Financial Services

Global Securities Industry Outlook

Connecting the Pieces in a Changing World

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Dear Colleague:

For the past eight years, the Financial Services practice of the member firms of Deloitte Touche Tohmatsu (DDT member firms) has produced the annual *Global Securities Industry Outlook* to address the "top 10" issues affecting firms in the year ahead. This year, we took a new approach, working with the Economist Intelligence Unit to develop both a long-term industry view, entitled *Global Financial Services Industry Outlook: Shaping Your Strategy in a Changing World*, as well as companion reports that consider the same issues at a more focused level by sector.

Broker-dealers, investment banks, electronic communications networks and exchanges should embrace the imperatives outlined in this report to achieve long-term success.

Our *Global Securities Industry Outlook: Connecting the Pieces in a Changing World* report finds that while issues like risk management and regulatory compliance remain a challenge, there are a number of opportunities for growth – particularly through globalization and expansion into new markets, innovative technologies to improve service delivery for both institutional and retail clients and new investment products to meet the needs of retiring baby-boomers.

To identify critical market drivers for our *Global Industry Outlook* reports, we conducted an online survey of 175 board members and global executives across the financial services industry, of which 38 were from the securities industry. Based on our findings and our client experiences, we believe that the issues identified within this report will have the greatest impact on securities firms as they approach 2010. Broker-dealers, investment banks, electronic communications networks and exchanges should embrace the imperatives outlined in this report to achieve long-term success.

We plan on continuing our research into the future of the securities industry and examining other ways in which securities firms can sustain growth and connect the pieces in a changing and dynamic world. In the meantime, we hope you find this report valuable.

Jeff Kottkamp
National Securities Leader
Deloitte & Touche USA LLP

Leading securities firms are positioning themselves to succeed in an increasingly competitive future. All of the details have yet to be filled in, but the challenges – new competitors, unfamiliar markets, exacting customers, myriad risks, stricter regulators – are clear today. Nevertheless, opportunities abound – primarily by growing in new markets, using technology to improve service and developing products and advisory services to meet the needs of retiring baby-boomers.

Every major investment bank has begun the process of reinventing itself to address challenges and take advantage of opportunities in the coming years.

In this paper, we focus on the five most important issues over the next three to five years as revealed through an industry survey, interviews with senior executives and practice leaders from the DTT member firms. The top five issues on the securities watch list include:

- **Globalize and localize to boost revenues and cut costs.** The same countries that are growing quickly also offer an abundant, less expensive and well-educated labor force.
- **Adapt technology to improve service delivery.** From improved customer analytics to automated execution services, investments in technology will help securities firms resist commoditization and strengthen ties to customers.
- **Increase compliance effectiveness.** An uncoordinated and defensive approach to compliance no longer works. Not only is it costly, but it can also be ineffective.
- **Enhance risk management.** The focus in risk management is now shifting to operational and reputational risk.
- **Adapt to an aging population.** The greying of North America, Europe, Japan and other countries presents both challenges and opportunities for securities firms.

Fairly optimistic outlook on margins

Survey respondents (board members, C-level officers, business unit heads and other senior executives) offered a cautiously positive picture on the economics of the securities industry. Over the next three to five years, about one fifth of securities industry respondents expect costs to grow faster than revenues. Just under two-thirds think revenues will grow faster than costs, while the rest believe revenues and costs will grow at about the same rate.

Among the trends cited by survey participants are:

- Fast-growing overseas markets offer potential for higher revenues on both the retail and institutional side, but startup costs can be high.
- Technology investments will pay off through improved operational efficiency and a more personalized customer experience, but again require significant upfront investments.
- The expansion of offshoring will enhance efficiency.
- Compliance costs will continue to be a drag on earnings.

The five issues to watch

1. Globalize and localize to boost revenues and cut costs

Over the next three to five years, large securities firms will face an imperative to tap into fast-growing markets to boost revenue, while simultaneously offshoring IT, business processes and other functions to reduce costs.

Nearly two-thirds of securities industry survey respondents (65%) rank globalization as the top transformative issue over the next several years. Slightly more than half (51%) say distribution opportunities in new markets and cross-border consolidation will be major drivers of profits in the years ahead – particularly due to the fast-developing economies and easing regulations in Asia, Central and Eastern Europe and potentially Latin America.

Whether through M&A activity, IPOs, retail brokerage or offshoring, securities firms have greater incentives to cross borders than ever before. But the appeal of overseas markets – especially in the developing world – is tempered by geopolitical risks and structural market challenges. Many investments will continue to be long-term ventures that may take years to become profitable. Securities firms must act decisively to take advantage of international opportunities, prudently to mitigate the risks posed by these investments and thoughtfully to tailor their offerings to the local market.

The most compelling market is China, followed by India, then Russia and Brazil. Despite significant regulatory and economic risks, more than seven out of 10 securities firm respondents (71%) say that China will be important or very important to their organization in 2010. Nearly two-thirds of respondents (65%) say the same about India, versus 38% for Russia and 23% for Brazil.

China has promised to open its banking market by December 2006 as a condition of its joining the World Trade Organization. That same agreement requests that China gradually open its fund management, securities and insurance sectors. Overseas brokers are currently pitching for minority stakes in joint-ventures with local firms. Their activities within China would include primary services (advising and underwriting) and bond trading. Outside China, the world's investment banks are already doing well from Chinese companies' overseas flotations. Foreign securities firms competed fiercely to underwrite the Hong Kong share listings of three of China's four state-run national banks. A number of those same firms, including Merrill Lynch and Goldman Sachs, had also acquired minority stakes in

those banks. Three big Chinese insurance companies have also recently gone public. The scope for underwriting, trading and advising on domestic and foreign mergers is growing as well: according to Merrill Lynch, investment banking, trading and advisory fees from mainland China will reach $12 billion by 2010.

On the cost side, offshoring will continue to encompass a growing range of activities. The number-crunching that underlies much investment banking activity can be done anywhere. JPMorgan now processes its foreign exchange and credit derivatives contracts in India, has research analysts in India, Hong Kong and Singapore and plans to have a total of 9,000 employees in India by the end of 2007.[1] Morgan Stanley and Lehman Brothers have both moved research operations to Asia to reduce costs and to get fresh research on clients' desks early in the morning in the European and North American time zones.[2] And according to the *Financial Times*, Deutsche Bank plans to move half of its sales and trading back-office employees to India by the end of 2007.[3]

A 2005 Deloitte Research report, *Global Financial Services Offshoring: Scaling the Heights* suggests that the financial services industry will move 20% of its total cost base offshore by the end of 2010, compared to the current average of 3.5%. The research also brings up a collateral benefit of offshoring: giving securities firms a foothold in emerging markets, where there are more opportunities to grow revenue than at home.

Finally, the pace of global stock exchange consolidation is likely to continue to gather momentum. Investors want easier access to the shares of ever more companies. NASDAQ's decision in April of 2006 to spend $781 million for about 15% of the London Stock Exchange was only the latest example. The benefits of consolidation are clear: firms want the larger pools of liquidity and talent that consolidation will offer. And greater scale may allow trading costs to come down.

However, US exchanges are anxious to own European counterparts for another reason. Many global companies are loath to incur the costs of complying with Sarbanes-Oxley rules. Although it remains unclear how trans-continental exchanges will be regulated, tie-ups with large European exchanges – as well as public share offerings to pay for the acquisitions – have become more likely.

While the opportunities abroad may be great, there are several risks and challenges securities firms will need to address before entering new markets. Recognizing and addressing obstacles, focusing on a long-term investment and adapting strategies to the local markets will help ensure success.

2. Adapt technology to improve service delivery

Securities firms can strengthen ties with customers by harnessing technology and innovation to provide better service and delivery.

Just over a third of securities firm respondents identify technology as a top profit driver over the next three to five years. Fifty-nine percent cite technology-enabled products and services; 46% cite growth in processing power and 30% cite technology required to build strategic alliances with customers, partners and other stakeholders.

On the retail side, the focus will be on personalization, ease of navigation and a revival of personal client contact as one component of a multi-pronged relationship. Rather than focusing on products alone, which are increasingly commoditized, the focus is on delivering a unique customer experience tailored to different segments. Innovation continues to be implicit in all three dimensions of that experience: convenience, value and service. Elaborate, technical functionality becomes less important than ease of use, navigability and personalization. Successful firms will balance personal contact and technology to provide personalized service at a reasonable cost.

Firms are developing solutions that merge client profile data with account, portfolio and planning information and collaborative tools that facilitate communication with advisers. Firms are increasingly using open platform technologies in offering third-party products. Merrill Lynch, for instance, is completing a global rollout of a new adviser workstation that provides enhanced contact management, sales and analytical tools. And Commonwealth Bank, a diversified Australian financial services provider, has implemented a CRM system that allows a single customer view across securities, insurance and bank product lines. Externally, the system has helped the bank present a consistent face to the customer; internally, it has helped to establish consistent performance measurements and comprehensive sales training.

On the institutional side, global competition is driving many large securities firms, as well as the major stock exchanges, to invest in technology to deliver the best value possible to investors. Major securities firms will develop more sophisticated client platforms that provide trading scenario analysis, risk modeling and performance management reporting. Multi-product electronic trading platforms featuring direct market access (DMA) and algorithmic trading are now offered by a host of securities firms. Hedge funds and other institutional investors like DMA's lower commissions, anonymity, faster execution and improved communication. Ongoing investment will further develop these platforms, making them more robust and able to provide high-level post-trade analysis, risk modeling and performance management reporting.

[1] *"Away and Up, Up," Désirée Van Gorp and Pieter Klaas Jagersma, The Wall Street Journal, January 11, 2006*
[2] *"The outsourcing wave hits investment bankers," Shaheen Pasha, CNN.com, February 22, 2006*
[3] *"Deutsche Bank in back-office exodus to India," David Wighton, March 26, 2006*

Meanwhile, prime brokerage, which has morphed into a big business for a few dominant firms (notably Bear Stearns, Goldman Sachs and Morgan Stanley), is becoming increasingly competitive as large hedge funds turn to multiple prime brokers.[4] Other securities firms have entered the market, and smaller specialized boutiques are flourishing as well. Many of these firms are increasingly adapting sophisticated technology to better service their hedge fund clients.

Sell-side firms are actively marketing these advanced execution tools to their clients. Goldman Sachs's Cube framework, for instance, executes orders differently depending on the size of the order, the liquidity of the market and the urgency of the transactions. Sell-side traders can use the framework in cases where human expertise is not needed. As the value proposition of traditional brokers comes under fire, some are attempting to reinvent themselves as "execution consultants" with a quiver of technology-enabled execution tools.

3. Increase compliance effectiveness

Expanding regulations, overlapping mandates and tighter enforcement worldwide continue to raise the cost of compliance and increase the consequences of noncompliance. Securities industry survey respondents ranked regulation second only to globalization as a transformative issue in the years ahead. Fifty-seven percent of the securities industry executives responding to our survey cite regulation as one of the main influences on profits over the next three to five years. Within the category of regulation, three-quarters of securities industry respondents say the implementation cost of compliance is a top concern, and seven out of 10 focus on the risk of non-compliance. A third see finding and training the right people as a major issue.

An uncoordinated and defensive approach to compliance won't work anymore. Instead, securities firms need to adopt a unified, proactive, principles-based approach to compliance, starting with the board of directors and top management and applied throughout the business as part of everyone's job. Firms must also make sure they have tight processes to monitor and document risks and implement training and controls throughout the organization. When roles are well defined and understood, there is less duplication of effort and more accountability. Costs tend to be lower as well.

Compliance departments should be fully involved in all stages of product development. Business lines may be concerned that involving compliance early in the product development process slows the pace of development. But scrambling for a fix after launch can result in additional direct costs and even longer delays in the product's launch.

Compliance professionals are gaining unprecedented exposure within their firms. A number of securities firms, including Bear Stearns and Morgan Stanley, have hired former regulators to run their legal and compliance departments.

About the online survey

In November of 2005, we polled 37 senior securities executives out of 175 across the financial services industry to identify the key transformative issues in the next three to five years. An online questionnaire was used. Respondents were comprised of board members, C-level executives, business unit heads and other senior executives at large securities firms. The executives surveyed were based in Asia-Pacific (46%), Europe (16%) and North America (35%). The average asset size of the securities houses polled was about $154 billion. Institutions with assets of more than $250 billion made up the largest single category (35%).

4. Enhance risk management

Securities firm executives are increasingly aware that reputational problems can irreparably damage their business yet feel it is the most difficult risk to manage. Having clear direction from the top and a crisis management plan in place that facilitates communication is seen as critical. Most of the executives interviewed believe that reputation is critical to success – and that it needs to be managed throughout the business rather than solely through the public relations department.

A third of securities industry survey respondents view managing risk as a key issue over the next three to five years. The impact of financial volatility is cited by 56% as a major influence on profits, followed by reputational risk (44%). In interviews, executives also focus on operational risk, reflecting the operational risk provisions of the Consolidated Supervised Entity framework for certain broker-dealers in the US and the equivalent Basel II rules for universal banks. To control the impact of risk on profits, securities firms need an enterprise-wide risk management framework that encourages a consistent approach to managing all risks strategically throughout the organization. In addition, more firms are raising the profile of chief risk officers (CRO) to ensure they have authority and work closely with the board of directors and the chief financial officer. According to the DTT member firm's *2004 Global Risk Survey,* 81% of global financial services institutions have established the position of CRO, three quarters of them report to the chief executive or board of directors, and the increase in board-level oversight of risk management increased by 25% over the previous two years.

Firms must take a hard look at operational risks, such as their control processes and systems, in light of failures at other entities – for instance, the $335 million botched trade by Japan's Mizuho Securities and the Tokyo Stock Exchange. Charles Schwab, for example, has a number of risk committees and an oversight body. Its Technology and Operations Risk Committee

[4]*Hedge Funds Turn 'Prime' Brokerage Into a Misnomer, The Wall Street Journal, January 23, 2006*

(TORC) meets monthly to assess and report on what Charles Schwab is doing and to learn from problems that have occurred at other institutions.

Related to reputational risk are the conflicts of interest – both real and apparent – that arise when combining both underwriting and asset management under the same roof. Reversing a long trend, banks and securities firms with asset management arms will increasingly look to exit the asset management business or separate manufacturing from distribution to improve the performance of both. Merrill Lynch's recent agreement to swap its giant fund business for a 49% stake in asset management firm BlackRock and Citigroup's 2005 swap of its money management arm for Legg Mason's brokerage business resolved a dilemma faced by a number of securities firms. Morgan Stanley, which talked with BlackRock before Merrill came on the scene but failed to come to terms, apparently saw the business case for such a move as well.

Though the steady fee income of asset management has appeal to securities firms as a hedge against volatile trading earnings, the challenge to running successful asset management businesses are many. Organic growth in many of those businesses over the past five years has been flat to negative. Regulators have indicated their displeasure with brokerages that favor in-house fund sales, and brokers at competing firms balk at selling other securities firms' funds. At the same time, pressure on fees and rising compliance costs has diminished the attraction of the business line.

5. Adapt to an aging population

As a result of declining birth rates and longer life expectancy, wealthy countries will increasingly have more old people and fewer young. In addition, as the baby-boomers retire, the ranks of the middle-aged will also dwindle. Between 2000 and 2050, the percentage of America's population over the age of 65 will grow from 12% to 21%, while the share of the population aged 40-64 will fall from a peak of 33% in 2010 to 28% by 2040. In Japan and some European countries, the shift will be even more dramatic.

As much of the world's population ages, affluent customers move from wealth accumulation to a lengthy retirement. As pension arrangements founder, responsibility for retirement security moves from employers to individuals. Firms must adapt their product and service offerings to retain existing customers, while profitably cultivating underserved segments and those that will bring sustainable future growth.

Securities firms are grappling with how best to take advantage of the trillions of dollars in retirement assets poised to begin paying out over the next decade and moving out of the equity market. To date, most have focused on products for the affluent mature accumulator, an overserved segment. They face the loss of assets if they do not build a strong advisory capability and a portfolio of protection and lifecycle products that anticipates customer needs. Few providers have targeted underserved segments, such as those forced to delay retirement.

Charles Schwab is investing in advisory capabilities, which it views itself as well positioned to deliver as it lacks a proprietary investment product that could raise conflict of interest issues. It is targeting the mass affluent through personalized solutions delivered through technology rather than relying on expensive personal contact. Meanwhile, Wachovia has moved into the ultra-high-net-worth market through its separately branded Calibre practice, which targets families with liquid assets exceeding $25 million. Specialized advisory services address such topics as transferring wealth across generations, raising children to become effective stewards of legacy assets and developing philanthropic strategies.

The shift to an older population will also affect the supply of skilled labor available to securities firms. In Deloitte Consulting LLP's *2005 Talent Management Strategies Survey,* one-third of the respondents said that 11% or more of their workforce is scheduled to retire in the next two to three years. Securities firms are dealing with the issue in two ways: by offshoring work to countries with a more abundant supply of workers and by investing in enterprise-wide process automation. Some national governments, such as Australia, are helping out by relaxing immigration policies to allow much needed skills to come in from abroad.

Nevertheless, there is more to be done: many firms have no demographic profile of their workforce and little idea about how much of it is retiring when. Ultimately, the combination of baby-boomers willing to work longer and companies needing to retain talent will result in flexible work arrangements and longer job tenures.

Looking ahead

Despite the challenges they face, the securities executives we surveyed felt that their margins are likely to grow over the next several years. To make this growth in profitability a reality, they will need to do several things. First, firms that have undertaken international expansion must move decisively into fast-growing markets, but temper these moves with a full understanding of the geopolitical and local market risks and how they can best be controlled. Second, the effectiveness of compliance – the return on compliance investment – must be increased. This requires enlisting senior management to support a unified, proactive, principles-based approach to compliance, embedded into the business units and reaching into all products and locations. Finally, prudent investments in technology can strengthen ties with customers, better prepare advisers, enhance trade decision-making and execution and improve risk management across the organization.

Industry Leader

Jeff Kottkamp
National Securities Leader
Deloitte & Touche LLP
+1 313 396 2770
jkottkamp@deloitte.com

Leadership Team

Matt Cahill
National Tax Leader – Securities
Deloitte Tax LLP
+1 212 436 3420
mcahill@deloitte.com

Jocelyn Cunningham
National Consulting Leader – Securities
Deloitte Consulting LLP
+ 1 212 618 4050
jocunningham@deloitte.com

Marilyn Hignett-Stern
National Financial Advisory Services Leader – Securities
Deloitte Financial Advisory Services LLP
+1 212 436 6291
mhignettstern@deloitte.com

Larry Rosenberg
Deputy National Securities Leader
Deloitte & Touche LLP
+1 212 436 4869
lrosenberg@deloitte.com

George Simeone
National Audit & Enterprise Risk Services Leader – Securities
Deloitte & Touche LLP
+1 212 436 4822
gsimeone@deloitte.com

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