



Who am I? Existential Question for an Investment Bank

by Dr. Ashok Hegde

The events unfolding in the global financial arena have been unprecedented in the history of Finance and are a concern to every economy - where goods are produced, services are rendered and value is created through this exchange. Influences of these events have been felt by rather remote institutions such as the Nobel Foundation. The Nobel committee awarded the Nobel Prize for Economics to Paul Krugman who has advocated an interventionist capitalism where relationships between true economy and the finance world is looked at in detail by the federal banks, and the authorities are perceived as a more preventative machine than as a post-event analysis and penalty imposing institution.

This is the second time in the history of capitalism (first being the Great Depression of 1929), that the US Senate is discussing in detail means to overcome the challenges posed by what is termed now as the sub-prime crisis. It is believed that falling mortgage prices triggered the catastrophic events of the recent past world wide. In reality, the financial over-engineering and structured products which were hiding the true risk associated with assets, created this mayhem. It is first time in modern history (last 10 decades) that we are witnessing a crisis which has spread quicker than the bird flu.

At a summary level, Lehman Brothers filed for Chapter 11 of bankruptcy protection, Bank of America acquired Merrill Lynch, the US Federal Government picked up stake in AIG, and the UK government forced a marriage between Lloyds TSB and HBOS. In an unprecedented move, governments across the world embarked on initiatives to create funds to support valuation of money market instruments and to ease liquidity in the system. They are taking measures to ensure credit quality does not deteriorate further. For the first time in the history of financial economics, a synchronized bailout of banks and financial intermediaries is being planned and executed with the same vigor with which a government protects and defends its borders against invasion. Truly, we are now in a global economy sharing the pains of the world, at least, if not pleasure! It is the first time in history of trading where the regulators all around the world are looking into what appeared to be a general practice of short selling. To that extent, 'bear' and 'bull' concepts will be redefined. On a lighter note, the new definition of a bear could be the person who takes government approval to sell early to minimize the loss! To put things in perspective, except Goldman Sachs, the rest have lost their top 5 positions based on the net capital calculations in the Institutional Banking

space. Further, the independence of leading institutional banks are now restricted primarily due the approved Bailout Agreement. Lehman Brothers and Bear Stearns two of the largest capital markets firms are now no more. Together they constituted upward of USD 42 bn in net-worth. The finance world will surely miss them.

That was a recap of the events that occurred during the past few months, though the storm brewed much earlier when the first signs of weaknesses in mortgage business surfaced in the year 2005. Beyond this interesting and nerve-breaking recap, what I want to look into is the question - what it means to all of us. What will be the structure of investment banks in years to come and how will it impact the spending on IT and IT-enabled services. Considering these are the organizations which first moved significant work to offshore and have built captives as well as offshore development centers within their service provider organizations, these are important questions that we will collectively try to find an answer to.

I would like to take this question by looking into a more fundamental issue - do we believe financial intermediaries, especially Investment Banks whose primary business caters to lead management, structured finance and trading will remain the same or more importantly will they survive this crisis and continue to exist? And my answer is big YES to both the questions. In addition to my personal belief of free economy, I believe Investment Banks as institutions have a significant role to play and they are critical to any market's economy. As long as the fundamental principle of economics holds good - the households will save and industries will consume the savings to produce goods and services for consumption by households, remains the same, the role for intermediaries will continue in years to come. Will they remain similar to what we have seen them as of today? Yes. Not as big? Probably no. Will they offer same services with same or similar asset class comprised of all instruments including structured products? No. Space such as credit default swaps and credit based derivatives product innovation will come under microscopic view both from internal and external risk managers. Insurance companies which used to underwrite these products to get better credit rating will no longer touch these instruments. SEC, FSA and Federal and Central banks of the world will increasingly scrutinize the off balance sheet transactions and will have a say about the nature of business being carried out or any innovation in financial markets. Risk and Risk mitigation from proactive initiatives will be the dominant theme for the

next few years. More regulations will emerge for risk measurement emerging from market practices. If you remember, the Enron debacle was one of the most important drivers and the Sarbanes-Oxley Act was used to place tremendous importance on disclosure of accounts and internal control systems. I believe year 2009 will be the year of Financial Regulations covering all intermediaries and their roles in an orderly financial world.

What is interesting to note is that regulations and interventions may bring upon consolidation within this space. If you look at American markets today, there are about 8000 banks and 7500 credit unions serving a population of 305 million. This capacity is definitely high in an age where banking touch points are now getting as close as the phone. In addition, the fact that a majority - about 80 percent - of the population lives in the urban areas, creates an unfavorable environment for banks to make healthy margins and remain competitive. It is my belief that consolidation and focus on improving service quality will further propel changes within the financial intermediaries' operations and business.

From an information and technology perspective, I believe, in the short to medium term (next 24 months), investment into this space will decline by about 15 percent. Considering that in the last five years, Investment Banking organizations have continuously improved their operational efficiencies there may not be further room available for drastic reduction without impacting the core business. For customers, asset class choice may get restricted. However, fact remains that these organizations will need to cater to the needs of trading and trading related services of their customers who are part

of the real economy. They still need to trade, settle and account for it. However, they need to hold the instruments within their custody.

Though the challenges in front of the investment banks are significant and daunting, it has not changed the need for Investment Banking (IB) services. Investment banks' role may be slightly different post 2009. Their world which has hitherto been propelled by an unprecedented exposure will be far more orderly. No doubt resilience built over a period of time will help troubled institutions to tide over the crisis and come out stronger than before.

Please send your feedback to

Dr. Ashok Hegde, Vice President & Head - Capital Markets
at ashok_hegde@mindtree.com or call + 91 80 26265182

About MindTree

MindTree is a global IT and R&D Services Company co-headquartered in the U.S. and India. With a passion for customer satisfaction, MindTree partners with its clients to create a transparent, value-based relationship. Our domain experts deliver business-enabling solutions by leveraging a consulting led, framework-based and IP-driven approach. MindTree's IT Services business provides a range of services to CIOs across a variety of industry segments. Our R&D Services business works with Technology companies to help build innovative products by providing Product Realization services.

Capital Markets Group at MindTree enables you to develop an IT environment to achieve quicker trade, faster settlement, and near real-time risk management through our range of IT service offerings. The capital market group provides solutions for investment banking and management, derivative and alternative investment service providers, market data feed handlers, stock exchange/ ECNs business and business solutions packages (OMS, Matching Utilities and Accounting systems).