Deloitte.

2014 Capital Markets Outlook
Repositioning for growth
New models for a new era

Deloitte Center *for* Financial Services

Contents

Foreword

Dear colleagues,

"It was the best of times, it was the worst of times…" So begins Charles Dickens' *A Tale of Two Cities*. While banking and capital market firms still have some ways to go, and thus this quote may not be true in the literal sense, industry leaders are looking forward to a better year ahead.

The good news is that the economy is showing some signs of life: balance sheets are stabilizing and consumer confidence is trending toward the positive. Revenues have also picked up in certain sectors, and credit availability is easing.

That said, next year will likely be one of continued challenge for industry executives. Margins are under extreme pressure, and business models and product structures are becoming more standardized, mortgages and derivatives being two examples. And regulatory concerns have shifted, from uncertainty over direction to uncertainty over long-term outcomes.

As firms begin to pivot toward growth, they will be challenged to remain relevant to their clients, realign business models, adjust to recent regulations, and attempt to innovate for growth. Firms will also continue to make strategic decisions, driven by capital constraints and demands for improved return on equity, divesting or acquiring in areas where they believe they can compete and win. We are seeing some renewed interest in innovation as well. Overall, banks and capital market firms will need to drive increased agility into their operations to take advantage of the ongoing uncertainty in the market, rather than simply waiting for more stable conditions to emerge.

We are pleased to share with you this outlook for 2014, based on original research combined with the insights and first-hand experience of many of Deloitte's leading banking and capital markets practitioners. Over the past year we have restructured our content into six major topical platforms, which are designed to explore both industry-wide competitive and market dynamics as well as examine tactical trends and opportunities within individual firms. Across all segments of the financial services industry, our 2014 outlooks rely on this new structure, providing insights aligned to the following:

- **Competition and markets** – Evaluates existing industry structure, competitive landscape, or market composition
- **Clients and products** – Explores emerging trends in retail or institutional customer behaviors, attitudes, and needs
- **Governance, risk, and compliance** – Reviews industry risk management practices and regulatory mandates and their potential financial and strategic impacts on industry participants
- **Financial management** – Highlights how finance leaders can better organize and deliver needed insights to their firms
- **Organizational effectiveness** – Analyzes how firms have responded to talent, process, and other operational challenges
- **Technology dynamics** – Examines the evolving role of technology in the industry

We've included a graphic element, which you'll see throughout the report, that provides a signpost as you navigate the outlook. If you pick up more than one of our financial services outlooks, you'll be able to easily compare how the various industry sectors are addressing each of the six topics by visiting the corresponding section. For example, you'll see technology trends by visiting the corresponding dark blue sections in all nine reports. We hope you find this report insightful and informative as you consider your company's strategic decisions in the upcoming year. Please share your feedback or questions with us. We value the opportunity to discuss the report directly with you and your team.

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Finding steady ground

After five years of tumultuous change, it is no surprise that capital markets firms have yet to find steady ground. However, heading into 2014, there is increasing evidence that they may have a chance to shift to a higher gear — or perhaps even accelerate.

Many observers expected 2013 to complete the postcrisis re-regulation and reshaping of capital markets. Yet developments have been slower than anticipated. Although regulatory clarity increased as the year progressed, uncertainties remained on how best to respond to the new landscape.

But we expect this to change in 2014. As each day passes, the regulatory context becomes clearer. Many major compliance dates, especially in over-the-counter (OTC) derivatives regulation, have passed. Perhaps more importantly, firms have been able to solidify their understanding of new capital requirements.

Moreover, final versions of the Volcker rule and the qualified residential mortgage (QRM) risk retention rule in securitization transactions are expected near the end of 2013 or early 2014, as is the announcement of the national market system plan for the consolidated audit trail (SEC Rule 613).[1] Almost all the major regulations will soon be in place — even if their long-term consequences remain indefinite.

Meanwhile, the economy has continued to recover. Recent projections put the United States on track for 2.5 percent GDP growth in 2014 — hardly a robust recovery, but a better rate than that of many European and emerging markets.[2] With equity market valuations near all-time highs, the data warrant at least a little optimism. That said, the continuing U.S. political gridlock and the country's unresolved fiscal issues may continue to be a damper on sentiment.

One major macroeconomic unknown is the timing of the Federal Reserve's eventual monetary tightening, originally expected in September 2013. Tighter money and rising rates may take a little time to materially affect capital markets, but this process is likely to be the major macroeconomic driver of activity in 2014.

Given 2013's increased regulatory clarity and macroeconomic improvements, 2014 may be an opportune moment for capital markets firms to pause and take stock. In doing so, they have a chance to critically evaluate their businesses and operating models against the requirements of this new era. Exchanges may be further along in this process than are many other businesses; with substantial industry reconfiguration already underway in 2013, exchanges are already experimenting with new models.

Other capital markets players, like investment banks, appear to be somewhat earlier in this process. Their task is difficult. Demands on businesses are many, the regulatory burden is heavy, and the path toward superior business and operating models is not readily apparent.

However, there are some clear common priorities for capital markets businesses in this moment of self-assessment and competitive repositioning. In particular, two stand out.

First is addressing the compelling need for better integration and interconnection in critical functions such as risk management, compliance, finance, and technology. Despite five years of continuous effort, the first two areas will likely continue to be major strategic concerns for capital markets firms.

The second, and related, priority is exploring the possibilities of industrialization in capital markets — especially with respect to boosting agility by creating new internal shared services and external industry utilities.

As Bob Contri, vice chairman, U.S. financial services leader, U.S. banking and securities leader, Deloitte LLP, noted, "Repositioning for growth in capital markets firms, both in 2014 and years ahead, will depend heavily on firms' ability to reshape their organizations."

Specialization a major trend; Exchange consolidation to continue

Specialization, driven by both capital and performance pressures, has been a dominant strategic trend among capital markets firms, especially investment banks, for several years now.[3] Many firms are focusing on core strengths by reassessing their business lines, along with the customer groups and geographic markets they serve. This strategy, a major shift from the previous trend towards diversification, is likely to alter the competitive landscape.[4]

In this competitive context, many investment banks will likely continue to look overseas for revenue growth. One market where U.S. firms have gained is the European investment banking business. The exit of European investment banks from certain business lines and geographies (driven by their need to strengthen capital positions and improve returns) has allowed U.S. firms to increase market share in the region. U.S. banks' share in the European investment banking (mergers and acquisitions [M&A], underwriting) underwriting) fee pool rose to 36 percent in 1H2013 compared to 28 percent in 1H2012, the highest since 2009.[5]

Meanwhile, in contrast to the specialization strategy dominant among banks, exchanges are pursuing consolidation and diversification. This trend is a result of multiple factors, including margin pressure from declining volumes and a desire for geographic and product breadth. One recent example is the acquisition of NYSE Euronext by ICE, which may help the latter to expand its business into multiple asset classes (including interest rates) and increase its global reach.[6] As Bob Walley, principal, Deloitte & Touche LLP, noted, "Consolidation, simply put, will dominate exchanges' agendas in 2014." And as exchanges look to build capabilities to cater to a global client base in the relatively lucrative derivatives business, more international and cross-product consolidation may be ahead.

Another area where the competitive landscape is changing significantly is, the OTC derivatives market. Centralized clearing and exchange trading, as many have noted, will likely weaken the dominance of traditional players. New players (swap execution facilities [SEFs] and exchanges/clearing firms) with technological prowess and scale could make significant inroads, potentially reducing big broker-dealer revenues.

While the net effect on different entities remains uncertain, the new competitive dynamics might be good for clients, providing greater product breadth, execution choices, and decreased costs.

What's new in 2014

As firms' specialization strategies take effect, competition in certain businesses may heat up, while other areas could be left to a few specialists. Those that have yet to go down this path could be at a disadvantage; as Bob Contri, vice chairman, U.S. financial services leader, U.S. banking and securities leader, Deloitte LLP, puts it, "2014 is the year firms make the investments they need to win in the markets they have chosen to focus on." But firms that have either already begun to specialize or those that have yet to do so will need to take account of changes to their risk profiles, especially as their exposure to certain markets or products becomes more concentrated.[7]

The gap between fees earned by European and U.S. institutions shrank to a four-and-a-half year low in 1H2013.[8] Continued retrenchment by European banks, although at a slower pace than before, will keep creating opportunities for large U.S. investment banks in European markets.

The search for greater efficiency and new opportunities may drive new consolidation amongst exchanges. In particular, equity-only exchanges with weak capitalization may become likely targets for acquisition. However, as firms become more aggressive, bigger and higher-profile merger plans could come under greater regulatory scrutiny.

As they diversify, U.S.-based exchanges will compete domestically and globally for a higher share of derivatives clearing volumes, driven by phased-in implementation of U.S. clearing mandates in 2013 and expected enforcement of European rules in 2014.[9] The push for market share in the much anticipated "futurization" (conversion of an OTC product to an exchange-traded product) of swap products may also hurt traditional broker-dealers due to the migration of business to the exchanges and more competitive pricing.[10]

The bottom line

Responding quickly to changing market dynamics will likely become even more important. From a revenue growth perspective, U.S. investment banks with a substantial international foundation in M&A advisory and underwriting business lines are likely to benefit the most from European opportunities. Meanwhile, we expect exchanges to make meaningful progress in the areas of multi-asset class trading, global expansion, and clearing services. In contrast, traditional broker-dealers will need to decide whether they should specialize in low-margin, high-volume standardized businesses or high-margin, low-volume bespoke businesses.

Modest revenue expectations overall; Derivatives transformation becomes a reality

An improving domestic economy, central bank support, and greater operational efficiencies led to revenue growth for U.S. capital markets firms in many areas over the last couple of years. In particular, equity and fixed income trading revenues increased moderately in 2012 and the first six months of 2013, as persistent low rates depressed bond yields, driving investors towards equities and riskier high-yield bonds.[11] However, bond trading revenues declined in the third quarter of 2013, mainly due to the Federal Reserve's decision to keep its bond-buying program intact for the time being.[12]

Furthermore, the Fed's decision to maintain low interest rates until aggressive macroeconomic targets are met has led companies to refinance, spurring bond issuance and helping grow underwriting fee contributions to revenues even as overall investment banking fees declined (Figure 1). The area that has most disappointed expectations recently is M&A advisory: Demand for these services slumped in the first three quarters of 2013.[13]

Achieving consistent revenue growth across business lines in 2014 will not be easy. Much will depend on how fiscal and monetary policies play out, both in the United States and abroad. Clarity on many regulations is greater than in years past, but there is always the chance of unanticipated second-order impacts.

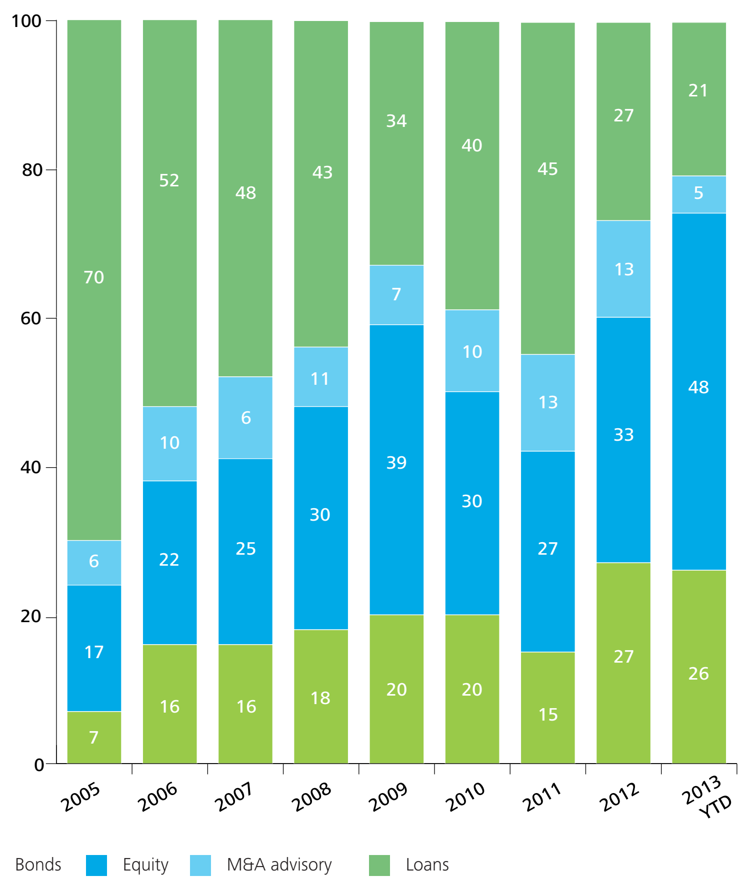
Nor can firms realistically look to product innovation for growth. Regulatory scrutiny and lack of investor confidence (given the experience of the crisis) make it unlikely that 2014 will see a return to large-scale development of new financial instruments. As Larry Rosenberg, partner, Deloitte & Touche LLP, puts it, "Innovation in 2014 should be more about rebuilding trust by making things less complex for the customer, rather than creating new products."

Possibly the most notable area of product focus has been — and likely will be in 2014 — the derivatives market. The transformation of OTC derivatives markets is in full swing, with a number of execution, clearing, reporting, and business conduct rules coming into force in 2013.[14] Consequently, market participants continue to standardize swaps contracts that can be cleared centrally and traded electronically.

That said, swaps dealers and electronic venues will likely face challenges from partial migration of their swaps (standardized or not) business to futures. Investors prefer futures over swaps as the latter may be subject to more complex and costly legal and operational requirements.[15]

Meanwhile, buy-side firms are adjusting to the new derivatives marketplace by reconfiguring their back- and front-office operations in areas such as trade execution, collateral management, valuation, accounting, and risk management disciplines in response to the changing market dynamics.[16]

Figure 1: U.S. investment banking fee composition trends (percent)



Source: Thomson Reuters

What's new for 2014

Looking ahead to 2014, revenue growth expectations are likely to be mixed across different capital markets services and products. While fixed-income trading revenues will likely remain subdued, due to the potential end of quantitative easing and rise in yields, advisory revenues will likely be boosted by an improved M&A environment. Factors expected to most influence deal activity include corporations' large cash reserves, favorable terms of credit, and strong equity markets.[17] Trading revenue from equities is also expected to benefit from increased investor interest and improved valuations in 2014.[18]

Meanwhile, U.S. equity underwriting, which witnessed a 42 percent year-on-year increase in 1H2013 due to resurgence in the initial public offering (IPO) market, is expected to sustain its good run.[19] Increased IPO activity will be supported by strengthening equity markets, provided macroeconomic conditions remain stable.[20] Conversely, the trajectory of debt capital markets is unsure, depending largely on the direction and timing of monetary policy. A decision by the Fed to curb its bond buying program will likely push yields higher — as shown by third quarter 2013 movements — restricting corporate bond issuance.[21]

With the advent of greater transparency in the OTC derivative markets, firms may need to reexamine their product pricing. As Ricardo Martinez, principal, Deloitte & Touche LLP, puts it, "Increased transparency and higher costs resulting from mandatory clearing, electronic trading, and increased margin requirements will likely force firms to reprice contracts including standardized flow products in order to remain competitive." Additionally, to prevent market liquidity moving to the futures market, market participants will continue to develop exchange-traded versions of swap contracts with standard coupons and quarterly maturity dates similar to futures products.[22]

Moreover, with cost management still crucial, client segmentation and tiered pricing are expected to become commonplace, as broker-dealers become increasingly selective in what they offer to their clients. However, pricing of noncleared bespoke trades is less likely to suffer; new initial and variation margin requirements do not come into effect until December 2015.[23]

Overall, one could expect the balance of power in 2014 to move further toward the buy-side, particularly as institutional clients take advantage of increased competition and price transparency. Indeed, the myriad changes and challenges facing sell-side firms make it hard to see another outcome.

The bottom line

Product rationalization and client segmentation will be further refined to manage cost pressures and boost returns. With respect to derivatives, firms will be able to effectively differentiate themselves based on their ability to provide integrated solutions to clients via a single platform in the areas of funding, execution, and clearing services. Some sell-side firms could look to capture new revenue streams in clearing and collateral optimization/financing to offset lost revenues from margin compression.[24]

Getting ahead of risk and compliance

2013 witnessed a fresh wave of rules and regulatory proposals concerning capital markets activities: U.S. Basel III capital rules, Commodity Futures Trading Commission (CFTC) rules on SEFs and clearing firms, U.S. Security and Exchange Commission (SEC) rules on financial responsibility for broker-dealers, and the risk retention rule in securitization transactions, among others. These brought much-needed clarity, as the expected finalization of the Volker rule and implementation of the SEC Rule 613 is anticipated to do.

While capital markets institutions were busy interpreting these new regulations, enhancing risk management remained a top priority. For instance, in the securities trading area, many firms have begun to replatform their technology infrastructure to be able to quantify risk positions on an intraday basis — across products and counterparty relationships.

Also, operational risk and compliance challenges came to the fore. Technological glitches, botched trades, and embarrassing compliance failures affected even the strongest firms.

Accordingly, two items will likely dominate capital markets firms' risk and compliance agendas in 2014: moving toward a better-integrated approach to risk management and compliance, and controlling operational risk.

What's new for 2014

As the regulatory parameters become clearer, firms will gradually adjust to the new order and be able to reposition their businesses for growth. But as Chris Thatcher, partner, Deloitte Canada, Deloitte & Touche LLP, noted, "Institutions that are more advanced in their risk management and compliance infrastructure will be better able to take advantage of market developments."

Many firms are not yet in this enviable position. The flurry of regulatory data and process requirements over the last few years forced many firms to prioritize speed over efficiency and comprehensiveness. This inevitable haste has left some firms with incomplete or poorly designed systems and processes that hinder effective and cost-efficient compliance.

Firms will likely face increasing market and regulatory pressure to address the causes of operational issues experienced in 2012 and 2013. As this pressure grows, so may the consequences of new failures. Firms must control their operational risk to maintain investors' and regulators' confidence — and their own profitability.

In particular, cyberthreats and related technology risks will merit special attention in 2014.[25] While the industry has generally become better at containing routine cyberattacks, firms and systems still remain vulnerable to more serious threats. Managing this vulnerability will likely require significant improvements to infrastructure and governance. (See the Deloitte-SIFMA report entitled "Quantum Dawn 2: A simulation to exercise cyber resilience and crisis management capabilities" for more details on how the securities industry is preparing to meet cyberthreats).

That said, the range of operational risks faced by large capital markets firms demands more than an unconnected set of task-specific solutions. Firms need a fresh approach. As with compliance and technological platforms, pursuing better integration is a likely strategy for managing operational risk.

Integration also brings benefits from a broader risk management perspective. Breaking down silos and improving risk analytics and metrics across products and asset classes may also bring both efficiency gains and competitive differentiation.

But better integration doesn't just mean bulking up the risk function, or expanding its role (though certainly firms may need to restructure their organization and responsibilities). Rather, institutions should distribute responsibility across the enterprise. As Scott Baret, partner, Deloitte & Touche LLP, puts it, "Risk functions need to transition from being the owners of risk management to being the enablers of risk management across the firm." Transforming risk management in this manner could bring new flexibility and efficiency to capital markets firms' activities, whether front-office trading or back-office compliance.

The bottom line

Compliance and risk management challenges will likely continue to head the agenda at many capital markets firms. In either case, there is a clear argument to be made for transformative efforts to integrate and rationalize current approaches, especially in trading environments. Robust compliance infrastructures need robust data, systems, and processes. And stronger risk management demands better governance and greater co-ownership by both front-line and back-office executives. Creating this change will rely on a wide range of efforts, but setting the "tone at the top" may be a necessary first step.

Transforming the finance function

The finance function in capital markets firms is under increasing pressure, having to balance investors desire for better returns with countervailing cost, regulatory, and risk factors. It is unlikely these demands will subside anytime soon.

One particularly important demand is for improved capital management, as risk-weighted assets (RWAs) remain high and returns on equity (ROEs) disappoint. Firms have trimmed many more capital-intensive operations, but need even more efficient capital deployment to achieve better return capital. And with increased regulatory scrutiny on wholesale funding programs and shadow banking activities such as repos and securities lending, capital markets firms will find it more challenging to optimize their funding structures.[26]

Meanwhile, evolving competitive and regulatory dynamics continue to spur the transformation of the chief financial officer's (CFO's) role into a more strategic function. In the aftermath of the financial crisis, many CFOs stepped up to lead their organizations through a range of strategic, system, and process overhauls, but these changes are not complete.

What's new for 2014

Creating a more robust finance infrastructure to enable scenario planning and real-time capital allocation decisions across various business activities will likely be a key goal of CFOs in 2014. As Jocelyn Cunningham, principal, Deloitte Consulting LLP, noted, "Driving this discipline down to the front-office without impairing their operational independence is crucial." Some capital markets firms have already implemented transaction-by-transaction capital planning, but others have yet to take more than first steps.

The challenge is, at its core, an issue of technology integration: the finance function must rationalize hundreds of feeds on a daily basis to generate consistent reports to permit quick decisions about risk, compliance, and capital allocation (see section "Completing the data picture" on page 13 for more on this topic).

But in making the transition, leadership may be almost as important as technology. As Jeff Kottkamp, partner, Deloitte & Touche LLP, observed, "Successful implementation of capital efficiency tools at the business unit and transaction level will require significant change in the culture of the organization. Leadership has to set the right tone and incentive structure to ensure compliance."

Meanwhile, as regulators pay greater attention to funding sources (e.g., repos, securities lending, and money market funds) CFOs and treasurers will be challenged to design and execute optimal funding programs within new regulatory and risk parameters.

In this regard, anticipating the implications of regulatory or market developments and discussing them with the board and chief executive officer (CEO) can help ensure that capital markets firms are positioned to respond to changing conditions. In this context, collateral management for secured funding (repos and securities lending) will become a key function, especially if fears of collateral scarcity become concrete.[27]

Because of these needs and the repositioning taking place at many firms, we anticipate 2014 will likely be a year in which CFOs solidify their positions as true strategic partners with other business functions within the firm.

There will likely be greater willingness to step beyond the traditional finance roles and more keenly engage with the board and senior executives on key strategic decisions and initiatives across the firm. This evolution of the CFO role and finance function will in turn, make deepening the bench of supporting talent even more important.

The bottom line

CFOs and the finance function are expected to face a range of new challenges in 2014. But these developments also present opportunities to build robust, capital, and risk-sensitive organizations. Ensuring that capital discipline percolates through to the transactional level across the organization should be a key priority. And anticipating and acting on regulatory and market developments in the wholesale funding markets will likely be critical to maintaining stability. To make its strategic impact felt, the finance function should cultivate better communication across business lines, making the flow of information and analysis more rapid and more transparent.

Moving beyond tactical cost reduction by embracing industrialization

Many firms have pushed tactical efficiency and cost reduction measures (such as headcount rationalization and compensation restrictions) to their limits. And in many cases, it could be argued that such efforts have not had the hoped-for impact on quality and service levels. Similar efforts are unlikely to achieve the cost flexibility firms need to boost profitability. Nor are they likely to promote the revenue growth firms seek.

A solution lies in building a more agile operating model, one characterized by the ability to rapidly build up and scale down operations in response to shifting opportunities. In an attempt to create such flexibilities, capital markets firms have pursued many forms of cost reduction, notably including piecemeal outsourcing or offshoring of their back- and middle-office functions. However, the benefits of this outsourcing and offshoring have maxed out in many areas, necessitating a more fundamental overhaul of the operating model. Indeed, the trend toward developing centers of excellence suggests firms recognize the need to move beyond labor arbitrage in offshoring to sustainable operational efficiency. This change is increasingly important because of the manner in which capital markets regulations and market volatility have changed business line dynamics.

These dynamics appear to increasingly favor players with scale and efficiency. This is particularly true in fixed-income and derivatives, where margins have been squeezed by increasing standardization and electronification. Having a fluid operating structure can build in the cost and process flexibilities, supporting capital markets firms' need to quickly seize growth opportunities where available and unwind businesses when necessary.

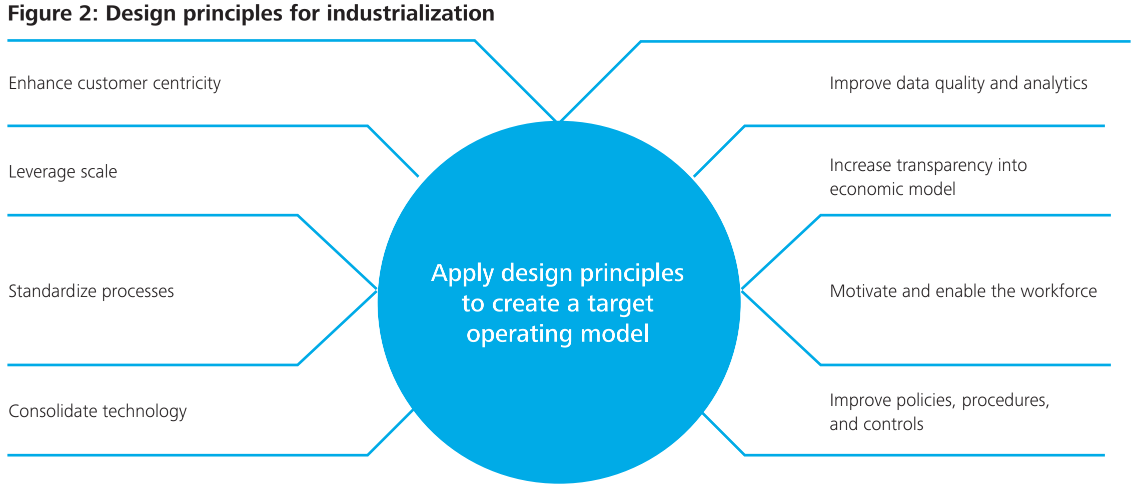
What's new for 2014

In 2014, capital markets firms will pursue fundamental changes to their cost base and operating models. A holistic, industrialized approach — as opposed to piecemeal programs designed to deliver narrow outcomes — is expected to provide a broader set of outcomes in areas such as quality, service level, risk, and controls. Industrialization is the holistic application of a wide array of changes on the supply side — standardized processes, streamlined product offerings, shared processing capabilities, and technology automation — to optimize management of financial, commercial, and risk demands, in addition to continuous cost improvement.[28]

Potential benefits from industrialization in middle-office and front-office functions are substantial, given the inefficiency of legacy systems and manual processes, and the frequent ineffectiveness of disparate past programs.

Successful industrialization can depend on the changes presented in Figure 2.

Figure 2: Design principles for industrialization



Source: Deloitte Consulting LLP, September 2013

As Sachin Sondhi, principal, Deloitte Consulting LLP, puts it, "Part of an industrialized model will be the sharing of capabilities and the creation of 'enterprise assets' that can be scaled and efficiently managed." Managing non-differentiable operations on a centralized, cost-efficient basis increases flexibility and agility. For instance, repurposing clearing and electronic trading infrastructure to drive synergies across fixed-income, currency, and commodities (FICC), as well as equities, could increase diversified broker-dealers' efficiency.

Moreover, third-party-managed services will likely gain traction for those standardized processes where scale determines cost efficiencies. Here, determining the preferred partner and location will be critical to realizing firms' goals. Talent, expertise, and ability to transform will likely outweigh simple cost considerations.

Capital markets firms may also create new industry "utilities" to share costs in processes that offer limited competitive differentiation and are also sufficiently standardized to be delivered by an external party.

Settlement and custody functions are areas with high potential for resource sharing. Already, know your customer requirements and other compliance tasks are likely to be transitioned to utilities shared by multiple institutions.[29]

The bottom line

In 2014, firms should industrialize their operating models with an eye toward increased agility. Successfully transforming to an agile model will require dedicated leadership and management attention. Their commitment will be crucial to ensure smooth program execution by laying down better governance structures, more standardized processes, and an effective talent strategy. At the same time, using an analytics-based approach to gain an understanding of performance drivers — whether in classic investment banking, trading, or other activity — and establish metric-based outcomes to drive industrialization decisions may be a prerequisite for implementing the change agenda.

Overcoming technology fragmentation

Technology is a crucial foundation for most capital markets businesses. As such, ensuring that technology is a true enabler rather than a detractor has become a priority for more and more firms. Despite this focus, severe technological failures appear to have affected a wide range of institutions over the past year. And less dramatic issues of inefficiency and small-scale errors are likely the norm for many organizations.

Capital markets firms' technology challenges run from vendor management to cybersecurity, but particularly persistent — and particularly damaging — are a fragmented technology infrastructure and poor technology risk governance.

Fragmentation, whether in the form of poorly connected systems or lack of an integrated governance and control structure, is a major operational challenge: Poor integration can decrease the chance of detection and rectification of errors, boost costs, make generating required compliance data difficult, and prevent firms from achieving a single view of their clients and exposures.

Fragmentation also slows a firm's response to changing market and competitive dynamics. As demands placed on the technology — for example, in securities trading — have rapidly grown, fragmentation's impact has likely grown correspondingly. Complex new regulatory data requirements challenge infrastructure never designed for that purpose. Risk management and compliance increasingly require real-time monitoring; and capital pressures mean some firms must now bring capital management down to the transaction-by-transaction level. In many cases, this entails large-scale "replatforming" to improve capabilities across the firm, from front-office trading to back-office compliance.

Beyond inconvenience or inefficiency, continuing fragmentation poses serious risk to firms' ability to fulfill regulatory requirements and execute on strategic goals. On this basis alone, there is often a clear and pressing need for closer technology integration and superior data management.

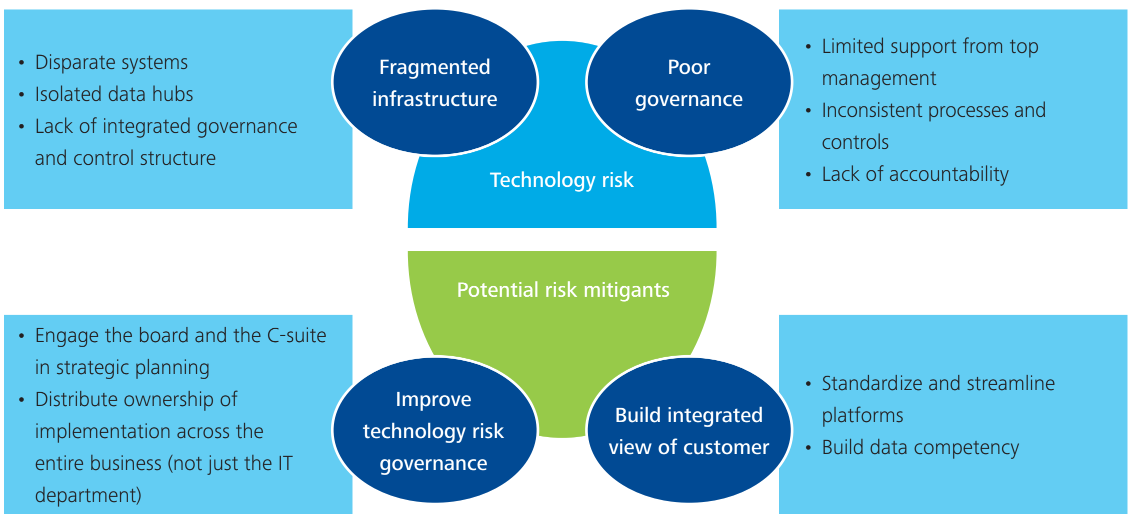
But firms — whether investment banks, exchanges, or other participants — should see better infrastructure as more than just another efficiency or risk management effort. An end-to-end, highly integrated view can also be a potent engine for profitability and revenue growth.

Fragmented technology is closely related to a broader issue facing capital markets firms' leadership: weak technology risk governance. Recent operational disruptions — whether from ineffective internal controls over system upgrades, inadequate legacy systems, or cyberattacks — illustrate that many firms' technology risk governance processes need an overhaul.

For many capital markets firms, technology-risk triggers are spread across the enterprise, whether in legacy trading platforms and infrastructure, or in third-party/vendor back-office systems. Poor governance is similarly a product of many potential factors, including limited support from management, inadequate efforts to identify and manage risk triggers, lack of accountability, and inconsistencies in processes and controls (see Figure 3 on next page).

Rectifying these issues could help manage many different risk types, including cyber risk. Getting the board and senior executives at capital markets firms more engaged — and making sure board members have the requisite expertise — is essential for this endeavor, as are better controls and clear accountability, particularly in transaction-heavy businesses, such as securities trading and processing. Technology risk at capital markets firms should not be seen as the sole responsibility of the IT department — every unit across the enterprise, whether in the front office or back office, should become more aware and better armed with effective tools to identify, communicate, and manage technology risks.

Figure 3: Key technology risks and potential mitigants



Source: Deloitte Center for Financial Services

What's new for 2014

Accordingly, many expect to see additional attention paid to two areas in capital markets technology in 2014: (1) building an integrated view of customers, products, and the transaction lifecycle, as in part required by the SEC Rule 613 and (2) leveraging technology for competitive advantage. (Instituting more robust technology risk governance will also likely be a priority: see sidebar on previous page for more discussion.)

By making investments that move them toward a comprehensive — and real-time — view of their business, firms will be better able to meet compliance data requirements, manage operational risk, and efficiently conduct operations. According to Larry Albin, principal, Deloitte Consulting LLP, "The challenge is to develop data competency to make one view available — whether one view of the trade, one view of the customer, or one view of the product — whenever needed." For example, a common view of the trade should support traders' daily profit and losses, risk management, and financial reporting. One major step may be "replatforming" and standardizing risk metrics and models to more effectively quantify exposure positions across products and counterparty relationships on an intraday basis. Doing so can be critical to meeting goals in risk management, capital allocation, and compliance.

One area where a comprehensive view of transactions will matter most to broker-dealers is meeting the reporting specifications for CAT, expected to be finalized by 2015. Meeting this new regulatory demand may require firms to make new investments in data management, technology infrastructure, and governance/control processes.[30] (Please see the Deloitte report "SEC Rule 613: Consolidated Audit Trail – National Market System (NMS) Plan – Considerations for broker-dealers" for more details.)

Institutions that choose to move beyond muddling through may find the business advantages sooner than they think. For example, the intra-day monitoring of changing exposures mentioned above may improve traders' ability to take and aggressively price positions — a potentially significant competitive differentiation. Indeed, firms' efforts to institute more common risk models and metrics show they are well aware of the potential for advantage.

But above all, streamlined and scalable technology can create much-needed competitive agility. Superior integration may also boost agility by improving capital markets firms' ability to identify tasks ripe for conversion to shared-service or "utility"-based provision — and ease cooperation with these utilities once they are up and running. Achieving this integrated view is an admittedly daunting task. Yet it is hard to see how firms can meet the demands of the marketplace and regulators without these changes.

The bottom line

Without substantial attention to updating and rationalizing their technological base, capital markets firms will risk costly disruptions and inefficiencies. In contrast, firms that move quickly toward a superior data environment by enhancing their systems, models, and processes may be better able to take advantage of scarce opportunities. To make this happen, firms should ensure the chief information officer (CIO)/chief technology officer (CTO) take part in strategic planning. And from the other direction, business leads should work toward joint ownership over the technology that enables their business.

Driving new models

After years of uncertainty, capital markets firms are ready to try a new route in 2014 as they reposition for growth.

Succeeding in this new era will likely require new models and new approaches. Though aims may differ, a common starting point is sharpening strategic focus and concentrating efforts in areas where returns are most capital-efficient.

Critical to this endeavor is the finance function, which will likely seek to expand capital management discipline across the organization and down to the transaction level. CFOs and senior finance executives may also be forced to be much more attentive to their funding strategies, as regulators shine their spotlight on wholesale funding markets.

Competition is expected to intensify in 2014, as a result of the ongoing fundamental shifts in many capital markets firms particularly those subject to direct new regulation, like derivatives. Many of the large universal banks dependent on capital markets lines of business will likely be forced to make hard decisions regarding their product portfolio, as well as the customer segments and geographic markets they wish to serve.

We also expect capital markets firms to devise new bundling and unbundling strategies. For instance, in the area of trading, efforts will likely be made to offer more integrated solutions, whether they are cross-asset class trading platforms or new services such as collateral optimization. At the same time, services previously bundled, such as OTC derivatives trading (where execution, clearing, and settlement services were often offered as a package), may be offered as distinct services.

But to be able to do this, institutions may need to invest more in developing a single view of the customer and transaction lifecycle. Regulations such as the SEC Rule 613 add urgency to this process.

Risk management and compliance will likely continue to be at the top of capital markets firms' agendas. In particular, moving towards comprehensive intra-day understanding of exposures and greater operational control in more technology-driven environments (such as trading) will likely be a key goal. Better quantifying risk and reducing disruptive operational failures can mean better integration, better governance mechanisms, and more robust data and analytics. Considerable strides have been made by some firms, but there is more to be done.

2014 could well be a turning point for many capital markets firms. To arrive at that desired juncture, as we enter a new era, firms should redouble their efforts to devise and implement new business and operating models.

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