



The New Financial World

Fourteen themes that will shape it

Mark Cliffe, Chief Economist, ING Group

Mark Cliffe is ING Group Chief Economist and Head of ING Financial Markets Research. He is responsible for a global research team in 16 offices around the world, servicing institutional and corporate customers with research on fixed income, equities and FX, money market and derivative products.

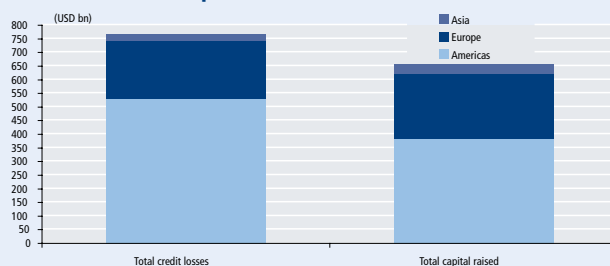
Mark travels extensively giving presentations to corporate and institutional ING-customers worldwide.

Over the past 25 years he has become well known in the international media. Prior to his career at ING he worked as Chief International Economist for HSBC Markets, Nomura Research Institute and ANZ Merchant Bank.

What will the new financial world will look like? While the crisis is far from over, there is broad agreement on some of its causes. This note outlines fourteen resulting themes that may define the future shape of the financial world.

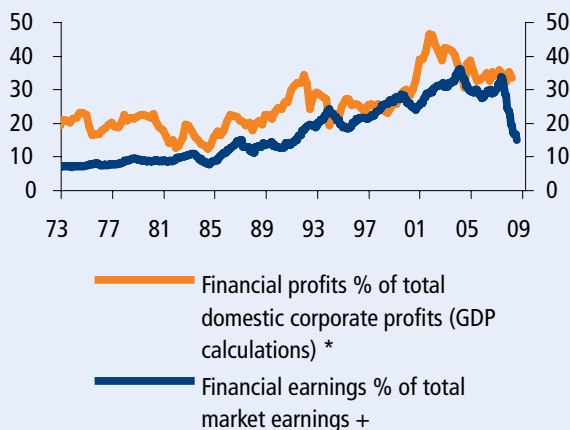
1. Tomorrow's rules won't be the same as today's
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Bank Losses & Capital Raised



Source: Bloomberg

U.S. Financial Sector Profits



Source: EcoWin, Datastream

Emerging consensus on the causes of the crisis points to 14 themes...

After the worst financial crisis since the Great Depression, things will never be the same again. But exactly what the new financial world will look like is unclear. The crisis is still far from over, and just when we think we understand it, another surprise pops up. Nevertheless, there is broad agreement on at least some of the causes of the crisis, and responses to these will help to define the future shape of the financial world. So what could that shape be? Here is a brief outline of fourteen forces that may drive the process:

The crisis keeps springing fresh surprises...

1. Tomorrow's rules won't be the same as today's

The crisis has wrong-footed observers repeatedly. This should make us wary of firm predictions of the new financial world. This sense of humility is reinforced by the realisation that the full extent of the damage caused by the crisis has not yet been realised. Thus the current tally of losses incurred by banks worldwide is over U.S. \$700 billion, but the final bill could be a multiple. As a result, the rules of the game may change several times before the picture becomes clear.

Figure 1: Global Bank Losses and Capital Raised So Far...



Source: Bloomberg

... forcing a rethink of previous orthodoxies

2. The law of unintended consequences

The law of unintended consequences has been at work in spectacular fashion in this crisis. Just one example should suffice: the previous celebration of the efficiency gains from the risk-spreading arising from the global distribution of structured credit instruments has given way to an awful realisation that the risks were concealed, and through the application of leverage, effectively multiplied in the process.

Efforts to make the system more robust may make recovery harder in the short term

Sadly, the law of unintended consequences will continue to apply. The severity of the economic downturn sparked by the turmoil will make everyone determined to avoid a repeat. The hope is that the prospect of a more conservative and robust financial system will revive confidence. But the danger is that the same prospects will make lenders and borrowers even more cautious in the short term, complicating efforts to revive the global economy. Thus banks, under pressure to raise their capital adequacy ratios to more 'prudent' levels in the face of a recession, will find it harder to step up their lending.

3. Back to Basics

Some of tomorrow's rules may look rather like yesterday's. Now that the credit boom has turned to bust, the financial sector is reverting to more traditional conservative practices. High returns from investment banks and hedge funds turn out to have been based on high levels of borrowing; they have been brought down to earth, in some cases with a

*Deposit gathering is
back in fashion*

crash. Suddenly, conservatively run banks with diversified sources of funding and large pools of retail savings are looking smart. The outsourcing of risk evaluation to the now embattled credit ratings agencies has given way to the idea that in-house credit skills are to be prized. Lending multiples have been reduced, and the cost of loans has risen to better reflect their risks. Even if these trends start to reverse in the next economic upswing, the reversal will be more cautious than it was in the past. If the price of this is a slower recovery, it is widely seen as a price worth paying for more stable and sustainable growth.

*Lending terms will
remain tougher*

4. The market isn't always right

*The boom was based on
faith in markets, and
market prices*

The credit boom was based on the belief that risks could be sliced, diced and priced efficiently by the financial markets. Fair value accounting was founded on the notion that market prices are the best measure of 'value'. Banks started to rely on the wholesale money markets, believing that they would always be a liquid source of funds.

*This has been shaken
by the crisis...*

These beliefs have been shaken by the crisis, which revealed that the financial markets fell well short of the perfection of the economics textbooks. When it came to the crunch, they lacked the large numbers of fully informed buyers and sellers required to produce viable prices and continuous trading. Some financial markets, old as well as new, simply shut down as a cloud of uncertainty over the scale and location of losses descended on the financial sector. Crucially, this led to a collapse in lending between, and to, banks. This massive market failure will have to be addressed in the new financial world. Transparent securities on open exchanges will be essential to the creation of liquid markets.

*... to be replaced by a
cloud of uncertainty
and mistrust*

5. The Age of Frugality

*A painful learning
experience for those
who borrowed
excessively*

Those who borrowed excessively are going through a painful learning experience. Some have been bankrupted as falling asset prices have combined with rising borrowing costs. Even those who escaped this fate will heed the lesson. In countries like the U.S. and the UK, where consumers borrowed heavily to fuel their spending, thrift will become fashionable. More expensive credit and the wealth losses that consumers have suffered will stimulate a rebuilding of savings. For their part, the banks, having discovered that the money markets can be a fickle source of funds, will be keen to cultivate retail savers by offering attractive interest rates and services.

6. Trust will need to be rebuilt

*Transparency will also
be required for a revival
in trust... and trading*

A collapse in trust in – and between – financial institutions has been both a cause and a consequence of the crisis. Confidence in the industry will need to be rebuilt, especially in markets where banks have failed. Financial institutions will have to show that they are worthy of consumers' trust and respect. Clarity about their financial strength, business models and products will be essential. Consumers, having had their fingers burnt with unexpectedly risky products or excessive leverage, will want to avoid a repeat. Transparency will also be required for a revival in trust, and trading, between financial institutions.

7. Keep it simple

*Complexity has been
another casualty of
the crisis*

Complexity has been another casualty of the crisis. Many investors, both individual and institutional, clearly did not understand the risks that the new financial markets were exposing them to. Indeed, even the banks and the issuers of many derivative-based securities failed to understand the complexity of the risks that they were running. So aside from transparency, simplicity will be appealing. This will lead to efforts to standardise products, which will have the incidental advantage of making them easier to trade. Consumers will demand easily understandable information about what they are buying. It will be all the more important for financial institutions to think from the customer's point of view.

8. Politicians will have their say

Financial institutions are under pressure to take non-commercial considerations into account

Now that taxpayers' money is on the line, politicians will have a crucial say in the shape of the new financial world. Popular anger at the real economic pain caused by the crisis will put pressure on politicians to press financial institutions to take noncommercial considerations into account. Now that some financial institutions are publicly owned or part state funded, they will be obliged to respond. This has been particularly evident in the U.S., where banks are attempting to head off more direct political intervention by modifying loans to troubled mortgage borrowers. More generally, politicians are calling upon banks to favour lending to domestic small and medium size enterprises, implicitly at the expense of other borrowers.

Politicisation of financial services is liable to intensify if the recession deepens

This politicisation of financial services is liable to intensify if the recession deepens. This will involve not just intervention on commercial decisions, but also the structure of the industry, as failing financial institutions force governments to pick the winners and losers with a view to consolidating the industry around the stronger players.

It is an open question how far this enhanced role for governments in the financial sector will persist. Most governments claim it will be temporary and that they do not wish to interfere in commercial decisions. However, the depth of the crisis is such that 'temporary' is likely to involve several years of involvement.

9. The paradox of thrift

The private sector in previously debt-fuelled economies will step up its savings...

The age of frugality points to the private sector raising its savings rate in previously debt-fuelled economies like the U.S.. After the searing experience of the current crisis, this is a rational response for the individual households, financial institutions and corporates concerned. However, as John Maynard Keynes pointed out, if everyone tries to save more this reduces spending, economic growth, and therefore the total level of savings in the economy as whole. He called this the 'paradox of thrift'.

... forcing the public sector to pick up the slack by borrowing more

One answer to this is for the public sector to pick up the slack by reducing its savings, in other words increase its borrowings, to compensate for higher savings in the private sector. In fact, government borrowing tends to rise anyway in a downturn as tax revenues fall and spending on welfare rises automatically. However, as we have already seen in the U.S. and Europe rising unemployment is leading governments to take additional measures, including tax cuts and extra spending. The side effect of this is that government deficits will deteriorate even more rapidly. This in turn will mean that investors will have to absorb a sharp increase in the supply of government bonds. Moreover, to the extent that governments try to stimulate their economies through extra spending, their overall role in the economy will grow.

One gap is "macro-prudential", systemic-focused regulations

10. Tougher discipline will be imposed

The list of needed regulatory changes is growing

The crisis is prompting regulators to pledge "never again!" As the crisis has unfolded, the list of regulatory changes that need to be addressed has lengthened. From its origins in the U.S. sub-prime mortgage market the crisis has morphed into a global contagion. The systemic nature of the crisis has revealed glaring gaps in international and domestic regulation. The new buzzword here is "macro-prudential", whereby regulations should focus on systemic stability and avoid exacerbating cycles. An example of the latter is the way in which rising asset prices tended to boost the measured capital adequacy and lower the measured risk of financial institutions, thereby intensifying the upswing by encouraging them to take more risk and increase lending. Tougher rules on capital adequacy and liquidity ratios are inevitable.

Transparency and consumer protection will also be strengthened

A second category of regulation concerns market integrity, which will prompt moves to improve disclosure and transparency. These include the efforts to shift the massive credit default swap market, and the over-the-counter market, which has been the locus

of much of the problems in the crisis, on to an open exchange. A third category of regulatory change is consumer protection. The terms and structure of U.S. mortgage loans will be an immediate focus of attention.

11. Central banks to pay more attention to asset prices

Past tolerance of asset price booms is now being criticised

The plunge in asset prices is forcing central banks to reconsider their previously largely passive attitude to the preceding boom. This approach, whose most vocal advocate was former Federal Reserve chairman Greenspan, was based on the belief that central banks could not second-guess the decisions of millions of investors, and therefore could not attempt to prick asset price “bubbles”. Instead, the central banks should step in merely to tidy up afterwards once the bubbles revealed themselves by bursting. This asymmetric approach, whereby rising asset prices were tolerated, while the subsequent sharp falls prompted monetary easing, has been widely criticised as having contributed to recent bubbles by encouraging excessive risk-taking.

Central banks may clamp down on strongly rising asset prices and credit growth in future

It is still not entirely clear how central banks will factor this critique into their thinking in future. Nevertheless, it seems likely that central banks will make more determined attempts to clamp down on strongly rising asset prices. They are also likely to pay more attention to credit growth, particularly lending within the financial sector, since rising leverage was at the heart of the credit boom that precipitated the current crisis. As a result, interest rates may be raised at an earlier stage in the next cycle. This is another reason to expect that the economic upswing may be more subdued than earlier cycles.

12. From globalisation to localisation

‘Economics is global and politics is local’

It is said that ‘economics is global and politics is local’. The inevitable politicisation of the crisis as it has intensified has raised real questions about the sustainability of the globalisation trend of recent decades. Why should taxpayers bail out foreigners? This question has greatly complicated efforts to address the casualties of the crisis. While most politicians in recent years have come to welcome the economic efficiency gains arising from international trade and capital flows, the downturn is confronting them with difficult questions about the equity, even morality, of market-based capitalism. The blame game, which has been raging for over a year now, has become more intense as the crisis has engulfed more countries as capital flows have been repatriated and the commodity boom has turned to bust.

Government intervention inevitably starts at the national level

Although a laudable search for global solutions is under way, greater self-reliance is likely to be the tendency for countries, just as it is for individuals, at least for the next few years. The rebuilding of trust and regulation, along with government intervention, will inevitably start at the national rather than the global level. Global financial institutions may be forced to embrace ‘multi-local’ business models to thrive in this new world.

Self-reliance also points to a global rebalancing of saving and investment flows

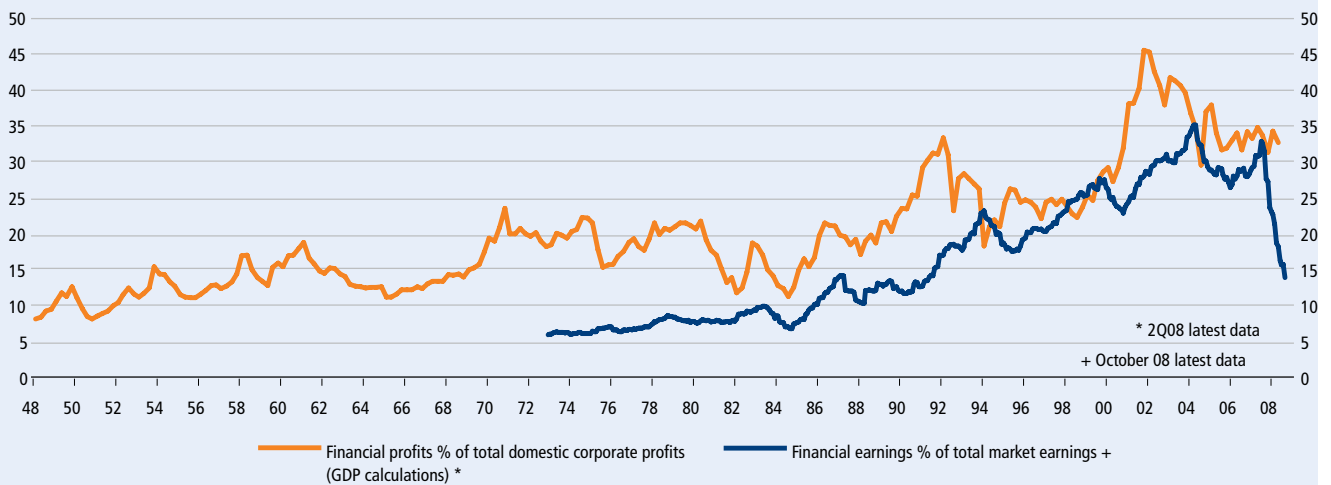
Another aspect of the shift towards self-reliance is a global rebalancing of saving and investment flows. Government policy is likely to encourage a move away from dependence on foreign capital. Debtor nations, led by the U.S., are likely to increase their domestic savings. The flipside of this is that creditor nations, led by China, will find it tougher to pursue export-led growth and will therefore have to boost domestic spending. Now that ‘cash is king’ and creditors royalty, this will accelerate the rebalancing of global economic and financial power towards the East.

13. A more competitive financial eco-system

Deleveraging has already changed the shape of the financial services industry

The financial crisis has already changed the shape of the financial services industry. The collapse in asset prices and savage deleveraging has already put paid to the heavily-leveraged business models of the U.S. investment banks and players in the so-called 'shadow banking system' such as hedge funds. State involvement in the regulated banking and insurance sectors has stepped up dramatically in recent months, and the functioning of many financial markets is dependent on extraordinary central bank liquidity infusions and support. Although these extraordinary interventions will be reversed once the crisis abates, this will still leave big questions about the structure and competitive landscape of the industry in the longer term.

Figure 2: Financial sector profits as a proportion of total profits (1948-2008)



Source: EcoWin, Datastream, ING

Those that avoided the toxic complexities of the crisis may continue to thrive

Smaller and more conservative financial institutions that avoided the toxic complexities exposed by the crisis will probably continue to thrive, but bigger institutions may face more aggressive restructuring. Marriages forced by the crisis may be followed by some complex divorces once regulators start to refocus on concerns about competition and excessive concentration in the industry. Global financial institutions will certainly face intense scrutiny, requiring clarity in their business models to justify their existence to regulators, investors and customers.

The long boom in financial sector profits is probably over

There will be no quick return to the long boom in financial sector profitability that has been running for the last 60 years (see Figure 2). Even once the current recession has ended, structural changes in the industry will weigh on profitability. These include lower leverage (which itself may crimp the next economic upswing), tougher regulations and possible extended state involvement, as well as margin pressures from product standardisation.

14. The cycle still exists... there will be an upswing

*Even super-cycles are
prone to busts...
... but aggressive policy
easing should stave off
depression
Savers will rebuild their
wealth...
...and there's still scope
for structural growth in
the emerging markets*

Not so long ago there was still talk of a 'super-cycle', despite the evident distress in the developed world. Subsequent events have shown that even super-cycles are prone to busts. Nevertheless, aggressive policy responses should reassure us that another Great Depression is not in the offing and that a recovery will ultimately emerge. Indeed, the crisis presents some tremendous opportunities as asset prices are driven down to below depression levels.

Moreover, while the financial sector faces strong headwinds, there will be positive countervailing forces. Thus, the industry will benefit from savers' efforts to rebuild their wealth, while in the emerging markets there is still scope for structural expansion of financial services. Survivors with strong, innovative brands will benefit from higher margins as competitors disappear from the scene, and public-sector-led investment initiatives, such as on infrastructure and energy, will present attractive long-term opportunities. The new financial world, while chastened and more conservative, will eventually shake off the current gloom.

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