion).

- Hypo Real Estate was rescued by the German government and a pool of German Banks (both of them will underwrite credit guarantees for 50 billion euros ($69.0 billion). This replaced an

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earlier round of 35 billion euros ($49.0 billion) that fell apart when the banks concluded far more money would be needed.

- Belgium based Dexia received a 6.4 billion euro ($9.0 billion) cash injection from France, Belgium and Luxembourg to stay afloat.

- Glitnir Bank, Iceland's third largest bank, was nationalized and extended 600 million euros ($840.8 million).

- Unicredit of Italy announced plans to raise as much as 6.6 billion euros ($9.2 billion), placing it next on the list of banks that might need bailouts.

- Ireland's government put in place a guarantee scheme which guarantees an estimated 400 billion euros ($544 billion) of liabilities to safeguard the deposits and debts at six financial institutions (Allied Irish Banks, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society). Germany, Sweden, Austria, Denmark were forced to adopt similar schemes, and the UK may soon follow suit (in UK the promised increase savers' deposits guarantee from £35,000 to £50,000 is not considered an adequate measure and the Spanish government is urged to follow the Irish pledge at the cost of roughly 200 per cent of their GDP).

- The European Union considered whether a U.S like bail-out response to the financial crisis was needed, but much of the regulatory control is still located at the country level, making coordinated action difficult.

Asia/Pacific:

- In the last week, the Nikkei 225 and Hang Seng indexes each plunged about 9.5%, fully half of that on Monday, October 6.

- Asian based central banks infuse local money markets with cash.

- Australian, Japanese, South Korean, Indian and Singapore governments consider what actions might be necessary if conditions continue to deteriorate.

- The Bank of East Asia avoids a run on the bank, after rumors of exposure to failing US firms were found to be unsubstantiated.

In the following section, we examine the implications of the credit crisis for regional economies and financial sector participants.

The European Economic Outlook Deteriorates

European banks are coming up against the same liquidity problems as their American counterparties. In the last two weeks, Northern Rock in the UK (the first run on a bank in the UK in 150 years) and Roskilde Bank in Denmark (along with a few smaller German banks) faced the ignominy of bailout, with one, HBOS, being rescued by a competitor, LloydsTSB. Denmark is expecting the collapse of further small banks after quite a lot of failures and in Spain those small lenders most exposed to property developers are expected to consolidate or fail.

European bank stocks are experiencing heavy selling (Europe's biggest banking names suffered double digit declines and several shares were suspended in trading sessions) alongside other industry stocks. Regional regulators have rushed to ban either short selling or naked short selling (in Russia also margin trading) and Brussels has announced new rules that will toughen capital requirements and strengthen supervisory arrangements for financial institutions with cross-border operations in Europe.

The financial climate is deteriorating at a fast pace, which is being felt in the economy. According to the European Commission's forecast, Europe is facing a sharp economic downturn:

- In 2008, the EU- 27 economy will expand by 1.4 % while in the EU-15 by 1.3 %, below the 2 % and 1.7 % respectively, which is below previous April estimations.
- UK, Spain and Germany's economy are entering into a technical recession.
- France and Italy will have flat growth.
- Eurozone inflation is expected to average 3.6 per cent in 2008 - above the ECB target of 2 %.
- Unemployment rate reached 7.5% in EU15 and 6.9% in the EU27; with a sharp increase in Spain (11.3%) and Slovakia (9.9%), followed by France and Italy.

European banking confidence crisis

Banks are scared and refuse to lend to each other. The Euribor (the rate at which European banks lend to each other) is reaching new records (as of October 1, 2006, the Euribor 6 month rate stood at 5.405%, an increase of 14.93% over the past 9 months. The Euribor 3 month rate was 5.2915%, up 14.42%, while the Euribor 1 week rate was 4.846%, up 17.5%), but institutions prefer to keep their liquidity. For example,

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last Tuesday, European Central Bank (ECB) had in its accounts overnight 102.8 billion euros - by far the highest amount ever – at the below-market interest rate of 3.25%, while at the same time 16 billion euros were borrowed from its marginal lending facility, which has a penalty interest rate of 5.25%.

The ECB has been pumping billions of euros into the money market in an effort to increase liquidity - on September 30th it lent banks 190 billion euros for seven days - but the system is reacting weakly. In addition, the Bank of England introduced a special liquidity scheme, allowing banks to swap untradeable mortgages for gilts for up to three years. More than 100 billion pounds have already been swapped, twice the original expectations. These emergency funds are now being extended well beyond initial planned time frames.

In parallel, Europe's banks are facing the risk of large-scale cash withdrawals, as started to happen in Ireland. Fear is mounting and depositors have started to worry about the security of their savings (given the protection promised by Ireland, local institutions are dealing with increased inquiries from overseas prospects considering opening savings accounts). Prior to this crisis, European banks had far lower limits for deposit insurance than their United States counterparts, so the risk to depositors of a bank failure was quite higher.

Asian Outsourcers Adapting Quickly to Wall Street Fallout

The downturn in the US will change the game for IT service providers. This is especially true for Indian outsourcing organizations, which derived a significant portion of revenues from Wall Street firms. They will now be forced to look at opportunities in Europe and the Middle East, which they perceive to be more stable; and in more mature Asia/Pacific markets, where opportunities still abound. Where there previously was a preference for high-ticket items, there is more willingness now to go for smaller-priced outsourcing deals, in the hope that there would still be enough discrete outsourcing opportunities. We also see a push to build more business with captive units of banks.

The cost management agenda of financial institutions might encourage them to consider players that are not necessarily the largest outsourcing companies, but are experts in specific areas in outsourced services or in specific business processes. The larger firms are fighting back, citing economies that institutions will see if they deal with just a few vendors --- preferably large ones, of course.

There are signs that outsourcing firms are more willing to bring down fees to meet the cost management agenda of clients. Price differentials between contracts signed with US-based companies and contracts with local Asia/Pacific firms are set to narrow. More vendors are willing to sign contracts out of India, or contracts in rupees. Previously of course,

there was preference for deals to be signed out of US headquarters or for local contracts in US dollars.

Assessing the Impact

Europe

In the near-term we foresee the European banking system evolving in the following directions:

- **Regulation:** Much more regulation and supervision. To address lack of visibility into institutions' risk portfolio and the true value of firms' assets, European watchdogs will further increase and coordinate oversight as well as tighten rules and their efficient implementation. Basel III and a deeper revision of IAS/IFRS are in the cards. Moreover, it is likely that Brussels and/or national authorities will put a ceiling on compensation and financial incentives (pay structure, bonus scheme, budgetary incentives, etc.) and "strongly encourage" firms to develop incentive structures tightly-linked to long-term performance.

- **Reach:** Shopping time! Continental operators with sound books have a unique opportunity to take advantage of the US crisis (and the easing of sovereign wealth fund activity) and acquire overseas operations to establish a stronger foothold in the USA and Asia. At the same time national acquisitions will be encouraged to help firms in difficult situations. The overall number of players will sensibly decrease, especially in Germany, France, Spain and Italy.

- **Relationship:** The winning business model in these turbulent times is the retail one, which provides a stable flow of funding for financial firms. Banks will be forced to further increase their customer centricity models to establish a relationship based on transparency and trust. To this end, some will put in place an open architecture business model, both in terms of products and services.

- **Readjustments**: The investment-banking model, which is under increased pressure in the US and UK, will not witness major changes, as the European banking industry does not have a pure stand-alone investment-banking model. Of course the investment bank or capital markets arms of big European banks will strongly focus their activity on M&A and underwriting, while prime brokerage and proprietary trading activities will be secondary and the primary focus will be on repairing balance sheets through deleveraging.

It is worth highlighting that in Europe the financial crisis will negatively impact small-to-medium enterprises (traditionally undercapitalized and dependent for short and medium term funding

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needs on banks rather the capital markets). Some of them are at the risk of bankruptcy or decreasing competitiveness, as they will not have the financial resources to invest in innovation to drive exports and stay ahead of companies from emerging/emerged economies. On the investment side some banks, like Mediolanum, and insurance companies have promised to reimburse some of the money lost by investors but in the retail investor segment trust on financial institutions is decreasing at a fast pace.

Asia/Pacific

Outsourcing companies will focus on operating costs, streamlining staff, processes and modes of operation so that despite a lowering of fees, margins will be maintained.

Furthermore, there have been changes to how contracts are structured. Outsourcing firms are resorting to converting headcount-linked contracts to fixed-price contracts. Fixed price contracts is also the growing preference of most clients, although this was so long before the financial industry fell into turmoil. Contract payments are also being staggered through a longer time horizon. Some financial institutions are opting for a phased approach for transformational IT outsourcing projects, although it should be noted that one often does not see a Phase Two of anything.

One other significant impact we have seen from the crisis in the US is the availability of more A Teams and mid-level to senior management personnel who were up to now tied up in huge, transformational outsourcing projects. If contracted fees are maintained, and especially if contracts are set to a fixed price basis, the involvement of more experienced personnel in projects give an implicit price cut for clients --- they get more experienced people at lower fees.

With more experienced personnel available, the service catalogs of some prominent IT outsourcers will broaden, and will be made available to as many clients as possible. Special services were typically offered only for key accounts previously. IT service providers also say that they are deploying senior people to undertake the benchmarking, scoping and initial assessment of projects (for free in a growing number of cases), hoping of course that this will give them downstream business later on.

IT Spend implications

Amidst the upheaval, financial institutions around the globe are tirelessly working to map out the best course to avoid failure, continue operations and keep future IT plans intact.

The IT community is trying to sort out what the implications are for their business as they've already seen IT budgets shrink, with the latest wave of events making the prospects even gloomier.

Europe

The tough question is if European firms will be entering a time of "flight to quality" and judicious IT spending or drastic IT budget cuts much like what was seen in the aftermath of the "Internet Bubble".

We expect to see a "flight to quality" and more judicious IT spending. The combination of upward and downward pressures on IT spending should lead to an overall minor impact.

First, the causes of the financial crisis call for further investments in business intelligence, analytics, advanced risk management and compliance.

Moreover, the European banking industry is addressing the cost cutting wave by greatly diminishing employment costs by means of both firing and postponing/cutting permanent hires. At the same time those firms are forced to:

- Retail Banking: carry on investing in compliance, remote channels, Web security and addressing the Enterprise 2.0 – Web 2.0 issue;

- Insurance: continue compliance projects, such as Solvency II and IFRS Phase II as well as "ease of doing business" projects (agency portals, customer self-service, etc.). To support these initiatives, insurers will modestly increase their spending on service-oriented architecture (SOA) and straight-through processing. Driven by the need to do more with less, insurers will also look to business process outsourcing (BPO) as a more cost-effective means of running the business.

- Investment Banking – Asset Management: focus on updating trading and risk platforms as well better alignment to compliance. Moreover the complete review of the trading strategies calls for an assessment of the alignment of IT systems to the different business needs and requirements;

Most European financial institution IT departments are highly over-staffed with the IT personnel needed for the abovementioned areas. Demand for specialized IT contractors will increase and this could lead to a moderate growth in services rates.

In addition to cost cutting sentiment, will see some firms seriously considering and embracing outsourcing and near sourcing (the bigger services firms - Accenture CSC, HP, IBM, - will benefit greatly from this) and software-as-a-service (SaaS) will have a dramatic boost.

Asia/Pacific:

The impact of the worldwide credit crisis Asia/Pacific outsourcers will be the following:

- TCS, the world's largest IT services company, drew half of its income from the US market. It has decided to focus more on emerging markets in Asia/Pacific as well as in Latin America, the Middle East and Africa.

- Merrill Lynch was a key client of TCS, as well as Satyam. It is estimated that more than 2,000 employees of these two firms supported Merrill Lynch. Merrill Lynch's acquirer, Bank of America, runs its own captive unit in India.

- Lehman Brothers is understood to have just a few outsourcing deals in India, with sub-US$100 million relationships with TCS and Wipro (Wipro has a few hundred staff supporting software services and infrastructure management projects for Lehman Brothers).

- Genpact, one of the world's most prominent BPO providers signed a seven-year agreement with Wachovia to run its captive unit. The deal, worth US$1 billion (over the lifespan of the deal) is now in limbo.

Guidance

Advice for Banks

- Europe:

    - Untouched: Those financial service firms, especially in the capital markets segment, that have not been or have only marginally been hurt by the financial turmoil, should take advantage of the IT cost cutting sentiment to greatly invest in innovation to further advance and strengthen their competitive position and market share. It is also the right time to take a complete review of the current IT strategy and investment to determine the realistic changes required to enhance efficiency and drive growth at the same time. Brave companies will be able to make difficult decisions with regards to their existing systems, which will help them in reducing maintenance costs and boost discretionary spending to drive the company not only forward but also several steps ahead of the market. For those aiming to be consolidators, it is crucial to strategically develop and invest in infrastructure.

- Touched but not destroyed: Take a deep breath, try to wisely cut discretionally and what you can of non-discretionary IT spending, while considering your medium term strategy

- Asia/Pacific:

  - Will near-shoring be a better alternative for firms based in the US and Europe, especially if fees of Asia/Pacific outsourcers start to come down significantly?

    Captive operations of banks, especially those based in India, should quickly readjust charge-backs to parent companies, seeing that prices of third party outsourcers are starting to come down. Outsourcing companies are also more willing to offer their services to captives where previously there was a rivalry going on. Captive operations must take advantage of opportunities to import best practices of third party outsourcers and the knowledge that they have built in undertaking a variety of projects for global clients.

Advice for IT Vendors:

- Europe:

  - Reduction of players, troubled companies, and the cost cutting mood puts IT vendors in a difficult position: tough contract negotiations/renegotiations, postponed decisions on hardware and software upgrades, longer and complex sales cycles, higher discounts, etc. Thus, it would be wise to focus on quality. Competition among Fintech vendors big and small will be fierce, and for some of them it will be a battle to survive. Quality and delivery (especially in terms of time) at a reasonable price will be a key success factor. This implies a review, in a creative fashion, of the model and cost structure of research and development as well as production. Highly specialized presales people and a strong brand image could make the difference. It is a time to wisely cut/optimize costs and headcount, not to cut down for the sake of cutting.

- Asia/Pacific:

  - Outsourcing meant to keep the lights on, especially in the areas of infrastructure management; production support and maintenance will most likely see an uptick, especially since the cost management issue has become more prevalent. Transformational projects of financial institutions will most likely decline, and outsourcing activities in support of these long-term, "change the bank" programs will inevitably dwindle.

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