

# Global Securities Industry Outlook

*Issues on the horizon*

Mid-year update: 2008



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# Executive summary

As 2008 began, many securities executives were probably reminded of the Chinese curse, "May you live in interesting times." What began as a problem in the market for securitized U.S. subprime mortgages rapidly spread to other markets and ricocheted around the world as investment dried up for a wide range of instruments.

The repercussions have been widespread. Major financial institutions have announced billions in write-offs, and many fear the crisis is not yet over. To replenish the lost capital, firms looked abroad to sovereign wealth funds, which took major equity positions in several leading firms.

The losses led to the departure of CEOs and senior executives at several major institutions. A round of industry consolidation may be in store, with firms that enjoy larger balance sheets and have suffered fewer losses acquiring institutions that have been hit hardest. Concerns about a recession in the U.S. economy continue to be a top story that the industry is monitoring closely.

Securities firms have prospered over the last several years in large part by taking on more risk through proprietary trading for their own accounts, often of increasingly complex structured products. While there has recently been much attention on operational risk, the turbulent events of the past year have underscored the continuing need for upgraded management of market, credit, and especially, liquidity risk.

The industry has been responding to a welter of new legislative and regulatory requirements over the last several years, and the credit crisis has already led to more proposals for additional regulations. Adopting more efficient approaches to managing these multiple requirements will be important to remain competitive. Securities firms face a more unsettled industry and economic environment than they have in a number of years. Here are issues that we believe securities firms will need to address as the year continues to unfold:

- **Enhancing risk management in structured products.** The recent problems in the credit markets, combined with securities firms increasingly investing their own capital in complex structured products, has moved market, credit, and liquidity risk management to the top of the agenda for senior management. Key priorities will be to improve the ability to manage the risk of improbable events, strengthen due diligence into the risks associated with securitized instruments, and increase the effectiveness of liquidity risk management.
- **Developing a pipeline of management talent.** The reverberations from the credit and subprime crisis have led to senior management changes at major firms and brought home the critical importance of succession planning for the C-suite. As the fallout continues, securities firms will need to devise both short-term strategies to ensure the success of any outsiders brought in to fill vacancies, and long-term plans to identify, grow, and retain a leadership pipeline over time.
- **Taking a holistic approach to compliance.** Over the last several years, securities firms have faced a substantial burden responding to a variety of new and more complex regulatory requirements. Most firms have addressed each new requirement individually, which has led to redundant processes, data gathering, and testing. Firms are finding that adopting an integrated approach that spans different compliance regulatory requirements, lines of business, and functions can substantially increase efficiency while also providing greater control of compliance risks.
- **Cost management back in vogue.** With the market turmoil and economic slowdown, cost reduction has assumed an even higher priority. Achieving substantial reductions that can be sustained over the long term, and doing so in a way that doesn't impair company performance, will require an enterprise approach.
- **Safeguarding data: The move to vendor risk management.** Events involving lost or stolen customer information have become all too common and have the potential to significantly damage a firm's reputation. Securities firms have increased their investments in keeping such data secure, but many of these efforts have a troubling blind spot—their numerous outsourcing vendors and other partners. To ensure these relationships do not create a weak link in the protection of confidential data, firms will need to take a more disciplined, enterprise-wide approach to vendor risk management.

# Enhancing risk management in structured products

The importance of managing operational risk has received substantial attention among securities firms over the last several years. While the focus on operational risk was overdue, the credit crisis that began in 2007 cast a spotlight on the continuing challenges of market, credit, and liquidity risk management in today's world of derivatives and structured products.

## The shot heard round the world

What started as a wave of defaults in U.S. subprime mortgages quickly became a liquidity crisis affecting the entire securitization market. Trading volumes collapsed in the primary and secondary markets for collateralized debt obligations (CDOs) of all types—including the tranches backed by high-quality assets unrelated to subprime mortgages as highly leveraged hedge funds and other investors sold whatever they could to meet margin calls or redemptions. As an example, CDO issuance, which had more than tripled from 2004 to 2006, plunged more than 60% from the second to the third quarters of 2007.<sup>1</sup> (See Exhibit 1.) Given the global integration of capital markets, the after-shocks were felt in Europe and Asia as well. By January 2008, commercial and investment banking firms had announced roughly \$100 billion in write-downs, and some fear there may be more to come.<sup>2</sup> The losses have led firms to turn to sovereign wealth funds for major capital infusions.

As 2008 began, the situation had stabilized somewhat—on January 3, the market for asset-backed commercial paper rose after falling for 20 weeks in a row.<sup>3</sup> Yet, nobody thinks the problems are over. The securities industry is bracing for further write-downs and a round of job losses, and preparing to defend against litigation over their roles. In the third quarter of 2007, U.S. federal securities class-action lawsuits were filed at an annual pace more than twice that of the year before.<sup>4</sup> The U.S. Securities and Exchange Commission and the New York attorney general have launched investigations into the activities of a number of firms.<sup>5</sup>

Exhibit 1



## Emerging risk management priorities

Although the full implications of the credit crisis are still emerging, it is already clear that there are a number of key issues that securities firms will need to address:

- **Expect the unexpected.** When risk management models failed to manage the credit crisis, some executives argued that the confluence of events and market developments couldn't be expected to occur more than once in 100 years. Yet, similar explanations were offered in the wake of other crises, such as the collapse of Long-Term Capital Management in 1997-98. But these events have emphasized the need for many firms to do a better job of managing the risks from these improbable events, which are not adequately addressed by Value at Risk (VaR) models. Techniques designed to address such rare events include stress testing (which takes into account whether a firm can withstand extreme market conditions), scenario analysis (where multiple factors are stressed at once), and correlation testing (which assesses the extent to which different instruments or positions are likely to move in tandem). Models also need to be back-tested to evaluate how they would have performed under historical market conditions.

<sup>1</sup> Securities Industry and Financial Markets Association (SIFMA), [http://www.sifma.org/research/pdf/SIFMA\\_CDOIssuanceData2007.pdf](http://www.sifma.org/research/pdf/SIFMA_CDOIssuanceData2007.pdf).

<sup>2</sup> Peter S. Goodman and Floyd Norris, "No Quick Fix to Downturn," *The New York Times*, January 13, 2008.

<sup>3</sup> "Stepping beyond subprime," *The Economist*, January 10, 2008.

<sup>4</sup> "The finger of suspicion," *The Economist*, December 22, 2007.

<sup>5</sup> Ibid.

- **Correlations are not forever.** Hedging strategies are based on measurable correlations between movements in different markets. This works fine in normal times, but a severe disruption in one market can alter the normal correlation with another market in unpredictable ways, with leverage exacerbating the effect. “High leverage in one market can end up devastating another, unrelated, perfectly healthy market,” observed Richard Bookstaber, author of a recent book on hedge funds and financial innovation. “This happens when a market under stress becomes illiquid and fund managers must look to other markets: If you can’t sell what you want to sell, you sell what you can. This puts pressure on markets that have nothing to do with the original problem.”<sup>6</sup>
- **Liquidity trumps all.** Hedging strategies and risk management controls can become virtually meaningless in an instant if no buyers can be found at any reasonable price. The recent market developments have underlined the importance of incorporating liquidity risk into risk management models to assess whether a firm could have problems in selling its positions or whether values in an illiquid market could be depressed when another investor unloads a large holding.
- **The promise—and perils—of ownership.** Over the last several years, more securities firms have moved from simply acting as intermediaries in packaging deals to investing their own capital in the hopes of greater gains. Proprietary investing has been a profitable strategy for many firms, but its attendant risks have been highlighted during the credit crisis. The firms that suffered the greatest losses were those that not only packaged subprime securities, but also bought them heavily for their own accounts. Yet, even among those committed to investing their capital, some firms sensed the early warning signs of trouble ahead and reduced their positions to the subprime sector before liquidity evaporated.
- **Need for more effective due diligence.** Many investors appear to have purchased complex securitization instruments relying solely on the ratings provided by the credit rating agencies. The ratings agencies have taken fire for assigning AAA ratings to high-quality tranches of CDOs, only to see those investments decimated when liquidity dried up. The agencies have responded that their ratings reflect the risk of default, not the liquidity of the markets. What is clear, however, is that institutional and individual investors cannot simply rely on ratings, but need to understand the nature of the complex securities they are purchasing and independently assess the associated risks.

The credit crunch is likely to reverberate throughout 2008 and into 2009. But beyond responding to the current crisis, forward-looking firms will be working to incorporate the lessons learned into more sophisticated risk management processes designed to avoid a repetition of recent events. Although the market for structured products may take time to recover fully, the benefits they provide are too attractive to ignore. As the market recovers, securities firms will approach these products with some hard-won experience of their risks and the unexpected turns they can take.

<sup>6</sup> Richard Bookstaber, “The Myth of Noncorrelation,” *Institutional Investor*, September 17, 2007.

# Developing a pipeline of management talent

Over the past several months, the subprime crisis has led to sudden changes in upper management at a number of securities firms. Those changes underscore an important imperative: Firms will need to strengthen efforts to build a leadership pipeline that identifies and grows talent, ensures smooth transitions, and enables promoted executives to succeed in their new roles.

Talent shortages have been an issue for some time in the industry. But the recent spate of high-profile departures of senior executives has highlighted a key aspect of the talent issue—succession at the top of the organization. When transitions in upper management are not handled smoothly, the disruption can be costly in terms of money, time, and corporate reputation. According to research conducted by Aon Consulting, the abrupt departure of a CEO typically has a negative impact on market capitalization of about 2.5%.<sup>7</sup> What's more, if there is significant upheaval in the management ranks, it could increase the potential for actions by regulators who are concerned about effective risk management and business continuity processes.

Nevertheless, many industries, including securities, have tended to give succession management short shrift. A 2006 survey by the American Bankers Association found that nearly one-third of financial institutions didn't have a formal succession plan in place.<sup>8</sup> In a recent Korn/Ferry International survey of CEOs and directors, 66% of respondents identified succession planning as one of a board's three most important functions—yet the same percentage said their boards do not give it the time and attention they should.<sup>9</sup>

## Growing pressure ahead

Too often, boards and management are distracted by short-term issues, such as quarterly results and compliance, and so put succession management on the back burner. Boards may feel reluctant to discuss a potentially difficult topic with the CEO. And executives may resist the idea of designating an heir in an industry where politics and power struggles at the top are not uncommon. At Wall Street firms, "a CEO spends half his time hanging onto his seat. He doesn't want to create a successor who is going to be there to push him over the side," Roy Smith, a professor of finance at the Leonard N. Stern School of Business at New York University, recently told *The New York Times*.<sup>10</sup>

Securities firms will need to overcome such obstacles because ongoing developments are making succession management more critical than ever. As the credit crisis plays out, securities firms will likely see greater pressure on management—and potentially the departure of more CEOs and other senior executives.

Broad structural changes in the industry will also increase the pressure to improve succession management. Although the mergers and acquisitions market has cooled, industry consolidation is likely to continue as firms that were relatively unscathed by the market downturn buy up those that took a more significant hit, and thus are available at a reduced price. Such deals increase the risk of top talent leaving and, at the same time, make it more difficult for management and the board to have an accurate view of potential replacements.

## Ensuring a smooth transition

In this environment, securities firms need to have robust succession plans in place. These plans may vary, but in general, they should encompass three fundamental components: identifying the qualities required for key positions; having the board, senior management, and HR work together to assess the talent pipeline; and creating development programs that will help ensure executives are successful in their new roles. As they build their talent pipelines, securities firms need to consider several leading practices:

- **Broaden the internal search.** Today, succession management plans usually cover senior management and the executive level, as well as some focus on middle management. But securities firms may want to start looking more deeply. As a recent report from the Society for Human Resources Management points out, "Current and impending talent shortages may force organizations to consider adding more levels to their succession plans to include employees in middle management and non-management positions."<sup>11</sup>

<sup>7</sup> Seymour Adler, "Replacing the Irreplaceable: Executive Succession Planning," Aon Consulting Forum, September 2007.

<sup>8</sup> Karen Krebsbach, "Exit Strategy," *US Banker*, August 2006.

<sup>9</sup> Joe Griesedieck and Bob Sutton, "Completing the CEO Succession Planning Picture," Korn/Ferry International Executive Insight, 2007.

<sup>10</sup> Louise Story, "No More Bench Strength," *The New York Times*, November 6, 2007.

<sup>11</sup> Shawn Fegley, "2006 Succession Planning," Society for Human Resource Management, June 2006.

- **Complement the internal pipeline with outside talent.**  
It is not always possible to rely on internal replacements, especially when a firm is seeking a dramatic change in strategic direction. Thus, securities firms should have processes in place for identifying talented executives at other firms and building relationships with those that are potentially a good fit. Doing so can provide a leg up when a position needs to be filled quickly.
- **Help new executives succeed.** Succession management has traditionally focused principally on the selection of candidates to fill key positions, rather than what they need to be effective. Today, it also needs to help executives adjust to their new roles. Onboarding processes should manage the executive's expectations, help him or her network and build a team, and provide individualized development programs right from the start.

Building a robust talent pipeline takes time. But with more executive departures on the horizon, securities firms may want to pursue several "quick fixes." They can, for example, form an interim talent task force comprised of the CEO and the board to determine what qualities key positions require. They can conduct a workforce diagnostic to identify possible replacements who are "ready now." And they can create processes to help executives adjust quickly to new positions.

Too often overlooked, the dramatic developments in the industry have brought succession management to the fore. By combining such short-term actions with a longer-term strategy, firms will be in a position to create a robust, sustainable pipeline of top talent.

# Taking a holistic approach to compliance

Securities firms have been facing an avalanche of additional compliance requirements over the last several years. Among the initiatives that have placed a significant burden on securities firms have been the section 404 internal-control requirements of Sarbanes-Oxley, anti-money laundering and customer identification requirements, the SEC Books and Records 36-month rule, and the NASD Supervisory Procedures and CEO Certification rules, among others.<sup>12</sup>

The proliferation of new requirements has driven up compliance costs, which can total an estimated \$500 million to \$1 billion at the largest institutions. The Securities Industry and Financial Markets Association estimated that the U.S. securities industry alone spent \$25.5 billion on compliance-related activities in 2005 and the figure is undoubtedly higher today. A 2007 survey by the Deloitte Center for Banking Solutions of 20 of the 50 largest bank and thrift-holding institutions, many of which have securities operations, found that compliance costs had increased on average by 159% from 2002 to 2006. Further, the survey found that compliance spending is claiming a larger share of net income, rising from an average of 2.83% in 2002 among those surveyed to 3.69% in 2006. Compliance responsibilities are also claiming more management time and attention that could be better spent developing new products, focusing on customers, driving profitability, and achieving business objectives. And, the complexity of compliance requirements is only expected to grow over the next several years. (See Exhibit 2.)

## Overlapping and redundant processes

Even when compliance processes are effective, they are undoubtedly expensive. Traditionally, firms have approached compliance requirements individually as they are received, without integrating them or leveraging existing activities, leading to multiple silos of overlapping and redundant compliance activities in lines of business and in functional areas such as internal audit, Sarbanes-Oxley, legal, regulatory compliance, and quality assurance. Further, when new regulatory requirements have been put in place, most firms have simply created another silo, with new internal policies, processes, and systems, without first determining whether some or all of the new requirements could be met by an existing function, i.e., looking for points of commonality.

These redundant compliance activities needlessly drive up costs. They also create opaque processes and a bottom-up approach that can lead a securities firm to spend too much time worrying about minutia while key compliance risks go unrecognized and unaddressed.

The magnitude of compliance costs would seem to ensure that increasing the efficiency of compliance would be a high priority for

CEOs and senior management, especially chief financial officers and chief operations officers. At most firms, however, compliance is not on their radar screen. For a start, many firms don't even realize how much they are spending across their multiple compliance silos. In Deloitte's compliance survey, many firms were not able to easily provide their total compliance spending. Instead, to answer this basic question they had to gather information individually from many different groups and functions.

Many new regulations hold senior corporate executives personally liable for compliance, which has discouraged CEOs from seeking to reduce spending in this area. Many companies have instead become extremely risk averse, adopting a policy of zero tolerance for compliance defects, whatever the cost.

Finally, the fragmented organization of compliance is itself a reason why compliance has not received sufficient attention at most firms. Typically, no single senior-level executive is responsible for the entire compliance function, with separate compliance silos reporting to separate corporate departments. Most firms thus lack a senior-level champion to bring compliance issues to the attention of top management.

## Tearing down compliance silos

But the escalating costs and the significant drain on management's time are leading firms to recognize that creating an integrated, enterprise-wide approach to compliance can achieve a competitive advantage. Creating a new compliance "ecosystem" will use resources more efficiently, forge more effective working relationships among business units and functional departments, and help ensure that all compliance requirements are being met. Improving coordination and transparency yields gains in effectiveness and substantial improvements in efficiency. Specifically, an integrated approach yields the following key benefits:

- **Lower costs.** Eliminating redundancies and rationalizing compliance controls, testing, and reports can reduce annual compliance-related costs by 20% to 30%. These improvements come in several phases: "quick hits" (within the first six months), improvements to management processes (in six to 12 months), and technology enhancements (requiring more than 12 months).
- **Improved effectiveness.** Streamlining and coordinating diverse compliance activities improves compliance risk management by providing a better understanding of functional interdependencies and identification of high-risk areas when planning the scope, frequency, and timing of testing.

<sup>12</sup> "The Costs of Compliance in the U.S. Securities Industry," Securities Industry Association, February 2006.

- **Greater transparency.** Developing integrated standards and consolidated reports ensures that senior management has a clear picture of compliance and risk across the organization. For example, one financial institution found that it was generating more than 200 compliance reports annually, far too many for senior executives to use effectively. They are now designing compliance dashboards for different levels of management to reduce the number of reports and to focus attention on high-risk, high-priority areas.

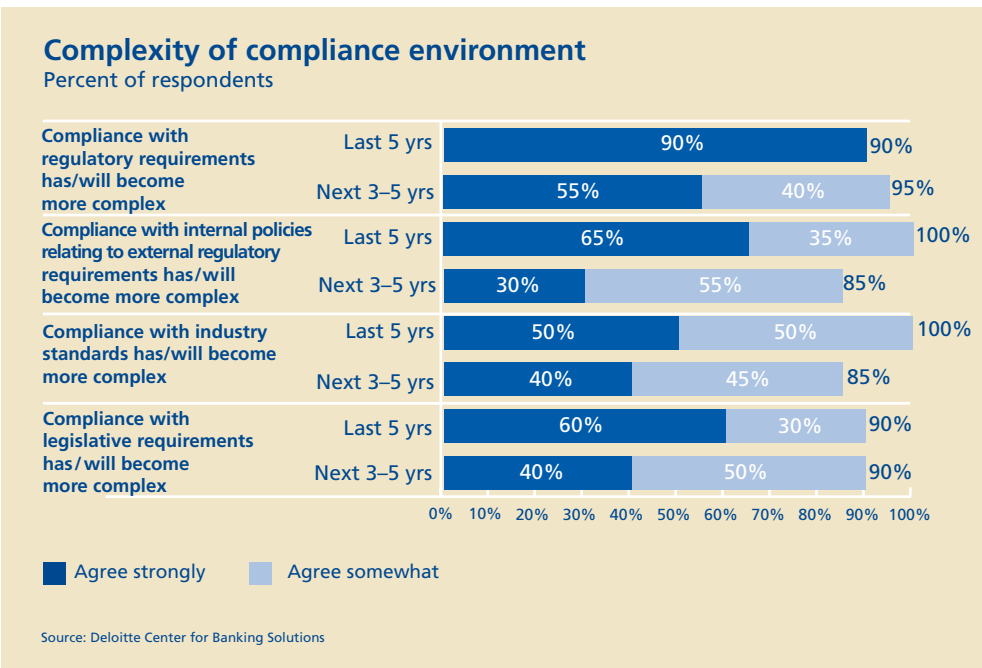
The first step in creating a more integrated approach is to conduct an in-depth assessment of the current state of compliance activities across the organization—identifying areas of burden, which could be redundant or overlapping activities, inconsistent compliance definitions employed by different functions, and incompatible technology platforms across compliance silos. The result of this assessment is a project blueprint that identifies opportunities to

streamline and rationalize fragmented compliance activities, roles and responsibilities, governance, and reporting.

Once this assessment is complete, a proof-of-concept pilot project can develop a detailed action plan to streamline compliance in one line of business or compliance function. It is preferable to focus on a single line of business because it will provide the most complete picture of how diverse compliance activities interact. Once a successful pilot project is completed, the plan can be fine-tuned and rolled out across the organization.

The increasing number and complexity of compliance requirements is a trend that is likely to continue over the coming years. Securities firms that take an integrated approach can achieve a competitive advantage by significantly reducing the cost and overall burden of compliance, while simultaneously improving their control of compliance risks across the organization.

Exhibit 2



# Cost management: Looking beyond one-off initiatives

With current market conditions, securities firms are gearing up cost-containment efforts to cope with pressures on revenue and the changing expectations of investors for greater efficiency. To succeed, firms will need to develop a more detailed understanding of costs and use that understanding to drive actions that will have lasting, long-term results.

The need to reduce costs is hardly new in the industry, but a number of factors are coming together to make it more important and, in all likelihood, something that will be an ongoing reality for securities firms. The credit crisis and the resulting disruptions to the market have clearly brought cost management to the fore. So, too, has the fact that expenses for people and technology have been rising over the last several years. But there are also other, more systemic, factors at work.

For example, fees and income have been under pressure for several years. Total annual U.S. equity commissions, which were \$13.4 billion in 2002, are expected to fall to \$10.8 billion by the end of 2008, according to the Tabb Group.<sup>13</sup> A key culprit is the growing use of electronic trading, which greatly reduces transaction costs. Commissions for electronic algorithmic trading are generally one half or less of those paid in traditional trades. Increasing competition and investor choice are also playing a role. In Europe, for example, one aim of the Market in Financial Instruments Directive (MiFID) that took effect in November 2007 is to encourage greater competition. *The Wall Street Journal* noted that the cost of trading stocks in Europe—which historically has been relatively high—could fall by as much as 25% within a year.<sup>14</sup> “It’s certainly the biggest thing for the European financial markets since the introduction of the euro,” said Richard Portes, professor of economics at London Business School and president of the Centre for Economic Policy Research.<sup>15</sup>

Against this backdrop, institutional investors have a growing awareness of trading costs and their impact on returns. They are making it clear that they expect the industry to find ways to bring those costs down, and securities firms are working to comply. “We’ve really tried to squeeze out the unfair inefficiencies that intermediaries have tried to layer onto the process,” John Wheeler, head of trading at the investment management firm American Century Investments, told *Institutional Investor*.<sup>16</sup> By 2007, American Century was using automated markets for 70% of its orders, double the percentage of five years ago.<sup>17</sup> Some institutional investors are asking brokerages to separate trading execution from other services that are baked into commissions, a move that highlights trading costs and ultimately tends to drive them down.

To meet such customer expectations—and maintain margins in a competitive field—securities firms need to strengthen cost management capabilities in trading and support operations across the organization.

## Cost-cutting tactics

With the current downturn, many firms are taking the traditional “belt-tightening” path to cutting costs, such as blanket headcount reductions, consolidation of departments, and cuts in investments in systems. Often, however, such reactive approaches end up bringing only limited, one-time gains. With a focus on short-term results, reductions in staff and systems improvement investments are liable to hinder growth and efficiency gains in the future.

Outsourcing and offshoring have become widely accepted ways to control costs in the industry. However, such arrangements can be disappointing if the efforts are not based on a clear understanding of the firm’s strategic goals for outsourcing and, especially, how the process can be improved. Simply handing off an inefficient process may provide some labor savings, but little else—and lead firms to miss opportunities to make valuable improvements in operations.

Firms should also consider organizational changes, such as migrating to a shared-services model in IT or creating customer-centered, cross-functional support operations to reduce redundant work in departmental silos. The right technology investments can also boost efficiency. Data from Elkins/McSherry found that brokerages that make use of the most advanced technological systems for executing trades rank the highest in terms of being able to minimize costs.<sup>18</sup> In addition, today’s technologies can bring increased efficiency to areas such as client account management, pricing, and counterparty credit checks, while advanced analytics can help pinpoint problems that drive up costs. And the basic IT strategy of consolidation can have a significant impact. One major firm that consolidated systems used for customer relationship management, market data, order management, compliance, and other areas achieved a \$50 million annual savings, with three quarters of the gains coming in back-office operations and the remaining quarter from reduced IT costs.<sup>19</sup>

## Developing an enterprise view

Each of these approaches can yield results. But firms need to look beyond one-off initiatives. They need to take an enterprise approach to cost management that allows them to make tradeoffs that optimize cost reductions and determine where to invest in system and process improvements to drive broad, effective, and sustainable reductions. In short, an enterprise approach makes it possible to ensure that cost strategy is aligned with business needs and overall corporate strategy.

<sup>13</sup> Pierre Paulden, “Trading - Daggers, Dark Pools and Disintermediation,” *Institutional Investor*, April 12, 2007.

<sup>14</sup> Alistair McDonald, “New Rules to Cut Hassle, Expense of Trades in EU,” *The Wall Street Journal*, October 29, 2007.

<sup>15</sup> Ibid.

<sup>16</sup> Pierre Paulden, “Trading - Daggers, Dark Pools and Disintermediation,” *Institutional Investor*, April 12, 2007.

<sup>17</sup> Ibid.

<sup>18</sup> Justin Schack, “TRADING - Addition by Subtraction,” *Institutional Investor*, November 13, 2007.

<sup>19</sup> David Easthope, “Front-Office Technology & Market Structure: The Impact on STP Systems,” Celent report, September 27, 2006.

An enterprise cost management effort should encompass all functions and business units across the company, and consider a full range of potential strategies, including shared services, reengineering of processes, and strategic sourcing. It should also include both more ambitious, long-term projects as well as short-term “quick wins” that do not impair the capabilities needed to compete tomorrow.

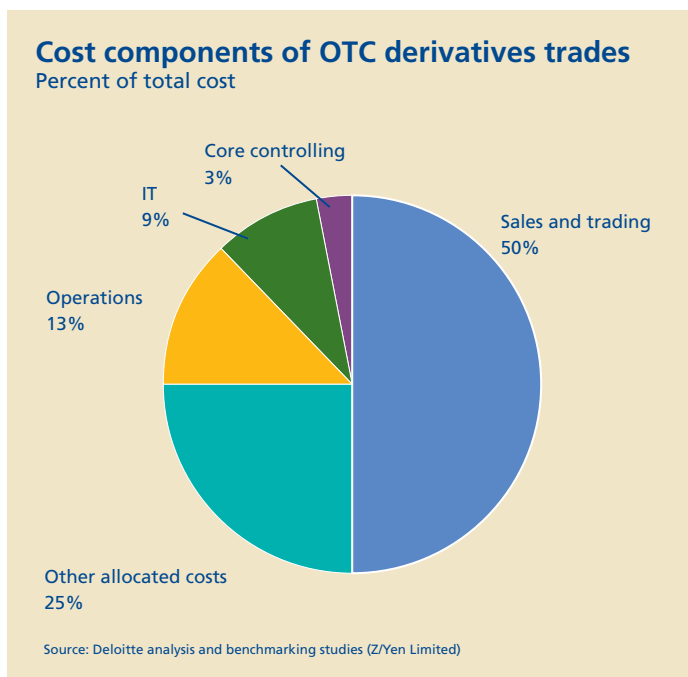
Enterprise cost management needs to be based on a detailed understanding of costs and cost drivers throughout the organization. In IT, for example, drivers might include the proliferation of market data feeds or redundant systems used for tracking profit and loss, while in the process arena, firms may uncover ad hoc and paper-based reporting or manual accounting adjustment data reconciliation work. Securities firms will find it worthwhile to look carefully at sales and trading costs, which typically account for about half of the total cost per trade. (See Exhibit 3.) Often, the key drivers are trade breaks that require manual intervention, process inefficiency, and IT operations and core controlling costs.

With an accurate baseline view of costs and drivers in hand, firms can take steps to identify opportunities not just to cut expenses, but also to improve performance. For example, a consumption-based costing approach takes activity-based costing to the next level, augmenting the tracking of costs with a view of the potential impact of costs on price and revenue. In particular, consumption-based costing enables firms to identify activities that are valued by customers, but are not reflected in pricing—that is, “free” services that customers would be likely to pay for.

Going a step further, firms can use proven techniques to develop a detailed view of the cost of serving customers, and then link specific revenues and costs to business drivers, such as the number of new accounts or the number of transactions handled. This makes it possible to develop a predictive view of how adjustments to a given business driver would affect costs and revenues—that is, what actions might best drive performance.

The key in these approaches is to understand costs at a more granular level than typically seen in the industry today, and to use those insights to inform decision making in core management processes, including strategic planning, budgeting and forecasting, pricing, and performance management. This will create one unified understanding of the cost profile, providing firms with the information they need to achieve greater cost reductions and to do so in a way that can be sustained over the long term.

Exhibit 3



# Safeguarding data: The move to vendor risk management

Protecting sensitive data has become a critical business issue. Lost or stolen data can lead to substantial costs as well as damage a firm's hard-earned reputation with customers. As they shore up privacy and data protection practices, firms need to consider the vulnerabilities that come with third-party relationships—and take a more holistic, mature approach to vendor risk management.

Data protection is a growing challenge for business in general and the financial services industry in particular. Many major financial firms have been in the news for data breaches involving tens of thousands of customer or employee records. The causes are varied, ranging from lost laptops to employee failure to follow security policy to phishing. At one securities firm, data involving some 6.3 million customers was stolen through the use of malware that was placed on its server.

Data breaches are particularly expensive for financial services companies. According to the Ponemon Institute, a breach generates an average cost of \$239 per record for financial services companies, compared to \$197 per record across all industries.<sup>20</sup> The impact can be wide-ranging, leading to lost business, damaged reputation, and potential action from governments and regulators. Recent research from the law firm of Scott & Scott found that among organizations that had experienced a data breach, 74% reported a loss of customers, 59% faced potential litigation, and 32% saw a drop in their share value.<sup>21</sup>

## The partner gap

Securities firms have been working diligently to tackle the problem. A recent Deloitte survey of financial institutions found that 98% spent more on information security in 2007 than they had in 2006.<sup>22</sup> Many firms are taking a “layered” approach to protecting data that includes encryption of data, firewalls, network and database safeguards, and strengthened policies. Some firms are also exploring the use of pattern analysis systems—like those used in the payment card industry—to detect threatening and suspicious activity. To extend data protection efforts even further, online brokerage Scottrade is not only strengthening internal safeguards, but also partnering with a security software company to provide some 1.6 million Scottrade customers with free security software.<sup>23</sup>

As they beef up data protection practices, however, securities firms often pay too little attention to an area of significant vulnerability—their third-party vendors and business partners. Outsourcing and offshoring have become standard practices in the industry and increasingly a competitive necessity. But these partners do not always have the same levels of data protection as the securities firms they serve. While outsourcing brings clear advantages, the simple fact is that engaging a vendor creates additional risks, and that is especially true when the vendor is handling sensitive data about customers or employees. And the number of third-party data breaches is growing: Research by the Ponemon Institute recently found that 40% of financial services firms surveyed had experienced a third-party breach, up from 29% in 2006 and 21% in 2005.<sup>24</sup>

With outsourcing becoming more common, most securities firms need to take a more rigorous approach to managing vendor security and data protection risks. They should conduct vendor security risk assessments to understand the information that is being shared with the vendor, whether the vendor has appropriate security and data protection practices in place, and whether the vendor is complying with industry and the firm's established security and data protection regulations and practices. Firms also need to establish ongoing security and data protection monitoring processes to ensure that the vendor's precautions stay in step with evolving needs.

## The enterprise approach

Indeed, Deloitte believes that vendor risk management, including security and data protection objectives, should incorporate an integrated, enterprise-wide approach that is evolving in the securities industry today. A securities firm may have hundreds of external partners, and a coordinated vendor risk management program can help a firm to manage risk consistently, efficiently, and holistically across vendors as well as internal functions. In addition, it helps ensure that the firm has the right resources and strategies in place to mitigate risks. By integrating security and data protection efforts into their vendor risk management program, firms can more effectively link financial, operational, and regulatory risks, and manage them in the larger business context. “[Data privacy is] far beyond just a technology problem. It's really an overall business issue, and it goes to the roots of how we do business,” Steve Van Wyck, CIO of ING U.S. Financial Services, told *Wall Street + Technology*.<sup>25</sup>

<sup>20</sup> Melanie Rodier, “Cost of Data Breaches Growing,” *Wall Street + Technology*, January 1, 2008.

<sup>21</sup> Melanie Rodier, “A Daunting Threat,” *Wall Street + Technology*, December 1, 2007.

<sup>22</sup> “2007 Global Security Survey,” Deloitte-Global Financial Services Industry.

<sup>23</sup> Melanie Rodier, “A Daunting Threat,” *Wall Street + Technology*, December 1, 2007.

<sup>24</sup> “Ponemon Study Shows Data Breach Costs Continue to Rise,” Ponemon Institute press release, November 28, 2007.

<sup>25</sup> Cory Levine, “For Your Eyes Only,” *Wall Street + Technology*, February 1, 2007.

- **Take a lifecycle approach to risk management.** There are potential risks in each stage of the vendor lifecycle, so firms need to manage risk from the initial assessment of outsourcing through the identification and selection of vendors, contract negotiations, ongoing performance management, and termination or renewal of the relationship. A coordinated vendor risk management program will enable the firm to identify dependencies and coordinate risk and control activities across these stages, as well as work closely with the overall enterprise risk management function.
- **Establish strong governance processes.** A comprehensive, top-down view of vendor risk management ensures that companies can address the full spectrum of vendor risks. For this reason, the governance of the function needs executive-level support and cross-functional involvement. Governance activities should include clearly defining the responsibilities of all key stakeholders—including lines of business, legal, compliance, and IT—as well as communication, documentation, and training in support of vendor risk management.
- **Establish robust risk assessment and management processes.** The vendor management program should incorporate tools, such as risk assessment questionnaires and due diligence procedures, that can be used to assess vendors and create a risk profile for each vendor. It should also drive a common understanding of risks and controls across the firm and develop “key risk indicators” that enable consistent reporting and comparison of vendors. Risk management processes should monitor risk, enable remedial actions when necessary, and be periodically updated to reflect the changing threat and regulatory environments.

While the implementation of vendor risk management programs continues to evolve in the industry, outsourcing and offshoring are standard and vital practices for securities firms, creating new and challenging sources of risk. To help combat the growing tide of security and data protection challenges, securities firms will need to tackle these risks with greater sophistication—and an integrated vendor risk management program will be a key element in that effort.

## Contributors

We would like to recognize the individuals who contributed their insights and support to this project.

**Christopher Doroszczyk**  
Principal  
Deloitte Consulting LLP  
+1 212 618 4044  
cdoroszczyk@deloitte.com

**Edward Hida**  
Partner  
Deloitte & Touche LLP  
+1 212 436 4854  
ehida@deloitte.com

**Jill Kmet**  
Manager  
Deloitte Consulting LLP  
+1 312 486 2064  
jkmet@deloitte.com

**Ricardo Martinez**  
Senior Manager  
Deloitte & Touche LLP  
+1 212 436 2186  
rimartinez@deloitte.com

**Jim Reichbach**  
Vice Chairman,  
Banking & Securities Industry Leader  
Deloitte LLP  
+1 212 436 5730  
jreichbach@deloitte.com

**Charles Saia**  
Partner  
Deloitte & Touche LLP  
+1 212 436 5177  
csaia@deloitte.com

**Mark Steinhoff**  
Principal  
Deloitte & Touche LLP  
+1 617 437 2614  
msteinhoff@deloitte.com

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# Deloitte Touche Tohmatsu member firm financial services industry leaders

Jack Ribeiro  
Global Managing Partner  
Financial Services Industry  
Deloitte Touche Tohmatsu  
1 212 436 2573  
jribeiro@deloitte.com

## Americas

**Argentina**  
Claudio Fiorillo  
54 11 43204018  
cfiorillo@deloitte.com

**Bahamas**  
Raymond Winder  
1 242 302 4841  
rwinder@deloitte.com

**Bermuda**  
Roger Titterton  
1 441 299 1313  
rtitterton@deloitte.com

**Brazil**  
Clodomir Félix  
55 11 5186 1655  
clodomirfelix@deloitte.com

**Canada**  
Cathy Bateman  
1 416 601 5953  
cbateman@deloitte.ca

**Cayman Islands**  
Dale Babiuk  
1 345 814 2267  
dbabiuk@deloitte.com

**Chile**  
Pablo Herrera  
56 2 2703 281  
paherrera@deloitte.com

**Colombia**  
Ricardo Rubio Rueda  
57 1 635 1910  
rrubio@deloitte.com

**México**  
Carlos A. García  
52 55 5080 6093  
cargarcia@deloittemx.com

**USA**  
Jim Reichbach  
1 212 436 5730  
jreichbach@deloitte.com

**Uruguay**  
José Luis Rey  
598 2 9160756  
jrey@deloitte.com

**Venezuela**  
José Antonio López  
58 212 2068567  
josealopez6@deloitte.com

**Asia Pacific**  
**Australia**  
Warren Green  
61 2 9322 5454  
wgreen@deloitte.com.au

**China**  
Wade Deffenbaugh  
852 2852 6629  
wadefffenbaugh@deloitte.com.hk

**India**  
V.V. Subbarao  
91 11 5562 2000 x2096  
vsubbarao@deloitte.com

**Indonesia**  
Basar Alhuenius  
62 21 2312879 x3212  
balhuenius@deloitte.com

**Japan**  
Yoriko Goto  
81 3 6213 1372  
yoriko.goto@tohmatsu.co.jp

Yukio Ono  
81 3 6213 3630  
yukio.ono@tohmatsu.co.jp

**Korea**  
Joseph Yong In Shin  
82 2 6676 1100  
yishin@deloitte.com

**Malaysia**  
Meng Kwai Ng  
603 7723 6560  
mng@deloitte.com

**New Zealand**  
Rodger Murphy  
64 9 303 0758  
rodgermurphy@deloitte.co.nz

**Philippines**  
Avelina Gille  
63 2 581 9055  
agille@deloitte.com

**Singapore**  
Prakash Desai  
65 6530 5585  
pradesai@deloitte.com

**Taiwan**  
Peter Tsai  
866 2 2545 9988 x7441  
petsai@deloitte.com.tw

**Thailand**  
Suttharug Panya  
66 2 676 5700 x5247  
spanya@deloitte.com

## Europe, Middle East and Africa (EMEA)

**Austria**  
Dominik Damm  
43 1 53700 5440  
dodamm@deloitte.com

**Belgium**  
Frank Verhaegen  
32 3 800 88 53  
fverhaegen@deloitte.com

**Central Europe**  
Mike Jennings  
420 2 248 955 76  
mijennings@deloittece.com

**CIS (includes Russia)**  
Vadim Sorokin  
7 095 787 0626  
vsorokin@deloitte.ru

**Cyprus**  
Nicos Charalambous  
357 25 868740  
ncharalambous@deloitte.com

**Denmark**  
Lone Moeller Olsen  
45 33 76 38 03  
lolsen@deloitte.dk

**Finland**  
Petri Heinonen  
358 20 755 5460  
petri.heinonen@deloitte.fi

**France**  
Pascal Colin  
33 1 40 88 29 62  
pcolin@deloitte.fr

José-Luis García  
33 1 40 88 28 15  
josgarcia@deloitte.fr

**Germany**  
Friedhelm Kläs  
49 69 75695 6111  
fklaes@deloitte.de

**Greece**  
Nicos Sofianos  
30 210 678 1219  
ns Sofianos@deloitte.gr

**Iceland**  
Pall Gretar Steingrímsson  
354 580 3065  
psteingrimsson@deloitte.is

**Ireland**  
Mary Fulton  
353 1 417 2379  
mfulton@deloitte.ie

**Israel**  
Dan Halpern  
972 3 608 5471  
dhalpern@deloitte.com

**Italy**  
Riccardo Motta  
39 02 833 22 323  
rmotta@deloitte.it

**Luxembourg**  
Eric van de Kerkhove  
352 451 452 468  
evandekerkhove@deloitte.lu

**Malta**  
Raphael Aloisio  
356 21 335290  
raloisio@deloitte.com.mt

**Middle East**  
Joe El Fadl  
961 1 363 005  
jelfadl@deloitte.com

**Netherlands**  
Rob Stout  
31 20 454 7055  
rstout@deloitte.nl

**Norway**  
Arve Rafteseth  
47 23 27 97 59  
arafteseth@deloitte.no

**Portugal**  
Maria Augusta Francisco  
mafrancisco@deloitte.pt

**South Africa**  
Casper Troskie  
27 11 806 5860  
ctroskie@deloitte.co.za

**Spain**  
Fernando Ruiz  
34 91 514 5692  
feruiz@deloitte.es

**Sweden**  
Jan Palmqvist  
46 8 506 723 82  
jpalmqvist@deloitte.se

**Switzerland**  
Philip Göth  
41 1 421 60 00  
pgoeth@deloitte.ch

**Turkey**  
Sibel Turker  
90 533 583 36 92  
sturker@deloitte.com

**Ukraine**  
Natalia Samoilova  
380 44 490 9000  
nsamoilova@deloitte.com.ua

**UK**  
Russell Collins  
44 20 7303 2929  
rcollins@deloitte.co.uk

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