2012: A FINANCIAL ODYSSEY

What will financial services look like in the future? In part one of a two-part feature, **Rohit Talwar**, CEO, Fast Future Research, talks about the need to lay new foundations for recovery

Attend any conference, industry event or social gathering and you will find participants seeking to outdo each other with gloomy statistics and forecasts about the scale of the current problem. We are warned that record collapses in retail sales, housing prices, industrial output and new car sales are all indicators of impending doom.

With global subprime losses standing at $650bn against estimates of a total exposure of $1.4trn to $2trn, there is cause for concern. At the recent Lucerne European Futurists' Conference, forecaster professor John Casti suggested that the Dow Jones Industrial Average could fall to three figures, unemployment could rise to 25 per cent in leading economies and the European Union could completely collapse. Will China and India take up the slack? No one can say, but the phrase 'that could never happen' has been permanently banished from our vocabulary.

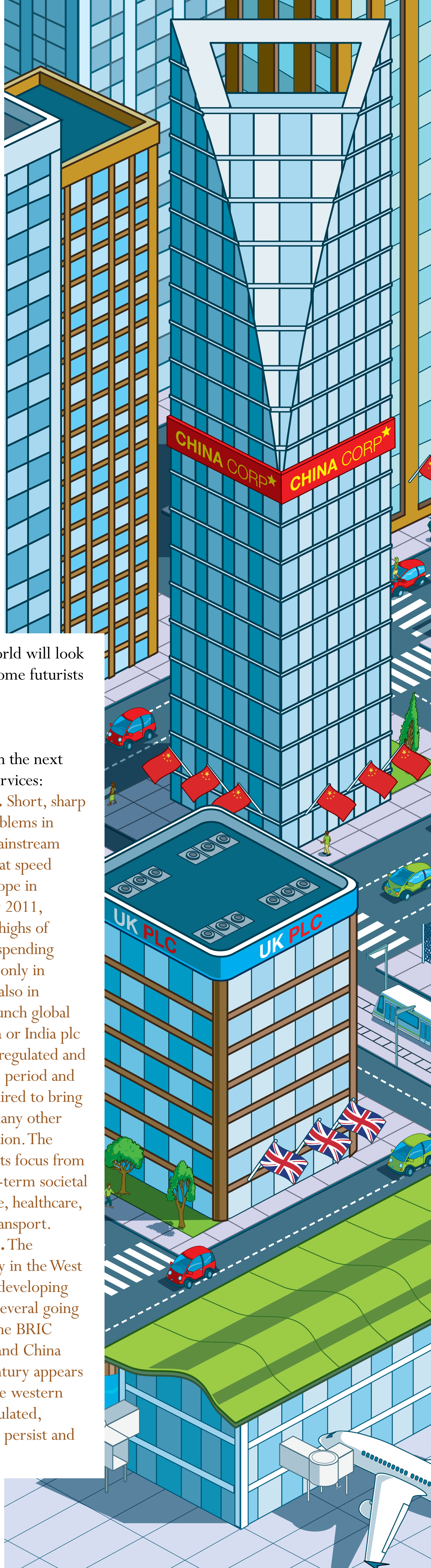
We also know that, while history tells us we can recover from the recession, it also provides evidence of the costs of recovery. Recent research from the International Monetary Fund examined 124 banking and financial services failures since 1970. It found that, on average, it takes up to seven years for a full recovery, the cost is about 13 per cent of GDP and the taxpayer gets back just 18 per cent of the bailout funds invested. With a total of more than $4trn estimated for the global recovery package, the stakes are high.

Any recovery process must address this loss of confidence in the real economy. Exit polls conducted at the US presidential election on 4 November showed that the overwhelming majority of voters disapproved of the $700bn bailout. There is also a growing understanding that there isn't a single outlook for how long or deep the recession will be and what the world will look like afterwards. We must all now become futurists and consider a range of scenarios.

Four paths towards 2012

There are four plausible ways in which the next five years may play out for financial services:

- **Scenario 1: The only way is up.** Short, sharp actions are taken to correct the problems in financial services and bolster the mainstream economy. The recession progresses at speed through 2009 but we see signs of hope in early 2010 and a global recovery by 2011, with growth rates returning to the highs of 2006-07 by 2012. China's $500bn spending programme is a major catalyst, not only in driving domestic consumption but also in acting as a stimulant that helps relaunch global confidence and demand. Will China or India plc outperform the US or UK? A well-regulated and transparent system evolves over the period and the international collaboration required to bring this about has positive benefits in many other areas, from trade to conflict resolution. The investment community has shifted its focus from short-term opportunities to longer-term societal priority areas, such as infrastructure, healthcare, education, green technology and transport.
- **Scenario 2: Back to the future.** The recession bites deeper, full recovery in the West doesn't start until 2011 and many developing economies begin to unravel, with several going into bankruptcy. Growth rates in the BRIC economies of Brazil, Russia, India and China drop. The much-vaunted Asian Century appears to have been put on hold. While the western financial system is gradually re-regulated, concerns remain that the problems persist and reforms have not gone far enough.



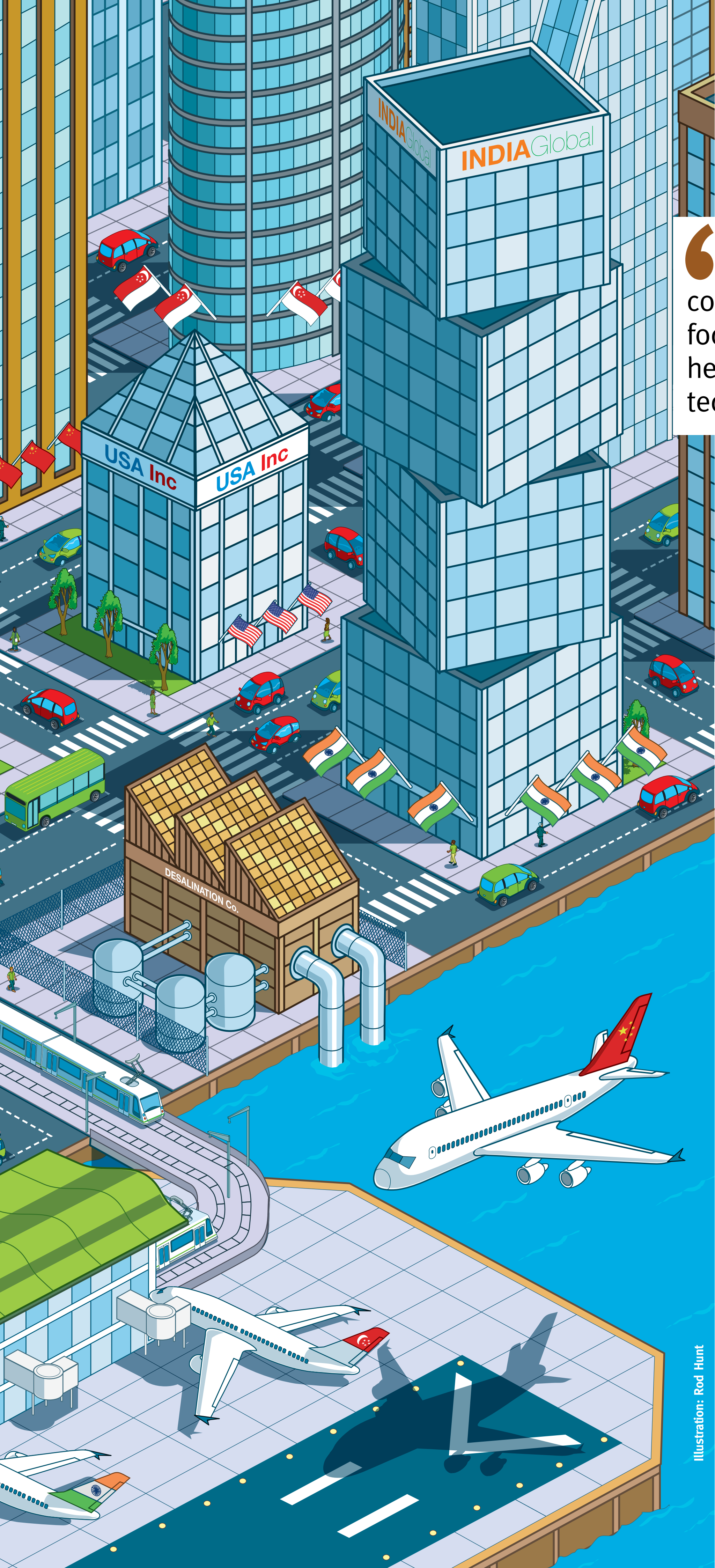


Illustration: Rod Hunt

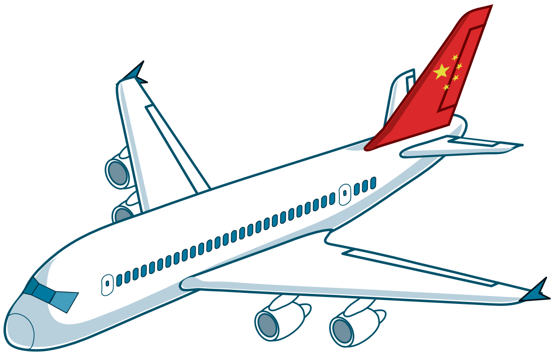
> "The investment community has shifted its focus on to infrastructure, healthcare, education, green technology and transport"

- **Scenario 3: Decoupled destinies.** The developing nations work together to prevent the crisis deepening. With tight financial controls and stimulus spending led by China acting to prevent a total collapse, their recovery starts around 2011. The flow of inward investment funds increases as foreign institutions, corporates and individual investors increasingly scale down their involvement in western economies and look to the developing world's major infrastructure programmes as the next source of opportunity. In the West, financial reform has been superficial and a further series of shocks from the financial markets help ensure that the first weak signs of recovery are not seen until the end of 2012 and a full turnaround is not evident until 2014-15.
- **Scenario 4: Road to nowhere.** Losses are far greater than anticipated, the recession worsens and there is no sign of recovery in most markets by 2012. By 2015, there is only a weak recovery. The picture is closer to the Great Depression, while many developing economies collapse and are forced to merge to remain economically viable.

Rebuilding for 2012

So what are the measures we need to take to steer us towards Scenario 1? The first step must be for governments to close stock markets. Their primary purpose was to raise money for business, but few players are conducting IPOs at present and stock market volatility is eroding confidence further. Industry players will argue that turmoil will ensue if you close the markets. This is patently nonsense. You cannot fix a car engine while it is still in motion.

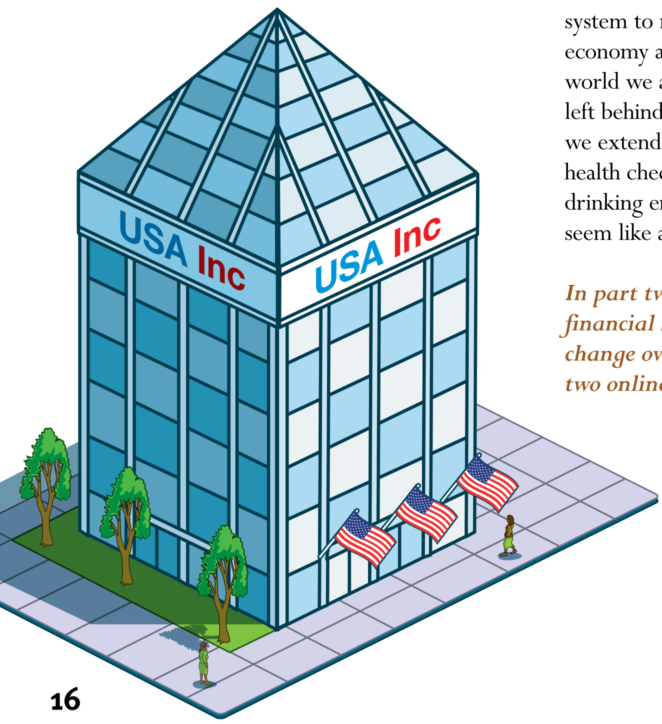
Governments and regulators need breathing space to develop recovery packages and sector reform programmes. Strict rules could be imposed to ensure that prices could not fall by more than 2 per cent a day for the first month after markets reopened. Closing the markets for up to three months might lead to some financial pain for the sector, but this is a price we must pay to get recovery on track and prevent future financial crises. ►



The regulators themselves need a deeper understanding of what they are trying to regulate. Firstly, charges levied on regulated firms will need to rise. Secondly, salaries for regulatory staff should become competitive with those they regulate to attract high-calibre staff. Finally, secondments should be compulsory – nobody should be allowed to take one of the top 5 per cent of jobs in any financial services firm without having spent a year working for the regulator. The regulator's talent pool would increase immensely, costs would be borne by their firms and both sides would have a much better understanding of the other. Regulation should apply to the activity, not the entity, to prevent the unregulated financial services sector from growing.

The next challenge is to simplify product structures. No instruments should be allowed that do not have a publicly traded element. No more than two layers of products should sit between assets and financiers. For example, banks could offer individual mortgages financed through bonds – but more complex derivatives would be banned. Whole sections of the market would disappear – but this is a small price to pay for greater transparency and control.

Banking reward schemes should be restructured. For the next ten years, bonuses should be paid only in share options that vest after seven years. The annual bonus would only be payable if an independently conducted and monitored satisfaction survey showed that 90 per cent of customers were happy with the service provided. Executive salaries should be set such that the highest earners receive no more than ten times the salary of the lowest paid staff. For the top few tiers of management, a sliding proportion of up to 50 per cent of their income would be placed in an independent loan fund for small businesses, which a new loan entity would administer; the fund would be topped up with government investment. The bank executives would receive shares in the fund and have an incentive to see loan recipients succeed.



Sorry is so hard to say

Perhaps one of the biggest complaints is that few have taken responsibility. This is remedied simply, without resort to court cases and fraud trials that could prove lengthy, expensive and ultimately unsatisfying. Instead, the top few layers of corporate management in the financial institutions that have caused the problems should be compelled to do public service one day a week for two years – whether or not they stayed with their banks. This group has completely lost touch with reality, so this would ensure that they regain contact with the world they are supposed to serve.

Many will argue that these measures will drive away top talent, but given that top talent got us into this mess, I'm willing to give others a chance. Others may say that the measures proposed would inhibit innovation, but maybe ordinary people will be happy with a far less creative financial services sector.

Nobody knows exactly how the future will play out, but many of the alternatives are unattractive. We need a radical overhaul of the system to reintroduce confidence in the wider economy and ensure that the system supports the world we are moving into, not the one we have left behind. We let the alcoholics run the bars, we extended the opening hours and the only health check we applied was to ask if they were drinking enough. Restocking the bars doesn't seem like a solution. ■

In part two, Talwar looks at how the global financial services industry landscape will change over the next five years. Read part two online at www.sii.org.uk