OLIVER WYMAN

10th Annual

State of the Financial Services Industry | 2007

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

About this report

Oliver Wyman's annual State of the Financial Services Industry report reviews the industry's performance and provides senior management with key insights for successfully navigating an evolving competitive landscape.

Our findings are supported by Oliver Wyman's deep financial services expertise and a number of proprietary analyses, including:

- An objective ranking of the world's largest 400 quoted financial services firms based upon our Shareholder Performance Index℠ (SPI)
- Projected industry value growth and top management priorities for the coming year from our annual CEO Growth Survey

Please note: many of the names in this report are existing and previous Oliver Wyman clients.Any statements pertaining to such clients have been derived from publicly available information.

Financial services 2007

In a market where capital is flowing freely in search of returns, 'winners' are coming from all regions and sectors. Achieving outperformance requires that firms 'think like capital' to identify and execute on their most attractive opportunities.

Executive summary

Investors in financial services had a great year in 2006. With shareholder returns of 26%, the industry reached a record $10.7 TN in market value.

Although returns have been strong for four years running, there is reason for caution. Participants in our annual CEO Growth Survey expressed concern about a number of medium-term trends. Slowing economic growth combined with soft real estate markets, flat yield curves and high consumer debt loads in mature markets threatens to create significant top-line challenges for many businesses. Strong contributors to recent industry growth may be among those most impacted businesses, including mortgage, home equity and asset-backed lending, consumer credit and structured finance. At the same time, increased competition for talent is creating cost problems that place downward pressure on margins.

After several years of robust and continuous growth, is the party finally over? While our outlook remains optimistic for the overall industry, we see value growth increasingly skewed toward nimble companies with superior execution that are actively migrating their positioning to benefit from high growth and high margin markets.

- Premier Performers of the past decade show that sustained long-term outperformance is possible independent of a company's sector or region, exceeding Market Performer returns by an impressive average of 8% per annum.
- Firms backed by private capital demonstrate that pockets of opportunity to build value remain available in financial services, and firms should 'think like capital' as they look for their own expansion initiatives.
- Specific megatrends are creating a favorable tailwind for sustained profit growth in some specific product and geographic sectors.

In this, our 10th anniversary State of the Financial Services report, we explore how companies can successfully navigate a changing marketplace to join tomorrow's winners' circle. ■

Market developments in 2006: Another record year

Key findings

- Market value growth in 2006 of 26% was well above the historical trend of 13%.
- Results were driven primarily by strong revenue growth and cost control, combined with a low loss environment.
- Emerging markets are an important driver of industry growth, representing 29% of the increase in total market value over the past five years.

Against a background of robust global economic growth of 3.8%, 2006 was another strong year for the world's financial services industry. The total global value of all quoted financial services companies grew by 26% in 2006 to a record $10.7 TN[1], driven by a strong performance in mature markets (22%) and outstanding results in emerging markets (43%). Indeed, the emerging market countries of Eastern Europe, Asia (excluding Japan), Latin America, and the Middle East and Africa now represent 21% of the total market value of global financial services and contributed nearly $688 BN of the $2.2 TN overall growth in value.

After four years of strong growth, there are signs of the markets' increased confidence in financial services' medium- to long-term growth prospects. In 2006, the industry's market value grew faster (26%) than that of non-financial sectors (22%). In addition, the PE ratio for financial services increased slightly to 15[2], while that for non-financial services sectors remained steady at 18, continuing a three-year trend toward the narrowing of financial services' relative discount, which currently stands at 18%. At the same time, not all market segments fared equally; many super-large-cap companies appear to suffer from a size penalty (Figure 1).

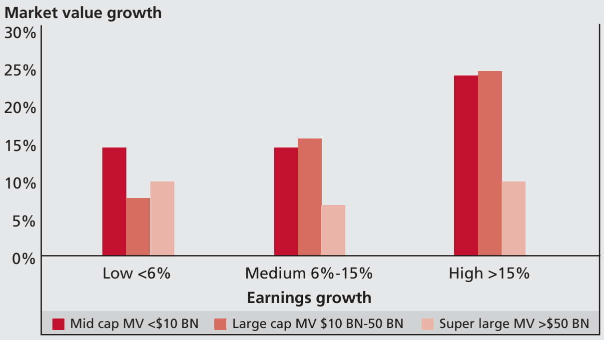
Based on a sample of the largest SPI 400 companies[3], earnings were of a high quality, driven by surging revenue growth and stable profit margins. The average cost-income ratio remained unchanged from last year:

- Average revenue grew by 18%, compared to 13% in 2005;
- Average cost-income ratio remained at 61%;
- Average ROE increased from 16% to 19%.

This year's results were supported by a low loss environment, strong bank credit quality and an absence of weather-related catastrophes, such as the hurricane seasons in 2004 and 2005 that caused more than $150 BN in property damage. ■

Market reward vs. company performance

Figure 1: Market value growth by level of EPS performance[4]



- Investors awarded greater market value increases to higher EPS growth mid- and large-cap companies. As a group, however, super-large caps appear to suffer from a size penalty across medium and high levels of performance, most notably in Europe.
- The gap in market value growth of super-large caps compared to large caps in the medium and high performance categories ranged from 9% to 15%. This represents a complete reversal from the prior five-year period, when super-large caps enjoyed a premium of 12 percentage points.
- Potential explanations for this gap include skepticism regarding future growth prospects and a fear that bigger companies may be more likely to participate in M&A activities that destroy shareholder value.
- One-fifth of super-large caps are exceptions to the discount. JPMorgan Chase, for example, has made significant progress bridging the firm's legacy cultures to achieve operational efficiencies and strong revenue growth in leading franchises in investment banking and commercial and retail banking.

1 Source: Datastream financial services index (excluding real estate and including health insurers)
2 Source: Datastream
3 Due to reporting period limitations, revenue growth is calculated by comparing the first half of 2006 to the first half of 2005. Source: Bloomberg, Bankscope, and interim company reports
4 Source: Datastream, Oliver Wyman analysis

Rising above the field: Premier Performers reveal the keys to sustained outperformance

Key findings

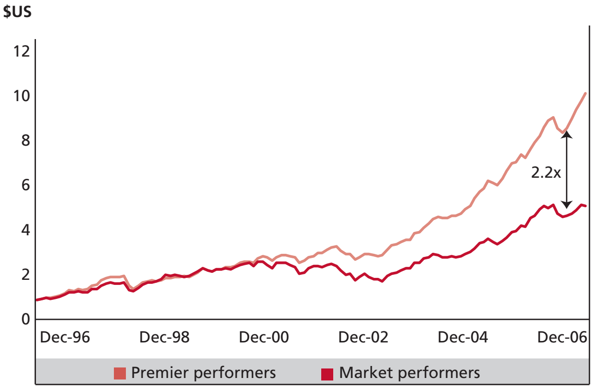
- Industry bifurcation is growing with the top performers widening the gap with the rest of the industry. The 54 best-performing companies delivered average annual returns 8% above the rest of the market over the past decade, increasing from 4% in the period from 1997-2001 to 16% from 2002-2006.
- Premier Performers successfully employed a full range of growth capabilities, including organic, in-market consolidation and adjacent market and cross-border expansion.
- Future winners will learn from Premier Performers by improving their growth capabilities and 'thinking like capital' to target the highest value growth opportunities, wherever they may be found.

To identify the keys to long-term success, we analyzed firms that have historically outperformed their peers and regions based on Oliver Wyman's Shareholder Performance Index (SPI)SM. We defined as 'Premier Performers' the 54 firms with SPI scores consistently above the average SPI for their respective subindustries and regions over time periods of three, five and 10 years. These firms represent nearly 17% of the SPI 400 market value. We identified as 'Market Performers' the 262 institutions that appeared in the SPI during these time periods, but did not meet the criteria for premier performance.[1]

The value of sustained outperformance is significant; Premier Performers generated returns nearly 2.2 times greater than those of Market Performers over the past 10 years (Figure 2). Premier Performers delivered average annual return premiums above Market Performers of 14%, 16% and 8% in the three-, five-, and 10-year periods respectively.

By contrast, most bottom performers continue to underperform. Of the 100 fourth quartile firms from our first State of the Financial Services Industry report in 1997, 44 were either acquired or failed to keep pace with industry growth and fell out of the top 400. Only nine of the remaining 56 companies have risen to the top quartile.

Figure 2: Value of Premier Performer outperformance



Growth in value of $1 invested in each of Premier Performers and Market Performers over the past 10 years. Following five years of mostly similar returns between 1997 and 2001, Premier Performers have outperformed Market Performers by an average of 16% per annum since January 2002.

About the SPI

Oliver Wyman's Shareholder Performance IndexSM (SPI) is a global measure of relative shareholder performance covering the 400 largest quoted companies in global financial services. The firms included in the SPI have a combined market value of $8.4 TN, more than three quarters of the $10.7 TN global total. The calculation of the SPI enables consistent comparisons of shareholder returns by adjusting for the volatility of returns, differences in local interest rates and mergers and acquisitions.

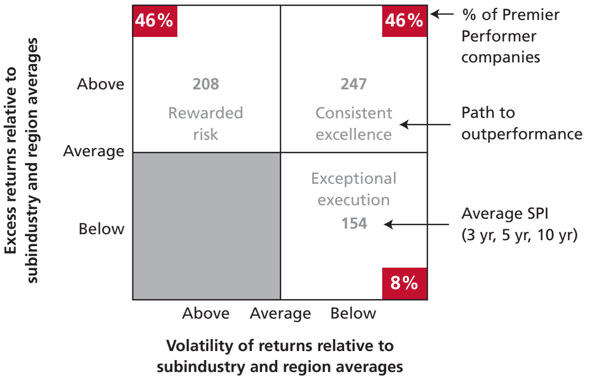
Though concentrated in Europe and North America and in retail and commercial banking, Premier Performers include both mid-cap and large-cap companies in both strong and weak performing regions and sectors.

Premier Performers share several key attributes. Nearly all (94%) have multiple business lines catering to both retail and corporate/institutional clients, enabling them to grow throughout all phases of the business cycle. More importantly, their strong management teams, high cost efficiency and robust operational controls enable them to concentrate resources on identifying, and positioning themselves to benefit from, the highest value growth opportunities. We call this 'thinking like capital.'

As Figure 3 shows, Premier Performers followed one of three paths to outperformance, which we have termed 'Rewarded Risk,' 'Exceptional Execution' and 'Consistent Excellence.'

1 We chose three years as the minimum period in order to reflect a company's execution performance and to minimize exogenous short-term market fluctuations. We selected 10 years as the long-term horizon in order to consider performance across business cycles and typical management team tenures, demonstrating a company's ability to successfully navigate succession planning with minimal shareholder impact.

Figure 3: Average SPI and path to Premier Perfomer outperformance



Note: Firms achieved Premier Performer status through superior returns, lower volatility or a combination of both.

Nearly half of the Premier Performers pursued the path of ‘Rewarded Risk.’ These companies are typically in high-volatility sectors (such as investment banking), have significant exposure to less commoditized, high-margin products or participate in riskier, high-growth markets.

‘Rewarded Risk’ firms have an average SPI (208) that is lower than that of ‘Consistent Excellence’ firms due to higher volatility. Their average cost-income ratio over the past 10 years (70%) is the highest of the three categories, due partly to higher talent costs and fewer opportunities to exploit operational efficiencies. Lehman Brothers (SPI 142) has followed this path, investing heavily in faster growing but less predictable Asian markets.

The smallest category, with only 8% of Premier Performers, is ‘Exceptional Execution.’ The low number of companies represented highlights the difficulty of achieving superior shareholder performance through volatility management alone. This avenue is typically associated with high cash-flow businesses in maturing markets. Accordingly, these firms have the lowest average SPI (154) and the best average ROE (18%) and cost-income ratios (62%).

The third category, accounting for 46% of Premier Performers, is ‘Consistent Excellence.’ These firms have the highest average SPI (247) and represent the ‘best of the best,’ achieving both higher average shareholder returns and lower volatilities than their peers. Encompassing firms from a range of geographies and sectors, this path is open to nearly every company with the right combination of strategy and execution.

Interestingly, the ‘Consistent Excellence’ category had the least volatile ROE of the three groups over the past decade. The average ROE for ‘Consistent Excellence’ firms (15%) is the same as that of the ‘Rewarded Risk’ group and less than that of ‘Exceptional Execution’ companies. As one might expect, the average cost-income ratio (65%) is between those of the other two groups, demonstrating that strong revenue growth continues to be more important than cost efficiency in creating shareholder value.

Achieving the highest return with the lowest volatility possible requires firms to possess a keen understanding of their execution capabilities. This entails knowing where they excel, where they lag and how they can improve with respect to organic growth from launching new products, developing new business lines and expanding into new markets, and also with respect to inorganic growth driven by in-market, adjacent market and cross-border mergers.

Each of these capabilities requires a number of specific skills. For example, launching a new product requires close coordination between product development, marketing, finance, sales, IT, treasury, legal and compliance and, frequently, other business units.

By comparison, an effective M&A capability demands other core competencies, which themselves will vary with the nature of a particular transaction. Strategic planning is critical for identifying high-priority capability gaps, surfacing alternative solutions and their associated economics and helping business sponsors to articulate the right integration path. Finance typically leads negotiations in partnership with legal in order to value, structure and execute transactions. Human capital management provides key input for structuring compensation and retention agreements and developing key employee messages. Investor relations conveys the strategic rationale to shareholders and the investment community. Finally, the business itself is responsible for integration and achieving the envisioned economics for the combined entity. In addition to ‘hard’ skills such as IT, branch and call-center integration, ‘soft’ skills like developing sufficient management depth and capacity, gaining cultural alignment and employee buy-in and formulating a compelling client value proposition are all critical determinants of success.

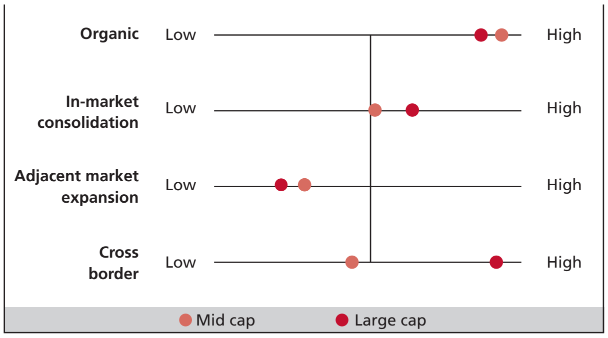
As a group, Premier Performers continually seek to expand their organizational capabilities, allowing them to undertake increasingly sophisticated initiatives and unlock new sources of value. We have identified four primary growth strategies of Premier Performers:

- Organic growth;
- Domestic in-market consolidation;
- Domestic adjacent market expansion;
- Cross-border growth.

It is noteworthy that there is a wide difference in perceived level of risk among these strategies, as organic growth is typically seen to be less risky than cross-border expansion. However, as we observe more and more frequently, risk to other companies becomes high-value opportunity to firms that have the right sets of competencies.

The frequency with which Premier Performers employed these four growth strategies is shown in Figure 4 below.

Figure 4: Percent of Premier Performers employing growth strategy



With 90% of the Premier Performers pursuing organic growth as a primary driver, home-grown expansion is the bedrock of strong performance. W.R. Berkley (SPI 298), a ‘Rewarded Risk’ insurance provider headquartered in the US, attributes the origin of 23 of its 31 operating units to organic growth.

More than half of the Premier Performers also sought to accelerate growth through in-market consolidation. Sydbank (SPI 561), a ‘Consistent Excellence’ universal bank, has grown its presence in Denmark and neighboring Germany with a series of acquisitions of regional banks starting in 1996. Among the smallest of the top 400 firms with a market cap of $3.3 BN, Sydbank had the highest SPI of all mid-cap companies.

Adjacent market expansion was the least common strategy, employed by only a third of the Premier Performers. This approach is most frequently used by mid-cap companies to increase the scope of potential profit pools and leverage established distribution channels. For example, India’s Kotak Mahindra Bank Group (SPI 335), a ‘Consistent Excellence’ retail and commercial bank, entered the life insurance business by forming a majority-owned joint venture with England’s Old Mutual in 2001.

Over two-thirds of Premier Performers successfully managed the risks of foreign market expansion. Perhaps unsurprisingly, more than twice as many large-cap companies were active in cross-border expansion as mid caps; larger companies have both greater resources and a bigger need for tapping new markets to support growth. Denmark’s largest retail and commercial bank, Danske Bank, (SPI 203), a ‘Consistent Excellence’ Premier Performer, represents a good example, acquiring Northern Bank and National Irish Bank from National Australia Bank Group in 2005 to gain access to the fast-growing Irish marketplace.

Mid-cap companies in small or slow-growing geographies were also frequent cross-border acquirers. For example, Morocco’s largest retail and commercial bank, Attijariwafa Bank (SPI 254), an ‘Exceptional Execution’ Premier Performer, teamed with Grupo Santander in 2005 to acquire a 33% interest in Tunisia’s Banque du Sud.

In conclusion, we see growing bifurcation of the financial services industry, with the marketplace being defined more and more by winners and losers. We expect the players that are best able to ‘think like capital’ by identifying and executing on the highest-value domestic, and, increasingly, foreign market opportunities to continue to be rewarded with outsized returns. ■

Finding new ways to compete: Private capital and its growing role in financial services

Key findings:

- PE firms have invested an estimated $70 BN in financial services since 2000, amounting to 0.7% of the industry's total current market capitalization.
- Private capital is leading the charge to identify new business models in order to profit from a changing financial services marketplace.
- Successful strategies for mainstream competitors will include developing the agility to innovate rapidly and a relentless focus on improving value-chain economics.

Private equity

Supported by innovations in securitization such as CDOs, and with high-yield credit spreads on investment-grade debt at 10-year lows, private equity dealmaking hit new highs in 2006. This trend is set to continue, given the industry's record $401 BN in new private equity commitments.[1]

Private equity is now able to provide levels of capital previously only available to companies through public markets, significantly expanding the frontier of possible transactions. With the largest fund now approaching $20 BN and the largest five PE firms estimated to control more than $2 TN in accessible capital[2], PE's role in reshaping the overall corporate landscape, whether by bringing public companies private or private ones public, has never been greater.

Compared to public companies, private equity firms enjoy several key competitive advantages. As they are not beholden to quarterly analyst targets, they are able to invest with longer time horizons. In addition, they are free of many regulatory burdens; this reduces expenses and often allows them to operate with greater leverage (i.e. a lower weighted average cost of capital). Moreover, with fewer shareholder restrictions, private equity firms are free to structure lucrative compensation packages to attract the industry's most senior and experienced talent.

The financial services sector remains a low priority for most private equity firms, garnering a portfolio allocation of less than 5%. Potential explanations for that figure include: robust existing competition, high capital intensity, the industry's already high use of leverage, and regulatory restrictions regarding dividend payments.

However, for a group of 15 to 20 of the largest PE firms with the requisite appetite, industry expertise and access to funding, financial services is an important strategic focus. Cerberus Capital Management's acquisition of a controlling interest in GMAC Financial Services for $14 BN in November 2006 is the largest transaction to date and is representative of private equity's growing role in the evolving financial services landscape. Indeed, the past two years have witnessed four times the level of private equity investment activity of the previous five years combined.

Since 2000, private equity firms have invested approximately $70 BN in financial services-related companies, equivalent to 0.7% of the industry's total current market capitalization. Garnering 80% of the investment dollars, specialty providers, brokers, reinsurers and consumer finance companies represent the most active subsectors.

We have identified the following four dominant private equity investment themes with respect to financial services:

Value chain unbundling

Private equity has historically been most closely associated with value chain plays specializing in technology-driven trading, processing and outsourcing (Figure 5). We expect this trend to continue given ongoing business process restructuring and further penetration of electronic trading across products and geographies.

Distressed properties/turnaround

Several players have sought to replicate Ripplewood Holding's estimated $3.5 BN gains from an investment in Japan's distressed Shinsei Bank following the Asian debt crisis. Most notably, Cerberus Capital Management's $3.3 BN IPO of Aozora Bank (formerly Nippon Credit Bank) in November 2006 represented Japan's largest IPO in eight years. More recently, Texas Pacific Group has announced its intention to invest $1 BN in Japanese regional lenders, consumer finance and insurance companies.

1 Source: Private Equity Intelligence
2 Source: *Mergers & Acquisitions*, September 2006

Ownership transformation

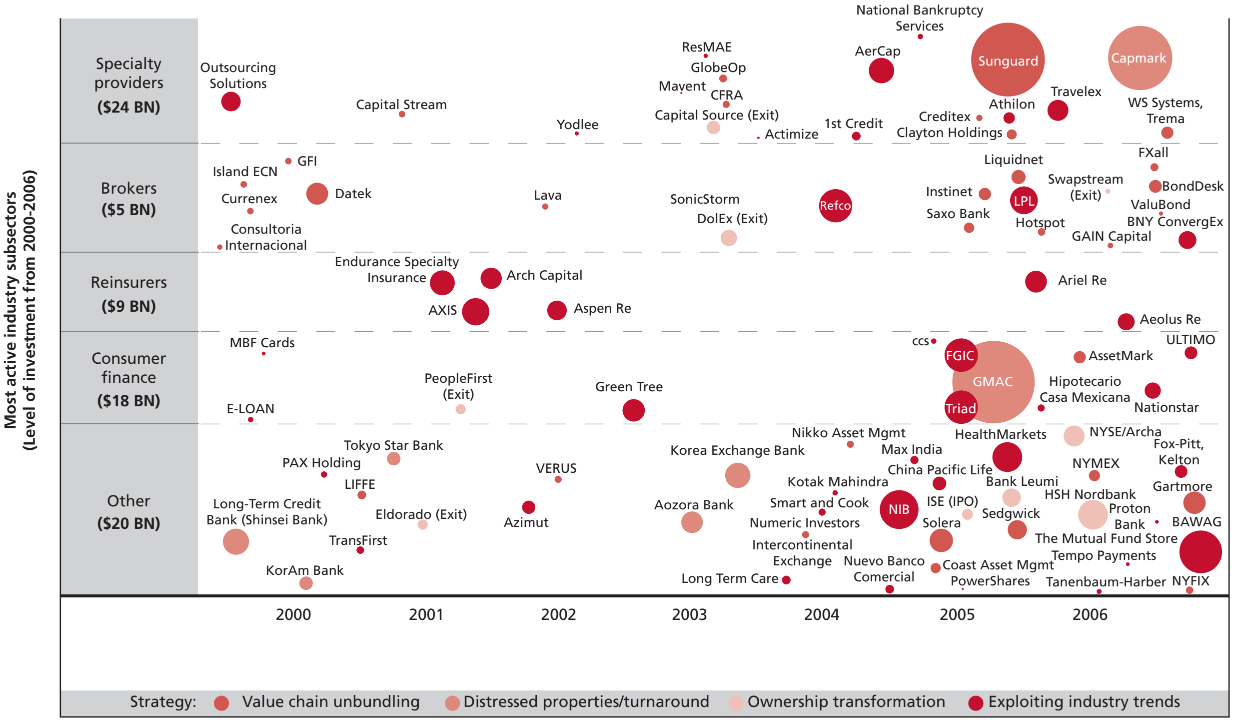
Another private equity approach seeks to profit from the process of ownership transformation. In September 2006, an investor group led by J.C. Flowers & Co. purchased a 26% interest in HSH Nordbank in anticipation of an IPO that would privatize the state-owned German Landesbank. Another good example is NIBC Bank, a privately-held Dutch bank, which is considering a $3.2 BN IPO in early 2007.

Exploiting industry trends

Drawing upon its competitive advantages, private equity is developing new models of competition to aggressively attack opportunities revealed by emerging trends. With a focus on specialty providers, subprime lending, credit insurance and re-insurance, notable examples include BNY ConvergEx Group, Nationstar Mortgage, Pension Insurance Corporation – a UK pension liabilities management firm and multiple Bermuda-based reinsurers.

Looking ahead, we see private equity-backed companies continuing to represent a small fraction of the overall financial services market. They will nevertheless make a significant impact on their chosen sectors. In response, managers of public financial services firms need to be able to 'think like capital' to identify growth opportunities and direct investment decisions. The best offensive strategies for established players are developing the agility needed to innovate rapidly and maintaining a relentless focus on identifying new opportunities that can confer scale and cost structure advantage. For example, some mainstream firms are considering new business models that combine private equity's advantaged funding with proprietary origination capabilities in order to engineer superior lending economics.

Figure 5: Selected private equity transactions in the most active industry subsectors



Note: Circle size represents the value of the private equity transaction (as publicly disclosed or estimated from public sources).

Hedge funds

Following five years of 20% average annual growth, an estimated 7,000 global hedge funds currently hold assets of $1.3 TN.[1] Not all firms have benefited equally; larger firms with more mature infrastructures for trading, custody, risk management and compliance have won a disproportionate share of increased institutional allocations. Indeed, the top 100 firms currently control more than 65% of industry assets, up from 58% in 2004.[2] With a recent study forecasting a trebling of institutional assets allocated to alternative investments by 2010[3], we believe the market will continue to migrate to mature players employing lower volatility strategies, creating a powerful force for industry consolidation.

Though they comprise only 2-3%[4] of global managed assets, hedge funds have an influence on capital markets far surpassing their market share. Representing an estimated 30-40% of all trading commissions, hedge funds benefit the financial services industry like no other, dominating trading in cash equities, listed options, credit derivatives and commodities. At the same time, as private lenders, hedge funds have assumed a significant presence in the rapidly growing $224 BN[5] institutional market for corporate debt and have entered middle market and small business lending.

Adapting to increased competition for short-term profit opportunities, some hedge funds have become longer-term holders, leading to owner activism from which financial institutions themselves are not immune. Notable examples include The Children's Investment Fund's successful agitation for the removal of Deutsche Boerse Group management to prevent a merger with the London Stock Exchange in 2005 and Sovereign Bancorp's more recent experience in its battle with Relational Investors with regard to a $2.4 BN strategic investment from Grupo Santander.

Fortunately the spectacular failure of Amaranth Advisors in 2006, when the market turned against its natural gas positions, resulting in the loss of more than $6.5 BN in investor assets, did not have widespread industry implications. It did, however, serve as a further reminder to fund managers, investors and global regulators of the unfettered control of huge amounts of capital that hedge funds place in the hands of a few individuals. And it pointed out the potential systemic implications of large-scale failures in the future.

The current counter-party risk management framework is considered by many to be insufficient, with US and European regulators already considering further regulation of hedge funds. In addition, the outgoing Chairman of the US Senate Finance Committee, Charles Grassley, has expressed alarm at the risks that hedge funds may pose to pension funds.

We believe the financial services sector has an opportunity to take the lead in developing appropriate solutions to the issues surrounding hedge funds. With little opportunity for the credit environment to improve, the industry must prepare itself for a trigger event that may test the system's integrity. If the financial services industry is not ready to meet the challenge, its valuable participation in establishing an effective framework for oversight and control will be trumped by political solutions that will undoubtedly be less efficient.

Looking forward, as clients, we believe hedge funds will continue to represent a vital source of industry commissions and deal fees for some time to come. At the same time, as competitors, we see a rapidly maturing industry marked by increased regulatory oversight, consolidation and growing competition from lower cost substitutes. High investor costs, limited capacity for new money among the top-performing funds and shrinking returns all offer compelling product innovation opportunities for established players. ■

How attractive are financial services companies to private capital?

- Bottom quartile SPI companies have a 46% market value discount relative to top quartile performers, based on their respective differences in return on equity and price-earnings ratios.
- From a sector perspective, we expect insurance will continue to represent an area of opportunity for private capital providers for two reasons. First, its opaque and complex economics cause the sector as a whole to trade at a discount to the broader financial services industry. Second, unbundling creates opportunities to target specific profitable niches within the insurance value chain.

1 Source: HFR
2 Source: *Institutional Investor, Alpha Magazine*
3 Source: Casey Quirk & Associates and The Bank of New York, October 2006
4 Source: *Perspectives on Asset Management*, Oliver Wyman, June 2005
5 Source: Reuters Loan Pricing Information

Tapping new sources of demand: Harnessing megatrends for sustained growth

Key findings

- We expect further consolidation, particularly among European banks and exchanges.
- Increasing ‘pain points’ around retirement, education and healthcare will drive product and service innovation focused on ‘decumulation’ products for consumers and yield and risk management for investors.
- Strong economic growth in emerging markets will continue to attract investment as regulators hasten the pace of deregulation.

With a challenging outlook for many of the industry’s recent growth drivers (businesses such as mortgage, home equity and asset-backed lending, consumer credit and structured finance), well-positioned firms are looking to new sources of demand to drive continued earnings growth. The following are examples of trends we expect will be important catalysts for future industry growth.

Mature markets

Consolidation – Banking and exchanges

We expect further banking consolidation in the coming years, particularly in Europe, as a result of excess capital, a warmer environment for cross-border mergers and increased competition.

Basel II implementation is anticipated to release an estimated 7-11% of regulatory capital for G10 banks[1], adding to existing excess capital estimated at $22 BN[2] for European firms. However, US banks may see a lesser amount due to continued differences in minimum capital ratios required by pertinent regulators.

There are early but distinct signs that the widely anticipated consolidation of the German and Italian banking markets has begun. Following years of national opposition, regulators in Italy approved the sale of Banca Antonveneta to ABN AMRO and Banca Nazionale del Lavoro to BNP Paribas. German regulators, meanwhile, permitted Bankgesellschaft Berlin (now Landesbank Berlin Holding) to sell Berliner Bank to Deutsche Bank and allowed a group of private investors to acquire a significant minority interest in HSH Nordbank.

Amid growing competition, Eastern European and Latin American banks represent attractive targets for Western European firms seeking faster growth. In addition, we see US banks’ net interest income margins of 3-3.5% attracting European interest. This is particularly true of firms with existing US footprints eager to improve upon a non-US domestic spread of 1.75-2%, and that are flush with Euros that have appreciated 48% against the US dollar over the past five years.

Exchanges rapidly evolved in 2006 ahead of the adoption of Reg NMS, MiFID and a hybrid NYSE. Sell-side players, private equity investors and the exchanges themselves sought to take advantage of trends toward cross-border, multi-product trading by making minority investments, launching new trading networks and attempting cross-border consolidation. With numerous new models of competition emerging, we liken the landscape to the advent of ECNs in the late 1990s and see this trend continuing in 2007 across asset classes such as equities, fixed income, options, futures, credit derivatives and swaps. In addition, we see 2007 bringing a resolution to the open question of trans-Atlantic exchange consolidation.

Product innovation

Industry dynamism is creating innovative retail products to meet new consumer and investor needs. For consumers, equity release products will harness the demographic trend of aging populations, allowing homeowners to tap into illiquid wealth to fund cash-flow needs.

For investors, increasing ‘pain points’ around retirement, education and healthcare are creating demand for products that generate yield and provide downside risk protection. This provides opportunities for asset managers, insurers, banks, brokers and investment banks alike. We see investors’ need for yield combining with flagging real estate values to drive money back into traditional investment products. At the same time, greater institutional participation and increasingly correlated global equity indices[3] will fuel further growth of alternative asset classes as a valuable source of diversification.

---

1 Source: *Results of the fifth quantitative impact study* (QIS 5), Bank for International Settlements, Basel Committee on Banking Supervision

2 Source: *European Banker*, October 2006

3 As of 2005, world indices are the most correlated we have seen with the exception of China, based on an analysis comparing correlations of the performance of major world indices with that of the NYSE for consecutive five-year periods during the 1990-2005 timeframe.

Among the most important products, exchange traded funds (ETFs) continue to gain popularity as mutual fund alternatives and as vehicles for new forms of investment exposure. Led by the US and followed by Europe and Japan, worldwide ETF assets have more than doubled over the past three years, now surpassing $500 BN in assets and more than 600 funds.[1] Investable strategies have expanded beyond standard index and sector mutual fund alternatives to include commodities, real estate, foreign market and even investment-style (e.g. growth, value and quantitative) exposures.

In addition, we anticipate continued strong growth of retail structured products with investors purchasing both yield enhancement and capital protection products in European markets. The penetration of these products is likely to remain low in North American markets, however, in part due to the wide availability of alternative asset protection products such as variable annuities, as well as ongoing concerns over client suitability. We expect to see further innovation in asset protection, including features such as cost-of-living and inflation-protected investments, along with new ways of delivering longevity protection beyond the traditional and unpopular format of immediate payout annuities.

In the corporate and institutional segments, we expect increasingly well-articulated and measured risk profiles to be strong growth drivers. Firms will increasingly compete for corporate mandates combining low-value vanilla lending with higher margin products such as swaps, interest rate and equity derivatives. This trend will favor universal banks with integrated sales teams and high cross-sell rates. Investment banks stand to benefit as well, with banks and insurers both increasing their use of capital markets solutions, including securitization, collateralized debt obligations and credit derivatives to create desired credit risk exposures.

Service innovation

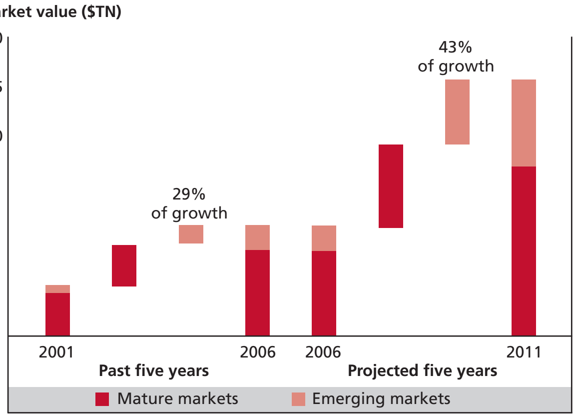
We expect distributors of customized solutions for well-defined client segments to see the strongest growth. In an age when there is a crying need for trusted advisors, providers that seek deeper client relationships will drive further value shifts toward distribution, as manufacturing of commoditized offerings offers little opportunity for standout performance and open-architecture models skew growth toward best-in-class manufacturers. The recent spin-offs of asset management units by Citigroup to Legg Mason and Merrill Lynch to BlackRock are good examples of client advisory firms seeking to gain competitive advantage by offering more independent advice.

Emerging markets

Emerging markets continue to become more attractive for both domestic and foreign players. Much has changed over the past decade, as 40% of emerging markets debt is now rated 'investment grade' up from 3% a decade ago.[2]

At current growth rates, emerging markets companies will comprise more than 40% of the growth in total market value over the next five years (Figure 6). Moreover, this figure does not capture the significant market value of foreign-domiciled companies driven by emerging markets activities, which now contribute an estimated 20% of earnings for the largest universal banks.[3] We register a note of caution about the sustainability of the current trend, however, due to a weakening in the quality of growth. Amid increasingly high market expectations, market values have risen more than twice as quickly as earnings growth over the past five years.

Figure 6: Emerging markets contribution to global financial services growth[4]



Within this group of countries, India and China, and in particular their banking, private wealth management and capital markets sectors, are focal points for foreign investment. These two countries have long represented attractive markets, with consistently high annual economic growth of 2.5-3.5 times the world average and with growing populations of affluent households.

1 Source: ICI, November 2006; *Investor's Business Daily*, August 23, 2006; *Wall Street Journal*, September 28, 2006; Oliver Wyman analysis
2 Source: *The Economist*, October 2006; Mellon Asset Management
3 Based on a sample of eight of the largest 20 universal banks by market capitalization.
4 Based on next five-year growth rates comparable to five-year historical averages.

Recently, both nations have undertaken important legal and regulatory reforms to open their financial services industries to foreign investment. In 2006, China took steps to honor its WTO obligations to fully open its borders to foreign banks. Despite significant progress, however, further reform is needed to bring the nation's financial infrastructure up to international standards. Transparency remains elusive, regulatory rules remain subject to revision and the legal system does not yet recognize the enforceability of collateral. Moreover, rules such as those limiting foreign bank branch openings to one per year constrain foreign players' menu of realistic options for market entry.

For its part, the Reserve Bank of India granted Warburg Pincus permission to purchase up to 10% of Kotak Mahindra Bank Group, a move widely seen as a precedent for foreign investors. In addition, India is again considering legislation that would nearly double the amount of foreign direct investment permitted in its insurance sector.

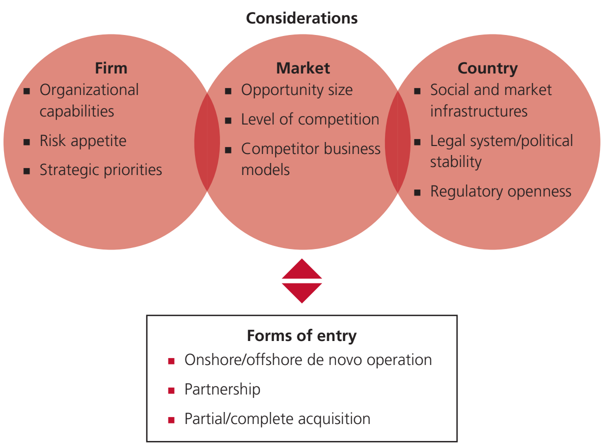
In the Middle East, Bahrain, Dubai and Qatar have emerged as aspiring global financial centers, with all three developing dedicated financial districts governed by international accounting standards. Long the region's financial center, Bahrain is looking to open the Bahrain Financial Harbor development in 2007. Dubai created the Dubai International Financial Centre in 2004. Most recently, in May 2005, Qatar established the Qatar Financial Centre. Beyond these special economic zones, the first independent credit agency, Emcredit, was launched in UAE in 2006, providing further evidence of the region's maturing financial services infrastructure.

In many cases, domestic players are looking to foreign capital and expertise to help them prepare to compete in a global marketplace. Industrial and Commercial Bank of China, China's largest bank, raised a record $19 BN on the Hong Kong and Shanghai exchanges in October 2006, becoming the third of China's largest four banks to have opened itself to private investment in a twelve-month period. The market cap of China's quoted retail and commercial banking sector ($237 BN) now exceeds those of Australia ($195 BN) and Japan ($180 BN).

If the past two years belonged to China's banks, 2007 looks as if it will be the year of China's insurers. Following its $3 BN IPO of shares on the Hong Kong Exchange in 2003, China's largest insurance company by premiums, China Life Insurance Company, is finalizing preparations to list an estimated $3.6 BN in yuan-denominated 'A' shares in early January, which will make it the first locally listed insurer.[1] Competitors Ping An Insurance Group of China and China Insurance International Holdings Company are also considering listings next year.

Emerging markets have become too important for most financial services firms to ignore. Given the diversity of opportunity within emerging markets and the spectrum of legal and regulatory risks involved, it is often important for firms to develop multiple emerging-markets strategies. We see foreign aspirants' strategies ranging from onshore/offshore go-it-alone plays to partnerships to outright acquisitions of domestic incumbents. The right strategies will be different for each company and may shift over time to take advantage of changing market conditions or growing organizational competencies. While there are many considerations for determining the right form of market entry (Figure 7), we believe it is critical for firms to understand their planning horizon, given the often-measured market access given to foreign entrants.

Figure 7: Considerations for entering emerging markets



One Premier Performer, Austrian insurance provider Wiener Städtische Versicherung (SPI 225), serves as a good example of a firm that has taken a differentiated approach to market entry. It successfully partnered with Germany's Huk-Coburg insurance group to acquire Polish insurers Compensa Sach and Compensa Leben in order to gain access to Eastern European markets while limiting its initial market risk. ■

1 Source: *Wall Street Journal*, December 27, 2006

CEO growth index

Key findings

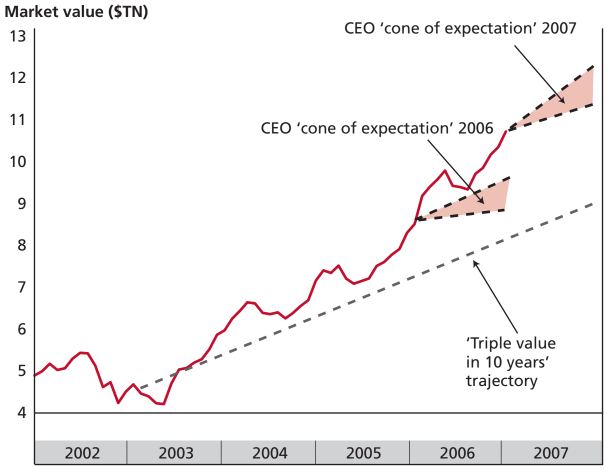
- CEOs expect stable market value growth of between 5% and 14% in 2007.
- Organic growth in existing markets continues to be a top strategic priority, with Asia (excluding Japan) and Europe representing the most attractive non-domestic market opportunities.
- Increasing costs represent a growing concern as firms grapple with the prospect of narrower margins and higher expenses for talent recruiting and retention.

For last year's State of the Financial Services Industry 2006 report, we surveyed CEOs of top financial firms to develop an executive-suite view of the sector's future direction, its key growth drivers and major challenges. The respondents' consensus estimate for value growth was between 5% and 14% in 2006. However, the industry once again demonstrated its ability to surprise, generating significant value amid much uncertainty in the macro environment. Market growth of 26% drove total industry market value to a record $10.7 TN, surpassing CEOs most bullish projections.

The results from this year's Fourth Annual CEO Growth Survey show that CEOs have slightly increased their expectations for financial services growth relative to global economic growth for the year ahead. The 2007 CEO Growth Index℠ (CGI)[1] of 327 compares favorably to last year's 306 and is similar to the 320 registered for 2005. Broadly, this year's CGI points to continued growth that is significantly higher than that required for the industry to triple in value between 2003 and 2013 (Figure 8), a scenario that we initially posited in the 2003 edition of this report.

While new markets are becoming increasingly important to the industry's long-term health, it remains vital to identify ways to grow organically in existing markets if the sector is to continue to prosper in the near-term. Consistent with past surveys as well as with our Premier Performer findings, 'organic growth in current markets,' cited by 94% of CEOs, continues to be a foundational strategic priority for increasing profit. In addition, 'organic expansion into new markets' remains a top priority for 74% of CEOs, down slightly from 78% in 2006. Similar to last year, nearly a third of CEOs expect to launch a major new business, while those planning to introduce a major product innovation dropped markedly from two-thirds in 2006 to less than one-half.

Figure 8: Past and present CEO perspectives on financial services market value growth



With respect to inorganic growth, CEOs expect lower M&A activity, with the exception of cross-border expansion. A quarter of CEOs intend to engage in a major merger, acquisition or disposal next year, down from a third in 2006. Last year's concentration on small M&A subsided considerably, as only 34% of CEOs cited it as a priority, down from 60% last year. In contrast, nearly 25% of CEOs are planning to undertake cross-border M&A activity, up from 21%.

As expected, revenue growth continues to dominate cost control as a profit driver. Both remain important, however, as 50% of CEOs intend to undertake substantial cost reductions. Facing a real cost challenge, CEOs are increasingly looking to revenue growth to compensate for expenses outside their control. Frequently citing higher expenses in the battle to attract and retain talent, the percentage of CEOs expecting costs to rise by more than 5% increased from 30% to 40%.

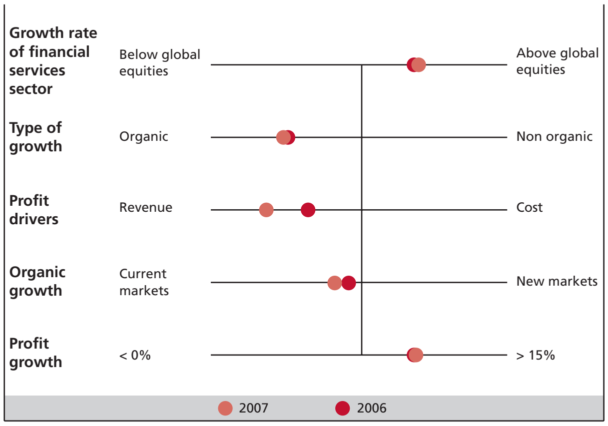
This year, we introduced two new questions asking CEOs to identify their most important client segments and products and services for revenue growth in 2007. As demonstrated by the strong representation of retail and commercial banks among Premier Performers, retail is a key client segment for sustained long term performance. Accordingly, 68% of our CEOs ranked retail number one, while only 28% did so for corporates.

1 The CGI is a short-term forecasting measure developed by Oliver Wyman for estimating the prospects for value growth in the coming year; it incorporates polling results from CEOs of selected top financial services companies. A CGI of 327 represents financial services industry growth of 3.27 times the global GDP growth.

In terms of product offerings that will drive revenue growth, CEOs cited credit products most frequently (70%) followed by life insurance and annuities (60%) and deposit products (59%). Other important drivers include investment products (49%), structured products and derivatives (44%) and traditional asset management offerings (44%). Least important for our CEOs are secondary market trading (15%) and M&A advisory (13%).

Furthermore, 72% of CEOs view the combination of manufacturing and distribution as important to their business models, while 19% are focused on manufacturing and only 9% favor distribution.

Figure 9: CEO growth forecast for 2007



Domestic markets continue to be major growth targets for 77% of CEOs. Similar to last year, Asia (excluding Japan) and Europe were the number one and two most frequently cited major growth opportunities in foreign markets, followed by North America. Interestingly, however, only 10% of mid-cap company CEOs ranked Asia (excluding Japan) as a major growth opportunity, compared to 88% of those of the super-large caps.

After several years of intense focus on regulatory and corporate governance issues, CEOs are shifting attention to address organizational concerns. In particular, 71% of CEOs are concerned about human capital management and more than half are planning to introduce new management processes. IT change management remains another top strategic priority among 61% of CEOs, down somewhat from 74% last year.

In addition, CEOs registered a number of challenges for the industry and for their firms over the next two years. Several expressed concern about slowing economic growth, a potential credit cycle downturn and further regulatory action. CEOs anticipate even tougher competition with new entrants from foreign and private capital-backed competitors and compressed profit margins requiring strong cross-border expansion capabilities to support continued growth.

Competition is moving behind the front lines with CEOs increasingly viewing talent acquisition and retention as major challenges to future growth. Innovation, speed of change and increasing efficiency represent other frequently named challenges, along with risk management and management of multiple distribution channels.

Despite continued concerns about the macroeconomic environment, CEOs are optimistic that their companies can generate strong organic growth in 2007, especially now that many of the regulatory-related requirements of the past several years (e.g. Sarbanes Oxley, Basel II, MiFID and Reg NMS) are well under way. This year's strong CGI score bodes well for the industry's growth outlook in the year ahead. ■

Emerging CEO agenda for 2007

- CEOs are optimistic about 2007; however, they expressed concern over a number of medium-term trends, including slowing economic growth in mature markets, declining margins, and increasing competition.
- Home market organic revenue growth from the retail and corporate segments represents the most important driver of value growth.
- Credit products, life insurance and annuities, and deposit products are expected see the strongest growth.
- Cross-border expansion is increasing in importance with Asia (excluding Japan) continuing to represent the most attractive foreign market.
- Human capital management is a major focus, as CEOs face an increasingly complex challenge attracting and retaining top talent.

Performance Matrix

A key challenge in performance evaluation is separating positional from execution factors. The SPI is a powerful tool in assessing this distinction. Using the performance matrix below, we divide the financial services industry based on sector and region, and indicate the positional performance of each segment.

Positional performance

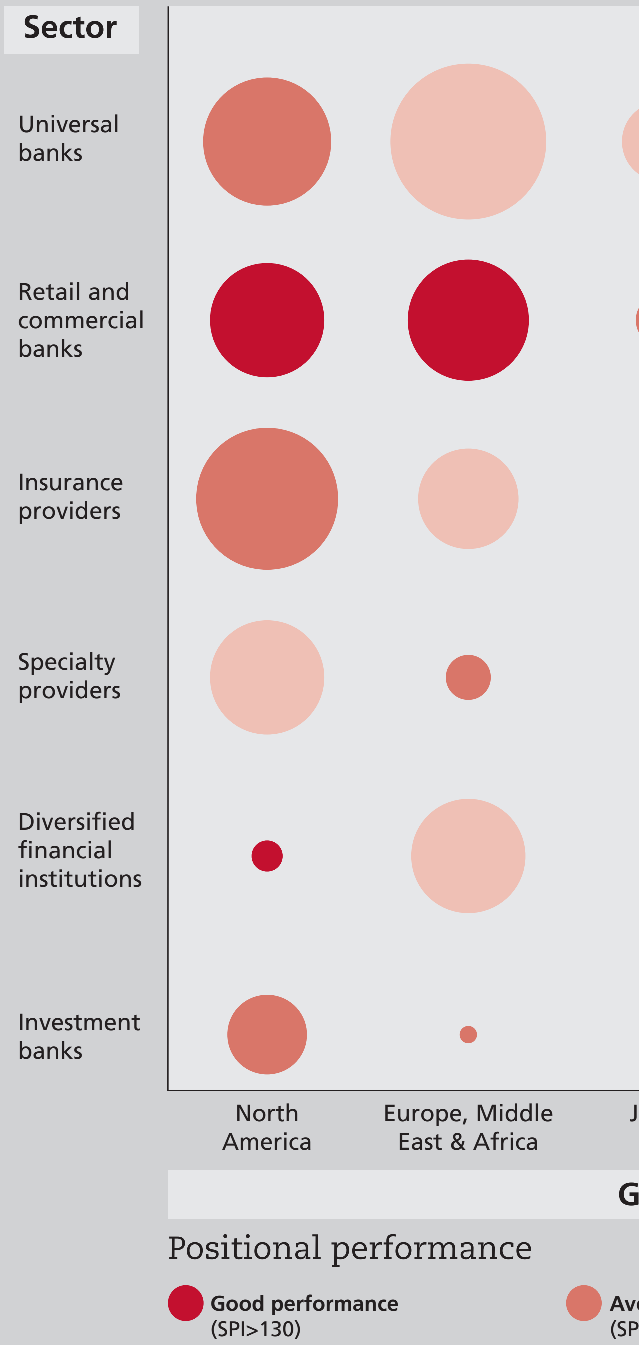
This refers to the average performance of a specific segment defined by sector and region. Positional performance gives an indication of the macroeconomic operating environment and provides a base for comparing execution performance.

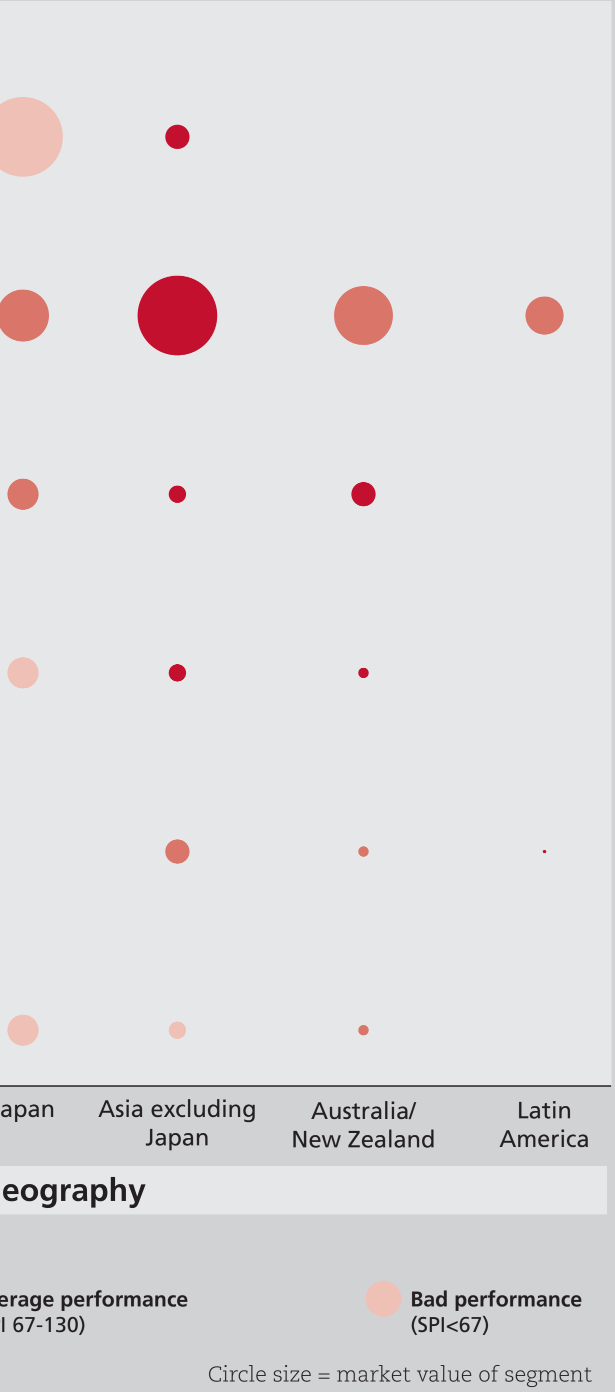
Exchanges (SPI 302) were the best performers in the last year across all geographies. In particular, nascent local exchanges in **Asia (excluding Japan) (SPI 384)** and established players in **Europe (SPI 194)** benefited from the strong capital formation in emerging markets. In 1997, the SPI 400 had only one exchange: Sweden's OMX with a market cap of $900 MM. A decade later, there are eight exchanges with a market cap totalling $79 BN. This 10-year period was marked by an explosion of new products, widespread adoption of electronic trading, growing competition from blurring business models and regionalization. The pace of change continues to accelerate now that the globalization of exchanges has begun, with the NASDAQ's bid for the London Stock Exchange and the pending merger of the NYSE Group and Euronext.

Asia (excluding Japan) (SPI 153) is the best performing geography, led by **insurers (SPI 258)** and **specialty providers (SPI 308)**. Continuing the region's success over the past 10 years, which produced three Premier Performers, privatization recently launched four institutions with a market cap of $210 BN that will join the SPI in future years. Due to its dynamic economic development, the region continues to be a top priority for foreign market expansion among CEOs surveyed.

Europe, the Middle East and Africa (EMEA) (SPI 48) is still the worst-performing region, although its market value growth is the highest among mature markets (38%). This apparent dichotomy is due to the fact that SPI scores are a result of actual shareholder value created over the past five years, while the region's strong market value growth reflects high expectations for future returns, bolstered by a banner year across sectors in 2006. Yet the region is home to eight of our 28 top-ranked companies, demonstrating that execution performance can outweigh positional performance.

Diversified financial institutions (SPI 13) demonstrate that a sector's positional performance can change dramatically over time. The sector fell from the top position in 1997 to the bottom in 2006. Nimble players were able to anticipate and adapt to changing market conditions while others struggled. This is reflected by the difference in scores between the sector's top (SPI 224) and bottom (-44) halves – the widest among all sectors. Well-managed firms are uniquely positioned to benefit from demographic trends that favor both banking and insurance solutions.





Execution performance

This term describes the ability of some players to significantly outperform their peers in a similar segment by leveraging differences in execution and strategy.

European Life Insurer – CNP Assurances (SPI 225) has achieved impressive returns in the difficult European insurance market. Key to its success is an alternative distribution channel strategy. The firm has become France's leading personal insurer by structuring unique relationships with the French Post Office and Savings Bank and recently building its own financial advisor network, called CNP Trésor. Employing a range of inorganic expansion strategies to augment organic growth, CNP Assurances has favored acquisitions in Europe (e.g. Italian Fineco Vita) and partnerships in emerging markets (e.g. Brazilian Caixa Econômica Federal).

Japanese Retail and Commercial Bank – Mitsui Trust Financial Group (SPI 219), Japan's best-performing banking group, was formed in 2002 and consists of Chuo Mitsui Trust & Banking Company and Mitsui Asset Trust & Banking Company. Mitsui Trust Financial Group is a domestically focused, full-service bank engaged in a broad range of business activities, including commercial and retail lending, asset management and alternative investments. The firm has outperformed all other Japanese banks included in the SPI by concentrating its efforts on asset management and high-margin business adjacencies.

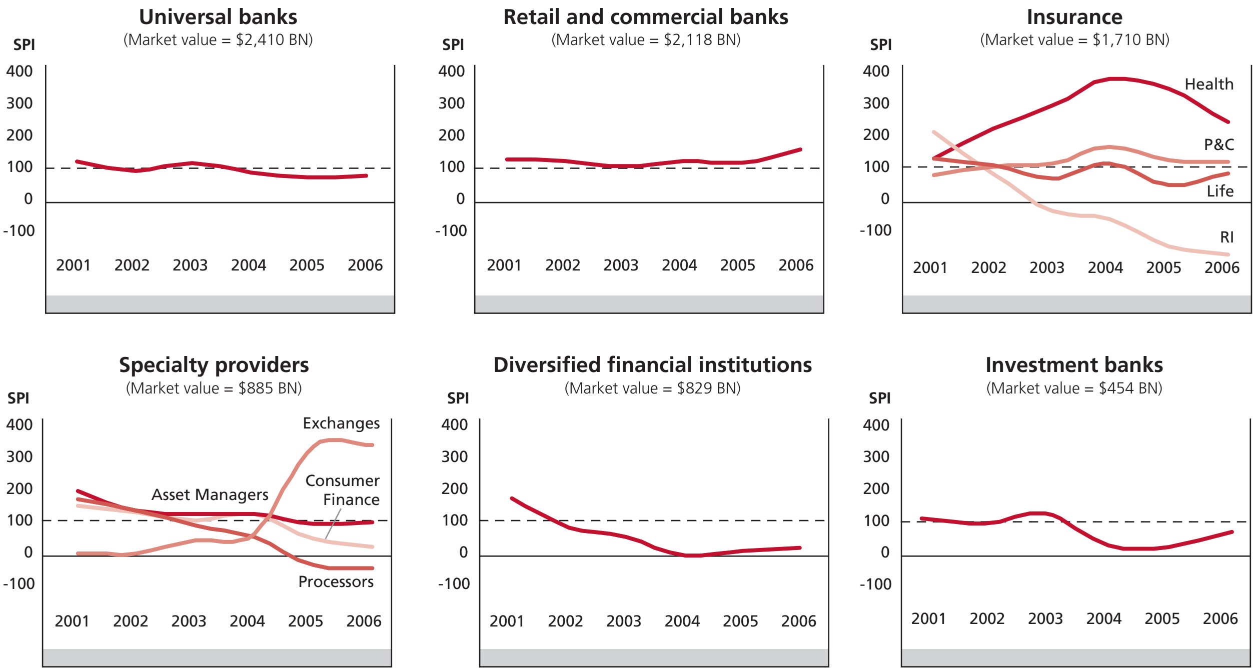
North American Investment Bank – Bear Stearns (SPI 230) is the best-performing company in this year's most improved sector, investment banking. This 'Rewarded Risk' Premier Performer has focused primarily on home market opportunities, unlike many of its peers, and benefited from its number three position in prime brokerage and strong mortgage banking capabilities. Bear Stearns has produced record profits for five years in a row, led by its capital markets division, which has posted 24% average annual growth. The firm's other principal divisions include global clearing services and wealth management.

North American Retail and Commercial Bank – U.S. Bancorp (SPI 148), the sixth largest financial services holding company in the US (#8 on the $50 BN Club list), profits from the combination of a nationwide branch network and local market orientation. Following a merger with Firstar Bank in 2001, the company has complemented organic growth with a series of targeted fill-in acquisitions and expansion into adjacent businesses such as payment processing. Distinguished within its segment, it has the highest overall combination of profit margin (25%), ROE (24%) and cost-income (44%).

Sectoral insights

Industry sector is a key determinant of 'positional performance' in financial services. For ease of comparison, we group the firms in our survey into six discrete sectors. In this section, we will review each sector's performance and discuss key themes for the coming year. The average SPI results by sector are illustrated in Figure 10.

Figure 10: SPI Performance by industry sector



Universal banks: Modest improvement amid favorable market conditions

Against a background of strong performance by both retail and commercial banks and investment banks, the performance of universal banks improved somewhat in 2006, with the average SPI increasing from 71 to 77. Trends favoring universal banks include growing consumer interest in risk protection products and corporate preferences for integrated banking and capital markets solutions. However, with the strongest region, Asia (excluding Japan), also suffering the largest drop in SPI, it remains to be seen whether the region that improved the most, Japan, can sustain the upward trend given the challenged outlook for banking.

We see the best-performing institutions in this sector breaking down internal silos and aligning incentives to maximize cross-selling effectiveness within their existing client bases, while continuing to target new opportunities. Bank of America's (SPI 183 and #5 in the $50 BN club) acquisition of MBNA represents a good example of a universal bank gaining exposure to new customer segments and origination channels in an established high-margin business – credit cards.

Retail and commercial banks: Among the best performers of the decade

Retail and commercial banking (SPI 148) is the best-performing sector again this year, driven by EMEA. EMEA retail and commercial banks improved the most with market values increasing 54% over last year, while those of Japan and Australia performed the worst. There have been a number of factors driving this sector including a house price and mortgage boom, unsecured lending growth and a series of cross-border acquisitions in Europe.

Looking ahead, commercial lending represents a bright spot in an otherwise cloudy picture posting strong growth for the first time in several years. Rising interest rates have begun to exact a toll on real estate markets in mature economies, resulting in across-the-board declines in mortgage lending, refinancing and home equity loan volumes. With a recent up-tick in consumer loan charge-offs and loan loss reserves at a 20-year low, retail and commercial banks appear vulnerable to a credit downturn in the year ahead. Firms that have invested in risk management and developed revenue streams from non-interest income sources will fare best should a credit down cycle occur.

While many banks have made big improvements to their cost-income ratios, we anticipate further improvements whether from US banks seeking to cut costs in advance of a possible market slow-down or from European banks looking to the next round of efficiency gains.

There remains a big opportunity for consolidation in Europe, both in fragmented local markets such as Germany and Italy and across borders. In addition, we expect strong growth to continue in those countries with underdeveloped mortgage and credit markets relative to the economic and regulatory opportunities.

Insurance providers: Widening gap between the best and the rest

With record earnings in 2006, insurers have begun the long march back after their weak performance in the early years of this decade. That said, the weight of previous years' underperformance and the lack of any significant increase in insurers' PE multiples means that health insurers (SPI 232) still comprise the only subsector to have performed above the median SPI (100). Significant differences emerged among firms and regions, however. Indeed, the spread between the SPIs of top and bottom performers within insurance was second only to that of diversified financial institutions (many of which have large insurance businesses), suggesting that the gap between the 'best' and the 'rest' is widening. Geographically, Australia soared to an SPI of 195 based on the strength of P&C firms such as this year's number two mid-cap performer, Promina Group (SPI 485) and the fourth-ranked large-cap firm, QBE Insurance Group (SPI 425). At the other end of the spectrum, EMEA remained in last place with an SPI of -70. However, with the market values of the region's insurers increasing by 31% compared to 15% globally, profitable growth has begun to return, though the market is still skeptical as to how long growth can be maintained at current profitability levels.

We still see the bulk of growth coming organically. Specifically, it will come from further expansion of distribution channels and improved effectiveness within existing distribution channels, more proactive capital management to support a higher-velocity balance sheet (such as AXA Group's recent motor and mortality securitizations), continual improvement in underwriting and pricing granularity for P&C insurers and, for life insurers, developing cogent retirement and asset protection solutions to compete against asset managers and broker-dealers/banks in the growing market for retirement funds.

In addition, we expect to see a gradual pick-up in cross-border consolidation, with the insurers with high PE multiples and strong capital positions seeking to fill in gaps in their geographic footprint by buying up insurers that are trading at a discount to the sector. (This will be particularly true in the fast-growing Asian markets.) We also see a continual trend towards clarification of corporate strategic portfolios leading to further spin-out of non-core businesses, with most of this activity occurring in the corporate P&C sector.

Specialty providers: Diverging fortunes led by exchanges

Exchanges (SPI 302) led the performance of specialty providers again this year. High valuations were supported by the limited number of investment opportunities, along with some outsize private equity gains. Bolstered by continued trends toward market electronification and globalization, 2006 was the year of cross-asset class and cross-border expansion. As the markets jockey for position ahead of the launch of Reg NMS in the US and MiFID in Europe, however, the picture is looking increasingly like a race for scale to secure a place among end-game winners.

Benefiting from a seemingly insatiable consumer demand for credit, many Consumer Finance companies have successfully ridden the mortgage lending and credit card waves. Competition in this area is highly diverse with nimble specialists, including a number of private capital-backed firms, competing successfully against larger, diversified players. Consumer debt loads and softening real estate markets will be key challenges in the coming year, particularly for those firms specializing in subprime markets. Institutions with superior risk and portfolio management capabilities are likely to fare best.

Asset managers had an SPI of 104 last year, representing a modest increase from 91 in 2005. Improving markets combined with low volatility bolstered investor confidence leading to strong market inflows. Looking ahead, employer-sponsored tax-advantaged accounts are likely to continue to provide solid growth opportunities, though traditional asset managers face growing competition from ETFs, structured products and hedge funds. Indeed, there is increasing divergence in profit margins between the top and bottom performers as margins slowly decline. Increased client segmentation and product customization (e.g. separate accounts and life cycle funds) represent strong offensive strategies.

The growing electronification of markets for nearly every asset class promises significant volume increases in the year ahead for processors and custodians, providing further competitive advantage to scale players. Trends such as the growing complexity of investment strategies, fragmentation of order flow among execution venues and demand for cross-asset class and portfolio-level margining capabilities represent important growth opportunities for players with existing scale that are willing to make the necessary strategic investments.

Diversified financial institutions: Continued weakness with outperformance for a few

Diversified financial institutions continue to be the worst performing sector this year with an SPI of 13; however, the story is highly differentiated by both region and player. The North American region had the highest SPI of 264, followed by Latin America (256), while Australia fell to 77 and EMEA registered the worst performance with an average SPI of -15.

While it is a compelling combination in theory, practice has shown the difficulty of achieving success in the marriage of banking and insurance. Whether owing to client purchase point preferences or the added complexity of navigating additional regulatory environments, the bancassurer model is among the most difficult models to manage successfully. The prize for doing so is outsize performance, however, as 20% of diversified financial institutions achieved Premier Performer status this year.

Investment banks: A boom year for a rapidly evolving sector

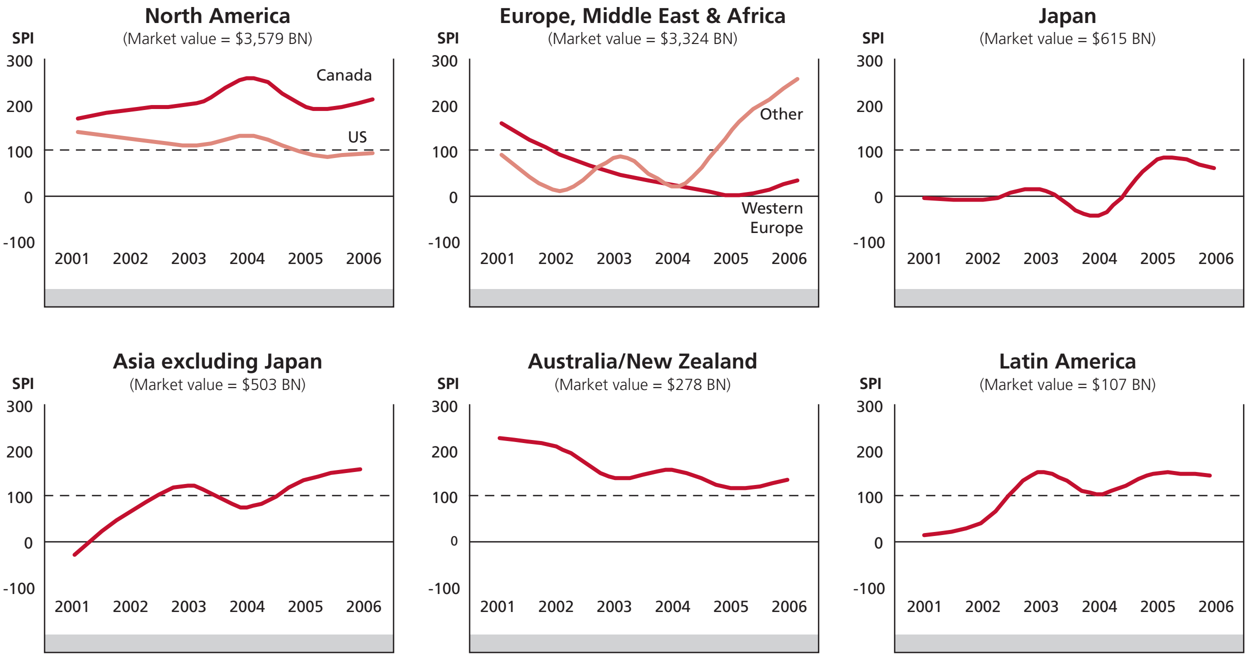
Led by strong results in North America and EMEA and partially offset by underperformance in Asia, investment banks significantly improved their performance in 2006, posting an average SPI of 77. In the most cyclical of sectors, continued strong results in fixed income, commodities trading, derivatives and record M&A volumes were key drivers of performance, particularly in Europe. In addition, proprietary trading was a primary contributor to earnings for many firms, although diverging bets on inflation, energy prices, interest rates and equity markets differentiated results in the second half of the year. Indeed, for a number of institutions, earnings are increasingly driven by the ‘house account’ with record levels of capital dedicated to proprietary trading, principal finance, hedge funds and private equity opportunities.

Looking ahead, increasing dependence upon proprietary trading combined with deep exposure to emerging markets and the real estate sector will make for difficult year-over-year comparisons in 2007. Sponsor groups, hedge funds, retail investment/retirement products and the public sector are among investment banks’ strongest growth opportunities for high-margin credit derivatives, CDOs and structured products. ■

Regional insights

Geography is another key determinant of 'positional performance' in financial services. For ease of comparison, we group the world's countries into six regions. The average SPI results by region are illustrated in Figure 11.

Figure 11: SPI performance by geographical region



Emerging Markets: Growth markets of the present and future

With strong economic growth and 60% of the world's population, emerging markets are on track to produce more than 40% of the industry's growth over the next five years. The 23 countries included in the emerging markets classification represent a wide range of market maturity contributing 74 companies, including eight Premier Performers, to the SPI 400.

Certainly, the economic, social and market infrastructures of Hong Kong, Singapore and South Korea are much more developed than those in such nations as China, India and Thailand. In the case of the former, there are current opportunities for market participation that can make a meaningful financial impact. In the latter case, while many of these countries are brimming with potential, large financial rewards are further away.

If they are to achieve broad-based market success, these countries require fundamental structural changes with respect to education, health care and a social safety net, as well as further progress toward better corporate governance and financial sector reforms.

Emerging markets have become a vital part of many firms' growth strategies. However, with soaring valuations for domestic partners driven by a combination of performance, scarcity and high demand from operators and private capital, it is important for companies to gauge their risk appetite and willingness to embrace a long-term planning horizon before opting for market entry. In many countries, political and legal risks continue to be real factors, with the rules subject to change should domestic incumbents fall too far behind. For firms that have not already entered these markets, we see additional opportunities to do so down the road.

Latin America

With an overall SPI of 134, and eight of 11 companies posting SPIs above 100, Latin America had another strong year despite dropping six points from 2005. Driven by strong economic growth due to surging demand and high prices for commodities and oil products, financial services market valuations increased 47% in 2006.

While real estate valuations are cooling in mature markets, real estate banking in Latin America remains a largely untapped opportunity. Domestic and foreign players alike are eager to pursue growth opportunities in consumer credit growth. However an upgraded business environment with respect to legal protections and regulatory stability remains a strong prerequisite. Among bankers, the past is not yet the past.

Japan: A false start for an island in a sea of potential?

After increasing somewhat in 2005, Japan's SPI performance slipped back to 68 last year despite strong economic growth. With insurers and specialty providers suffering the largest SPI declines of any region, it is clear that the region's restructuring effort still has far to go. Private capital has served as a strong catalyst for some change, polishing such diamonds in the rough as Shinsei Bank and Aozora Bank; however, wider systemic reform remains necessary for a true rebirth of the region's financial services sector.

With a domestic demand-driven economic turnaround now well underway, Japan has finally reduced its dependence on exports and stemmed a seven-year period of deflation. Though high public debt and a growing worker dependence ratio remain real threats to sustained economic growth, we continue to see strong potential for the region which still commands 7% of the global market value of financial services. Not all firms will prosper; however, rich rewards await those able to move past their historical difficulties to focus on faster-growing Asian markets.

Australia/New Zealand: Changing sector leadership

Australia/New Zealand SPI performance changed little in 2006. However, the stability of the region's average SPI fails to reveal a significant rotation among top-performing sectors. In contrast with what was happening in most other mature markets, SPIs for investment banks, diversified financial institutions and retail and commercial banks all experienced significant declines, representing the largest drops among all regions. Specialty providers and insurers, led by P&C, performed the best overall.

After nearly a decade of strong positional performance, record consumer debt loads have begun to limit opportunities for domestic revenue growth outside the continued performance of mandatory superannuation funds. As a result, future earnings growth will increasingly require cross-border expansion along with the requisite institutional knowledge, execution and risk-management capabilities for success. To that end, insurers are leading the charge in creating shareholder value and overcoming a 'straitjacket' domestic growth environment through industry restructuring and overseas expansion.

EMEA: Another cycle or a new beginning?

Ending a five-year slump, EMEA financial services SPI increased to 48 in 2006. However, the average SPI fails to capture the profound change of EMEA's fortunes; the region's overall market value increased 38%, led by retail and commercial banks (SPI 165), investment banks (SPI 116) and universal banks (SPI 56). At the same time, while somewhat improved, insurers (SPI -70) of all flavors continued to suffer, dragging down the region's overall performance.

Looking forward, with Basel II implementation expected to release additional excess capital, we see renewed interest in cross-border banking consolidation. Indeed, slowing economic growth in Western Europe will apply further pressure to tap into the fastest-growing markets both within the EU and across the globe for revenue-driven earnings growth and effective capital utilization. It remains to be seen whether this year's results reflect a new chapter for the region as the locus of capital formation migrates eastward, or merely the beginning of another business cycle.

North America: A last hurrah?

In 2006, North America's SPI performance improved somewhat to 103 based upon strong performance by retail and commercial banks and investment banks defying projections for a tough year driven by a cyclical credit downturn and a yield curve that was flat to inverted. Health insurers performed best among insurance providers, although the group suffered an overall decline in market value of 11% as two leading players, UnitedHealth Group (SPI 277) and WellPoint (SPI 265), focused on integrating large acquisitions from the prior year, and the slow adoption of consumer-driven health plans (CDHPs), aimed at increasing consumer accountability for health-care costs, failed to meet high market expectations.

With solid performance across many sectors, North America's 15% growth in market value stands in sharp contrast to that of EMEA. That is the case even though both regions share a deteriorating environment of higher interest rates, historically high consumer debt loads and declining real estate valuations.

There are several potential reasons for the divergence. Growth in riskier low-payment mortgage products and Wall Street innovations in securitization have allowed North America to extend the real estate cycle by further penetrating the subprime market. However, when the credit cycle turns (as started to become apparent in the subprime sector in Q4 2006), the recovery period may be longer and more painful. With the rapid growth of new risk-transfer products since the last credit cycle, it is still unclear how much risk remains on the industry's balance sheet and how much resides in investor portfolios. In addition, EMEA companies are geographically better positioned to enter nearby high-growth markets and have more experience at successful cross-border expansion, as evidenced by the region's 28 Premier Performers.

Potential avenues for future growth include increasing emphasis on fee-based businesses such as asset management and advisory services, and continuing to leverage product innovation and technology to develop highly segmented, client-driven solutions. ■

How much has the supernormal loss environment benefited US commercial banks?

- The total market value of US commercial banks increased by $394 BN over the past five years to $1.4 TN. As of Q3 2006, the average charge-off rate was 0.42% of assets compared to the historical average for the past 10 years of 0.70%. If losses were to revert to the historical average, this could reduce market valuations by $137 BN, representing 35% of market value growth since 2002.
- In addition, the industry average loan-loss reserve of 1.23% of assets as of Q2 2006 was 47 bps less than the average for the past decade. If banks were to replenish their loan-loss provision to reflect historical norms, this could result in a one-time charge to earnings of $17.1 BN industry-wide, or about 11% of estimated 2006 earnings of $150 BN.
- While risk management and capital markets have significantly increased risk-transfer efficiency, it is unclear whether the market is properly considering the potential for mean reversion toward historic loss levels.

Shareholder performance hall of fame

The firms below have outperformed the other 400 companies on one or another dimension in the last five years.

2006 SPI Winners

Large cap

The 20 best-performing companies (out of 170), with an average market value over the previous year of greater than US $10 BN.

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
1	Anglo Irish Bank (Ireland)	R/CB	11.9	511
2	Chicago Mercantile Exchange (US)	EXC	15.9	472
3	Sberbank (Russia)	R/CB	36.9	457
4	QBE Insurance Group (Australia)	PPC	13.8	425
5	China Life Insurance Company (China)	PLI	12.6	347
6	Erste Bank (Austria)	R/CB	18.8	308
7	Scotiabank (Canada)	UB	41.3	306
8	Moody's (US)	SPO	18.0	300
9	ICICI Bank (India)	R/CB	12.7	297
10	Prudential Financial (US)	PLI	37.9	283
11	Principal Financial Group (US)	PLI	14.5	278
12	UnitedHealth Group (US)	PHI	70.2	277
13	Bank of China (Hong Kong)	R/CB	22.6	274
14	WellPoint (US)	PHI	48.5	265
15	RBC Financial Group (Canada)	DB	54.8	264
16	State Bank of India (India)	R/CB	11.2	255
17	Franklin Resources (US)	AM	25.3	252
18	Wachovia (US)	R/CB	101.5	248
19	KBC Group (Belgium)	DB	39.5	245
20	Sampo (Finland)	DB	11.8	244

Mid cap

The 20 best-performing companies (out of 230), with an average market value over the previous year of less than US $10 BN.

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
1	Sydbank (Denmark)	UB	2.4	561
2	Promina Group (Australia)	MI	4.6	485
3	Singapore Exchange (Singapore)	EXC	2.7	466
4	People's Bank (US)	R/CB	4.9	441
5	Australian Stock Exchange (Australia)	EXC	4.3	429
6	Grupo Financiero Banorte (Mexico)	R/CB	5.7	407
7	Jyske Bank (Denmark)	R/CB	3.7	378
8	Gruppo Banca Carige (Italy)	R/CB	5.2	377
9	Banco de Valencia (Spain)	R/CB	4.3	366
10	Allco Finance Group (Australia)	AM	2.1	361
11	Hypo Real Estate Holding (Germany)	SPO	8.3	358
12	Hong Kong Exchanges and Clearing (Hong Kong)	EXC	7.3	356
13	Banco Pastor (Spain)	R/CB	3.8	352
14	Topdanmark (Denmark)	MI	2.7	337
15	Kotak Mahindra Bank Group (India)	R/CB	2.1	335
16	Grupo Bancolombia (Colombia)	R/CB	3.6	332
17	Public Bank (Malaysia)	R/CB	6.4	314
18	Wing Hang Bank (Hong Kong)	R/CB	2.7	311
19	Bank Rakyat Indonesia (Indonesia)	R/CB	5.5	308
20	Banca Popolare di Sondrio (Italy)	R/CB	3.7	307

'The $50 BN Club'

The 10 best-performing companies with average market value of more than US $50 BN over the previous year.

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
1	UnitedHealth Group (US)	PHI	70.2	277
2	RBC Financial Group (Canada)	DB	54.8	264
3	Wachovia (US)	R/CB	101.5	248
4	Wells Fargo (US)	R/CB	114.3	201
5	Bank of America (US)	UB	222.5	183
6	Crédit Agricole (France)	UB	58.7	171
7	Manulife Financial (Canada)	PLI	50.1	168
8	U.S. Bancorp (US)	R/CB	57.1	148
9	American Express (US)	CON	66.8	131
10	Société Générale (France)	UB	67.1	130

There were 37 super-large-cap firms with average market values greater than $50 BN in 2006, up from 30 last year. The group's average SPI is 67, significantly below the overall average of 100. Thus, super-large-cap firms continue to deliver lower shareholder performance, on average, than smaller companies.

American Express (Amex), a Premier Performer, provides credit, payment processing and travel services to consumer and SME clients worldwide. Amex has recently undertaken a series of strategic initiatives to significantly improve its performance, including the spin-off of Ameriprise Financial. In 2006, the firm increased its ROE (from 23 to 26), grew its revenue (the first half of 2006 was 13% higher than the first half of 2005) and decreased its cost-income ratio (from 70 to 68). Its unique position as a card issuer, network processor and merchant acquirer allows Amex to capture the entire payments value chain. There are a number of threats to future growth, however. On the one hand, merchants are pushing for lower fees; on the other hand, there is growing competition from merchants, such as Wal-Mart, now seeking to enter the banking and processing industries, and from new entrants such as Tempo Payments, an alternative payment network featuring retailer-branded debit cards.

Subindustry key:

AM = Asset Manager
BR = Broker
CON = Consumer Finance
DB = Diversified Financial Institution
EXC = Exchange
IB = Investment Bank
INBR = Insurance Broker
MI = Mixed Insurance
PHI = Pure Health Insurance
PLI = Pure Life Insurance
PPC = Pure Property & Casualty Insurance
PRO = Custody/Processor
R/CB = Retail and Commercial Bank
RI = Reinsurance
SPO = Other
UB = Universal Bank

Consistent performers

Large cap

Top 10 companies (out of 170), with an average market value over the previous year of greater than US $10 BN, with the highest average SPI over the last five years.

#	Name	Sub-industry	Avg 2006 MV (US $BN)	Avg SPI over last five years
1	Anglo Irish Bank (Ireland)	R/CB	11.91	410
2	UnitedHealth Group (US)	PHI	70.18	382
3	St. George Bank (Australia)	R/CB	12.17	281
4	Erste Bank (Austria)	R/CB	18.81	268
5	Scotiabank (Canada)	UB	41.35	259
6	Great-West Lifeco (Canada)	MI	23.63	237
7	SLM (Sallie Mae) (US)	CON	21.33	235
8	RBC Financial Group (Canada)	DB	54.80	234
9	MAN Group plc (UK)	AM	14.42	222
10	Manulife Financial (Canada)	PLI	50.06	219

Mid cap

Top 10 companies (out of 230), with an average market value over the previous year of less than US $10 BN, with the highest average SPI over the last five years.

#	Name	Sub-industry	Avg 2006 MV (US $BN)	Avg SPI over last five years
1	Gruppo Banca Carige (Italy)	R/CB	5.18	344
2	Housing Development Finance Corporation (India)	CON	7.46	287
3	Public Bank (Malaysia)	R/CB	6.37	268
4	National Bank of Canada (Canada)	UB	8.89	256
5	Banca Popolare de Sondrio (Italy)	R/CB	3.68	253
6	People's Bank (US)	R/CB	4.93	243
7	CIC (Crédit Industriel et Commercial) (France)	R/CB	8.95	238
8	Grupo Financiero Banorte (Mexico)	R/CB	5.69	231
9	RenaissanceRe (US)	RI	3.57	225
10	Bank of Oklahoma (US)	R/CB	3.33	222

Anglo Irish Bank owes much of its success to a concentrated focus on business lending, treasury and wealth management in the Irish, UK and US markets. Business lending, its largest and most profitable segment, has grown by 38% annually over the last 10 years. A centralized loan approval process has helped the bank maintain high asset quality and minimize the risks of portfolio concentration. In addition, the bank has exploited synergies among its narrow business mix to achieve a low cost-income ratio of 27%, providing a strong foundation for organic growth.

Grupo Financiero Banorte, one of Mexico's leading banks, has maintained steady growth in shareholder returns despite a volatile home market. In 2004, after years of successful in-market organic growth and consolidation, the firm launched a multi-strategy approach for entering the US that leverages its competitive advantages with the Hispanic market, the largest and fastest growing population segment in the US. To date the firm has created alliances with Wells Fargo and Citizens South Bank (2004) and acquired a majority interest in Texas-based INB Financial Corporation (2006), making it the first Mexican bank authorized by the Federal Reserve to offer banking services in the US.

Rising stars

Large cap

Top 10 companies (out of 170) that have improved their SPI ranking by the most places since last year.

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI	Ranks moved
1	American Express (US)	CON	66.8	131	167
2	China Merchants Bank Company (China)	R/CB	13.4	153	163
3	Banco Sabadell (Spain)	R/CB	10.7	226	158
4	QBE Insurance Group (Australia)	PPC	13.8	425	153
5	Wells Fargo (US)	R/CB	114.3	201	153
6	Allstate (US)	MI	36.4	170	146
7	Aflac (US)	PLI	22.8	155	140
8	Goldman Sachs (US)	IB	69.1	127	136
9	Capitalia Gruppo Bancario (Italy)	R/CB	21.0	104	130
10	EFG Eurobank Ergasias (Greece)	R/CB	12.0	132	119

Mid cap

Top 10 companies (out of 230) that have improved their SPI ranking by the most places since last year.

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI	Ranks moved
1	Piraeus Bank (Greece)	R/CB	6.7	135	212
2	Banco BPI (Portugal)	R/CB	5.3	257	204
3	Banco Espirito Santo (Portugal)	R/CB	6.9	143	188
4	The Bank of East Asia (Hong Kong)	R/CB	6.4	274	180
5	Landesbank Berlin Holding (Germany)	R/CB	6.5	88	176
6	P.T. Bank Danamon Indonesia (Indonesia)	R/CB	2.7	89	172
7	Banca Popolare dell'Emilia Romagna (Italy)	R/CB	4.8	250	168
8	Attijariwafa Bank (Morocco)	R/CB	4.1	254	151
9	Hong Kong Exchanges and Clearing (Hong Kong)	EXC	7.3	356	133
10	Cullen/Frost Bankers (US)	R/CB	3.1	185	131

QBE Insurance Group is an Australian property and casualty insurance company that has grown via numerous cross-border acquisitions and achieved diversification across geographies and products. Revenue derived from Australian operations now represents a mere 25% of the firm's total. The firm has branched out from traditional PPC products into new markets such as reinsurance and niche commercial risks. With a strong customer focus, QBE's disciplined, systematic business planning approach has enabled it to successfully integrate large acquisitions (seven in 2005 alone) while achieving an impressive 87.9 combined ratio.

Hong Kong Exchanges and Clearing is comprised of leading securities and futures exchanges in Asia (excluding Japan). The firm has benefited from strong regional capital formation and the rapid growth of the Chinese economy. In 2006, it raised $41.9 BN in IPO offerings, ranking second only to the London Stock Exchange. Through Hong Kong Exchanges and Clearing's close partnerships with the Shanghai and Shenzhen exchanges, mainland companies represent approximately 50% of its listed firms' market capitalization.

Regional and sectoral performance league tables, end 2006

The tables below list the top-performing financial services companies with SPIs greater than 100 (the global median) by region and sector. The market value progression by sector is also provided for each region.

North America

Banks

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
Large cap				
1	Scotiabank (Canada)	UB	41.3	306
2	RBC Financial Group (Canada)	DB	54.8	264
3	Wachovia (US)	R/CB	101.5	248
4	BMO Financial Group (Canada)	UB	29.3	240
5	Bear Stearns (US)	IB	16.5	230
Mid cap				
1	People's Bank (US)	R/CB	4.9	441
2	National Bank of Canada (Canada)	UB	8.9	281
3	Hudson City Bancorp (US)	R/CB	7.6	280
4	Compass Bancshares (US)	R/CB	7.0	221
5	Colonial BancGroup (US)	R/CB	3.9	212

Insurance providers

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
Large cap				
1	Prudential Financial (US)	PLI	37.9	283
2	Principal Financial Group (US)	PLI	14.5	278
3	UnitedHealth Group (US)	PHI	70.2	277
4	WellPoint Inc. (US)	PHI	48.5	265
5	Great-West Lifeco (Canada)	MI	23.6	244
Mid cap				
1	W.R. Berkley (US)	PPC	6.8	298
2	Markel (US)	PPC	3.6	273
3	Arch Capital Group (US)	MI	4.4	221
4	Philadelphia Consolidated Holding (US)	PPC	2.5	195
5	Humana (US)	PHI	9.1	185

Europe

Banks

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
Large cap				
1	Anglo Irish Bank (Ireland)	R/CB	11.9	511
2	Sberbank (Russia)	R/CB	36.9	457
3	Erste Bank (Austria)	R/CB	18.8	308
4	KBC Group (Belgium)	DB	39.5	245
5	Sampo (Finland)	DB	11.8	244
Mid cap				
1	Sydbank (Denmark)	UB	2.4	561
2	Jyske Bank (Denmark)	R/CB	3.7	378
3	Gruppo Banca Carige (Italy)	R/CB	5.2	377
4	Banco de Valencia (Spain)	R/CB	4.3	366
5	Banco Pastor (Spain)	R/CB	3.8	352

Insurance providers

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
Large cap				
1	CNP Assurances (France)	PLI	13.7	225
Mid cap				
1	Topdanmark (Denmark)	MI	2.7	337
2	Wiener Städtische Versicherung (Austria)	MI	6.6	225
3	Amlin plc (UK)	PPC	2.7	210
4	UNIQA (Austria)	MI	3.9	198
5	Corporacion MAPFRE (Spain)	MI	4.8	185

Rest of World

Banks

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
Large cap				
1	ICICI Bank (India)	R/CB	12.7	297
2	Bank of China (Hong Kong)	R/CB	22.6	274
3	State Bank of India (India)	R/CB	11.2	255
4	Mitsui Trust Financial Group (Japan)	R/CB	10.7	219
5	St. George Bank (Australia)	R/CB	12.2	200
Mid cap				
1	Grupo Financiero Banorte (Mexico)	R/CB	5.7	407
2	Kotak Mahindra Bank Group (India)	R/CB	2.1	335
3	Grupo Bancolombia (Colombia)	R/CB	3.6	332
4	Public Bank (Malaysia)	R/CB	6.4	314
5	Wing Hang Bank (Hong Kong)	R/CB	2.7	311

Insurance providers

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
Large cap				
1	QBE Insurance Group (Australia)	PPC	13.8	425
2	China Life Insurance Company (China)	PLI	12.6	347
3	Millea Holdings (Japan)	MI	32.1	128
4	Mitsui Sumitomo Insurance Company (Japan)	PPC	18.8	128
Mid cap				
1	Promina Group (Australia)	MI	4.6	485
2	Aioi Insurance Company (Japan)	PPC	5.4	255
3	Insurance Australia Group (Australia)	PPC	6.7	145
4	Samsung Fire & Marine Insurance Company (Korea)	PPC	7.0	136
5	NIPPONKOA Insurance Company (Japan)	PPC	7.0	134

Specialty providers

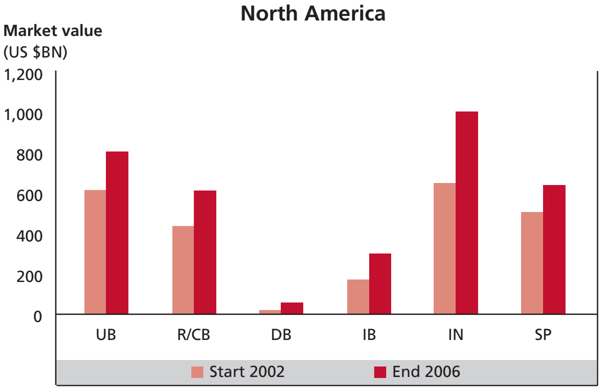
#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
Large cap				
1	Chicago Mercantile Exchange (US)	EXC	15.9	472
2	Moody's (US)	SPO	18.0	300
3	Franklin Resources (US)	AM	25.3	252
4	Countrywide Financial (US)	CON	22.5	232
5	Fidelity National Information Services (US)	SPO	12.8	199
Mid cap				
1	First Marblehead (US)	SPO	3.3	166
2	First American (US)	INBR	4.0	139
3	Alliance Data Systems (US)	PRO	4.2	125
4	Global Payments (US)	PRO	3.7	123
5	Erie Indemnity (US)	INBR	3.1	110

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
Large cap				
1	Deutsche Boerse Group (Germany)	EXC	14.8	181
2	MAN Group plc (UK)	AM	14.4	120
Mid cap				
1	Hypo Real Estate Holding (Germany)	SPO	8.3	358
2	Henderson Group plc (UK)	AM	1.9	305
3	Euronext (France)	EXC	9.8	240
4	ICAP plc (UK)	BR	5.5	161
5	Northern Rock plc (UK)	CON	8.6	133

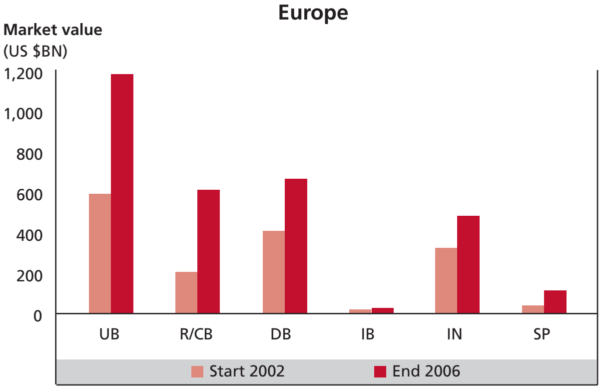
#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
Large cap				
1	ORIX (Japan)	SPO	24.8	153
Mid cap				
1	Singapore Exchange (Singapore)	EXC	2.7	466
2	Australian Stock Exchange (Australia)	EXC	4.3	429
3	Allco Finance Group (Australia)	AM	2.1	361
4	Hong Kong Exchanges and Clearing (Hong Kong)	EXC	7.3	356
5	Housing Development Finance Corporation (India)	CON	7.5	246

Market value by sector

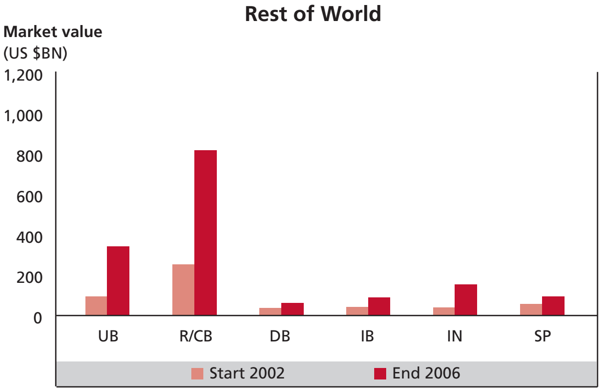
North America



Europe



Rest of World



Premier Performers of the past decade

Premier Performers represent the 54 firms with SPI scores consistently above the average SPI for their respective subindustries and regions over time periods of three, five and 10 years.

Large cap

The 20 best-performing Premier Performers (out of 27), with an average market value over the previous year of greater than US $10 BN.

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
1	Anglo Irish Bank (Ireland)	R/CB	11.9	511
2	Scotiabank (Canada)	UB	41.3	306
3	UnitedHealth Group (US)	PHI	70.2	277
4	RBC Financial Group (Canada)	DB	54.8	264
5	KBC Group (Belgium)	DB	39.5	245
6	Sampo (Finland)	DB	11.8	244
7	Great-West Lifeco (Canada)	MI	23.6	244
8	Bear Stearns (US)	IB	16.5	230
9	Danske Bank Group (Denmark)	R/CB	25.2	203
10	St. George Bank (Australia)	R/CB	12.2	200
11	SEB Group (Sweden)	UB	16.8	196
12	Banco Popular Español (Spain)	R/CB	18.5	192
13	Bank of America (US)	UB	222.5	183
14	Natixis (France)	R/CB	15.3	181
15	TD Bank Financial Group (Canada)	UB	40.2	164
16	OCBC Bank (Singapore)	DB	13.3	164
17	Commonwealth Bank of Australia (Australia)	R/CB	44.4	159
18	Swedbank (Sweden)	R/CB	15.4	155
19	Canadian Imperial Bank of Commerce (Canada)	UB	24.5	154
20	ORIX (Japan)	SPO	24.8	153

Mid cap

The 20 best-performing Premier Performers (out of 27), with an average market value over the previous year of less than US $10 BN.

#	Name	Sub-industry	2006 Avg MV (US $BN)	SPI
1	Sydbank (Denmark)	UB	2.4	561
2	People's Bank (US)	R/CB	4.9	441
3	Grupo Financiero Banorte (Mexico)	R/CB	5.7	407
4	Jyske Bank (Denmark)	R/CB	3.7	378
5	Banco de Valencia (Spain)	R/CB	4.3	366
6	Banco Pastor (Spain)	R/CB	3.8	352
7	Topdanmark (Denmark)	MI	2.7	337
8	Kotak Mahindra Bank Group (India)	R/CB	2.1	335
9	Banca Popolare di Sondrio (Italy)	R/CB	3.7	307
10	W.R. Berkley (US)	PPC	6.8	298
11	National Bank of Canada (Canada)	UB	8.9	281
12	Banco de Crédito e Inversiones (Chile)	R/CB	2.7	281
13	Markel (US)	PPC	3.6	273
14	Banco BPI (Portugal)	R/CB	5.3	257
15	Attijariwafa Bank (Morocco)	R/CB	4.1	254
16	HDFC Bank (India)	R/CB	5.9	253
17	Banca Popolare dell'Emilia Romagna (Italy)	R/CB	4.8	250
18	OTP Bank (Hungary)	R/CB	9.7	234
19	Banca Popolare di Milano (Italy)	R/CB	5.5	229
20	Wiener Städtische Versicherung (Austria)	MI	6.6	225

METHODOLOGY

Background and approach

The financial services industry is becoming increasingly global. Financial services firms can pursue opportunities in many different sectors and geographies. Their senior managers thus require an objective measure of risk-adjusted shareholder value performance specific to their sector/geography that can be used to track their performance relative to peers.

Investors, meanwhile, have correspondingly broad options when allocating capital in the financial services industry. As such, they require a relevant benchmark that puts all financial services providers on an even playing field, regardless of the sectors and geographies in which they operate.

Oliver Wyman has created, and systematically tracks, a single performance index that provides a solution to both needs. Since creating the Shareholder Performance Index (SPI) in 1997, we have calculated it annually as a benchmark for the volatility-adjusted shareholder value performance of the world's largest financial institutions.

Several features distinguish the SPI from other performance-based indices for financial institutions:

- It is a measure of risk-adjusted performance. If two firms have produced the same absolute return to shareholders, the one whose returns are less volatile is ranked higher;
- It covers all parts of the global financial services 'value chain'. Sector definitions are given below;
- Takeovers, mergers, spin-offs and currency effects are explicitly captured and used to adjust raw performance data. A firm cannot move up the rankings simply by getting bigger in a local currency.

The SPI calculation

Each calculation of the SPI is based on a five-year moving 'window' of performance data for the top 400 financial institutions worldwide, in terms of market valuation at the end of the period. Consequently, the present index is calculated over the period January 2002-December 2006 and for the 400 largest firms worldwide as of December 31, 2006.

This five-year window is designed to measure shareholder performance over the medium-term. As a result, SPI scores can be affected both by the inclusion of the past year's data, and the exclusion of data from over five years ago. Changes in SPI from year to year do not solely reflect performance in the last year – rather, they reflect changes in a company's five-year medium-term performance.

The first step in calculating the SPI is to compute the five-year Sharpe Ratio for a given institution:

Sharpe Ratio(firm) = Return(r^*)/Risk(r^*) where

r^* = Monthly measurements of total merger-adjusted shareholder return net of the risk free rate (Excess Returns)

Return(r^*) = Geometric average of r^*

Risk (r^*) = Standard deviation of r^*

We calculate the Sharpe ratio for each of the 400 institutions in our universe and rank them from highest to lowest. The SPI for a given firm is then defined by comparing it to the median firm in our universe:

SPI (firm) = [Sharpe Ratio(firm)-Sharpe Ratio(median firm)] x 1000 + 100

Sector definitions

Retail and commercial banks primarily serve retail customers and small- to medium-sized companies. They do not have significant wholesale/capital markets operations and their activities are predominantly domestic. Examples include Wells Fargo, Danske Bank, Commonwealth Bank of Australia and Jyske Bank.

Universal banks are multi-line commercial banks that combine a retail network with a significant wholesale/capital markets operation. Their wholesale activities tend to give universal banks a significant international presence and they are among the most visible global financial institutions. Examples include HSBC, JPMorgan Chase, Barclays, Deutsche Bank, ABN AMRO and Sumitomo Mitsui Banking Corporation.

Investment banks are firms that engage primarily in corporate advisory work, securities underwriting, brokerage and sales and trading of capital market instruments. Examples include Wall Street bulge bracket firms, such as Merrill Lynch and Morgan Stanley, and non-US investment banks such as Nomura Holdings and Macquarie Bank.

Diversified financial institutions are companies that operate both major banking and insurance operations. Examples include Fortis, ING Group, Lloyds TSB and Allianz.

Insurance providers include firms whose sole or primary business is insurance (whether life, health, P&C and/or reinsurance), such as Aegon, AXA Group, Chubb and Swiss Re.

Specialty providers are 'narrow-line' or 'monoline' companies that are primarily engaged in a single activity (or related set of activities). We cover six sub-segments: asset managers, brokers, consumer finance, custody/processors, exchanges and insurance brokers. Examples include State Street (custody), Fannie Mae (consumer finance) and Charles Schwab (broker). ■

Oliver Wyman

For additional information please contact:

North America
1 212 541 8100
marketingna@oliverwyman.com

EMEA
44 20 7333 8333
marketingeu@oliverwyman.com

Asia Pacific
65 6510 9700
marketingasia@oliverwyman.com

OLIVER WYMAN

Originally published in January 2007 by Mercer Oliver Wyman

State of the Financial Services Industry 2007

MMC MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN