



# Banking and Securities Outlook 2010

2010 is certain to be another tough year for the banking and securities industry. During 2009 there was constant pressure. Despite a bounce-back in many asset markets, many financial services companies continue to deal with troubled assets. Management teams, including boards, face big new challenges. Some of these have resulted from the credit crisis that began in 2007 — for example, boards may be giving new attention to succession planning after a run of unexpected CEO departures. Other challenges are ongoing as part of broader efforts to restore trust and confidence to the financial system. There may be a lot more debate, for instance, over compensation in the industry, particularly for those institutions in receipt of public funds.

However, even this politically charged subject will be overshadowed by five major trends that will dominate the industry in 2010. These are:

- The playing out of banks' exposure to distressed assets
- The extent to which new regulations may impact financial firms' business models
- The call for continued efforts to improve governance and risk oversight, especially at the board level
- Meeting the challenge of core IT systems and data aggregation
- Seeking growth in weak markets

Peering into the future is a perilous business. The only certainty is that any forecast one makes will be wrong, whether by a little or a lot. The unexpected is always just around the corner and we simply don't know whether or when it will happen. So the outlook for 2010 is just that — an outlook, not a forecast. The trends we have laid out above are likely to dominate discussion and activity, possibly beyond 2010. Equally possible, there may be one or more new trends as a consequence of unknowable events.

#### **Distressed and toxic assets: When will the deals begin?**

A top concern for senior banking executives in 2010 will be how they continue to deal with the distressed assets and debt on their balance sheets. In particular, they will keep a wary eye on their levels of commercial real estate loan defaults, where market conditions have continued to deteriorate. More than 20 percent of the \$6.4 trillion market will come due before the end of 2012.<sup>1</sup>

To date, banks' collective strategy has been to extend these loans' maturation. According to the Federal Reserve, fewer than a dozen of the 50-plus U.S. banks surveyed in

October 2009 said that they had refinanced more than one quarter of maturing commercial real estate loans through September 2009.<sup>2</sup> The remainder of the loans had been rolled over.

It may prove challenging for many banks to manage their distressed debt exposures. Some may explore their options through M&A. Many more will likely be taken over by the FDIC, continuing the trend of 2009.

But the really big question is when in 2010 there will begin to be a flow of actual deals among banks and investors. Potential purchasers of banks' distressed assets have been waiting on the sidelines, unwilling to commit capital while they think market conditions might deteriorate further and reduce prices — this is particularly the case in the commercial real estate sector. As with everything, it all comes down to price. Who will take the plunge?

#### **New regulations**

We can speculate about the final shape that new regulations and supervisory structures might take in 2010. New regulations are expected to tighten capital, liquidity, and risk management rules. Legislation will likely be proposed to impose new systemic risk procedures, create a new consumer protection agency, and to streamline regulatory agencies and procedures. Whatever emerges will sit on top of existing regulations that are already being implemented more thoroughly. Indeed, the real story in 2010 may be how regulators continue to apply their existing powers to keep pressure on the industry.

Banks face a tricky dilemma in how they should respond to this issue. Some are realizing that they risk a further political backlash if they vigorously lobby either against regulatory change or against tougher enforcement. Instead they are trying to cooperate with regulators and anticipate where new rules might head. For example, numerous banks are engaged at the industry level with global supervisors in active discussions over voluntary measures to improve bank governance and risk management. Some of the larger banks have raised their capital levels well above regulatory minimums — either voluntarily or at the direction of the regulators overseeing banks in the Supervisory Capital Assessment Program. They have changed the mix of their businesses, trying to make more efficient use of their capital. And they have responded to proposed reforms of capital standards by suggesting new approaches such as shifting part of their capital structure to contingent funding, which makes new capital available in bad times.

<sup>1</sup>"Why This Real Estate Bust Is Different," BusinessWeek, November, 5, 2009.

<sup>2</sup>"The October 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices," Federal Reserve Board, October 2009. <http://www.federalreserve.gov/boarddocs/SnLoanSurvey/200911/>

There may also be more pressure on banks to show that they can treat consumers better. Tougher consumer protection standards are coming. Until they arrive, banks run the risk that in their push to deleverage they withdraw products and charge for services in ways that hit the poorest consumers hardest. Working with their regulators, banks can try to build greater trust in the system. Getting consumer strategies right will be vital.

### Improving governance and risk management oversight

In 2009, major industry reports from the Senior Supervisors Group and the Institute of International Finance called for faster progress in improved governance and higher standards of risk management, while regulators also have raised their expectations. In 2010, it is expected that there will be significant new work as financial firms put in place new systems and approaches.

Nowhere is this truer at the board level. The trend for greater clarity of board oversight of risk management is likely to continue. It is expected that more boards may introduce explicit charters setting up risk committees (or adding risk to the Audit Committee’s responsibilities) and reporting structures to strengthen board oversight and make sure this is communicated to shareholders. Additionally, boards may fine tune their existing risk appetite statements by making them more specific. More boards might ask for their firm’s Chief Risk Officer to be given independent access to board members, allowing a check and balance against the executive powers in the business lines.

As the focus on risk intensifies, 2010 may also be the year when Operational Risk is recognized as a larger component of banks’ overall risk profiles and is given correspondingly more attention. As banks move to improve their risk management in future, they may increasingly focus on the operational processes and procedures embedded in their Credit or Market Risk functions, rather than on the functions themselves. Regulators, too, will likely be looking harder at Operational Risk for capital calculations.

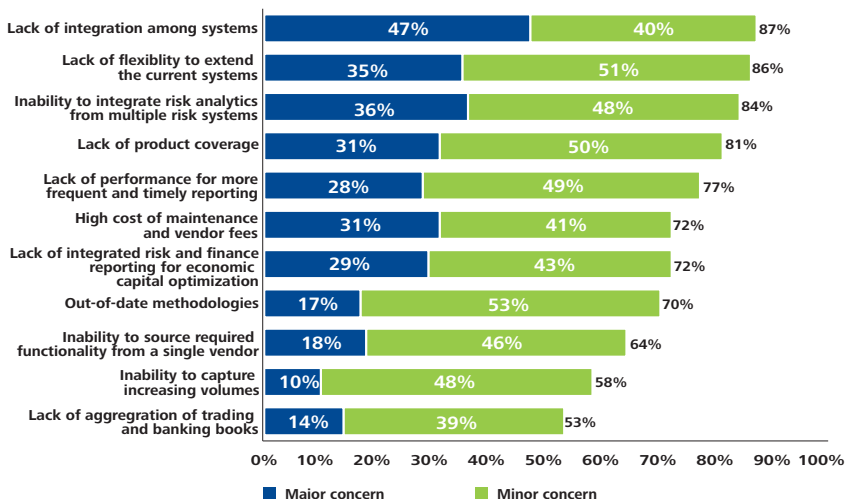
### Meeting the challenge of core systems and data integration

As they introduce greater clarity to governance and risk management structures, it is expected that banks are likely to begin a phase of heavy new investment in their technology infrastructure. 2010 could be a year when the link between IT systems and overall risk management becomes explicit and budgets, although tight, are directed towards improvements. Many banks have fragmented systems as a consequence of serial mergers and of myriad

front-office applications designed to give fast-moving trading businesses competitive advantage. Many have a better appreciation that this may affect their ability to integrate and then aggregate data so that they may be able to obtain a more comprehensive view of the risks they are managing.

The main priority for 2010 in this area will likely be data integration in the context of large infrastructure improvements. The limited integration amongst risk systems was highlighted by a recent Deloitte<sup>3</sup> survey, which showed that almost half of financial services executives viewed this as a major concern<sup>4</sup> (See Exhibit 1). Many banks are either re-evaluating their data governance programs or have plans to invest in data governance programs to determine clear ownership, accountabilities and quality metrics for their critical data assets, especially those impacting risk management.

Exhibit 1  
How much of concern are the following issues with your risk management information technology systems?



Source: Deloitte Global Risk Management Survey: Sixth Edition — Risk Management in the Spotlight

### How to grow in weak markets?

Many banks face a strategic dilemma: They want to restore their balance sheets and rebuild capital, and one of the quickest ways to do this is to grow their businesses. In the past, mergers and acquisitions were a major source of growth, and this remains an avenue for those unafraid to purchase failing or failed institutions. However, many banks don’t have enough capital for this to be an option. They need to find ways to grow organically. And this is an especially tough challenge because the economy is in fragile recovery, regulation is likely to expand, and consumers are hunkered down trying to pay off debts and increase their savings.

<sup>3</sup>As used in this document, “Deloitte” means Deloitte LLP and its subsidiaries. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

<sup>4</sup>“Global Risk Management Survey: Sixth Edition — Risk Management in the Spotlight,” Deloitte Touche Tohmatsu, June 2009.

In 2010, the industry may see tighter competition as banks seek to take market share in the most profitable customer segments — particularly the small business segment and the mass-affluent segment, which offers a rich source of deposits as well as more profitable and less risky customer relationships. Banks will need to develop a deeper understanding of the needs of each segment, focus on adding value and building stronger customer relationships. They are likely to focus on:

- Their customers' overall relationship with the bank
- Customers' lifestyle preferences and behaviors
- Alternative products, channels, and experiences for meeting those preferences

Retail banks with many customers may need to invest significantly in data collection, integration, and aggregation, and use it to drive deepening customer relationships rather than merely tweaking products. Banks may also choose to make more use of business intelligence tools to analyze this data and draw conclusions about customer behavior and requirements.

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