Financial Services

Global Financial Services Industry Outlook

Shaping Your Strategy in a Changing World

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Industry Leadership

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Financial institutions will increasingly take advantage of innovative tools and technologies to enhance the customer relationship and address the needs of an aging population in the coming years.

Dear Colleague:

For the past several years, our Global Financial Services Industry practice has produced annual points-of-view on the "Top 10" issues of the coming year. This year, we took a new approach, working with the Economist Intelligence Unit to develop a high-level, cross-sector report with deeper analysis on a handful of longer-term "transformative issues."

Our Global Financial Services Industry Outlook finds that the forecast for financial services is mostly sunny; financial institutions, for the most part, are cautiously optimistic about the road ahead. While regulatory compliance and risk management remain top of mind, more efficient ways to manage compliance costs and more sophisticated methodologies to control risk are emerging. Additionally, opportunities in new markets abound – particularly those in emerging markets and Asia Pacific. And financial institutions of all stripes will increasingly take advantage of innovative tools and technologies to enhance the customer relationship and address the needs of an aging population.

To identify critical market drivers, we conducted an online survey of 175 board members and global executives, and 21 in-depth interviews with chief financial officers (CFO), chief executive officers (CEO) and financial services leaders from the member firms of Deloitte Touche Tohmatsu. Based on our findings and our client experiences, we believe that financial institutions will need to embrace the imperatives we have outlined in this report to achieve long-term success and differentiate themselves from the competition. To complement this piece, we are producing brief companion reports that consider the same issues in greater detail in terms of their impact to the banking, insurance, investment management and securities sectors.

We plan on continuing our research into the future of the industry and examining other ways in which financial institutions can sustain their growth and shape their strategy in a changing world. In the meantime, we hope you find our report valuable.

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Executive summary

As financial service providers look to the future, they are struggling to sustain growth in a world of fast-changing threats and opportunities. The choices that financial institutions are making every day will determine whether they can achieve their goals of exploiting emerging opportunities, managing risks and gaining a competitive advantage during this crucial period.

This report, based on an online survey and in-depth interviews with senior management at leading asset managers, banks, insurers and securities firms, explores the top trends, challenges and opportunities that global financial services providers must address over the next three to five years.

Engines of growth

Financial services executives cite the same transformative issues – globalization, regulation, risk, demographics and technology – but rank them differently depending on their sector. Based on those issues and our client experiences, we have identified five strategic imperatives for financial services firms:

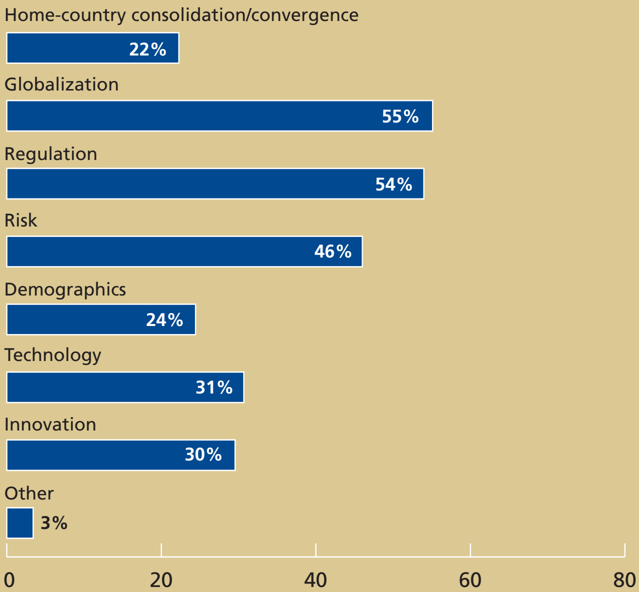
1. Embrace opportunities in new markets

The most successful firms will continue to exploit the promise of fast-developing economies and easing cross-border investment regulations. Most large financial institutions are already there: in Central and Eastern Europe, and in Asia, where there are at least a half-dozen countries vying to become regional financial services hubs.

Europe is poised for retail financial services consolidation on a scale seen in the US market in the 1990s. Many European institutions are looking at opportunities in other European countries. While not "new" markets in the traditional sense, they are strategically viewed as a way to gain entry into areas where institutions have not previously had a strong presence. Cross-border mergers, driven by the need to grow earnings, the appeal of economies of scale and a more encouraging regulatory climate, could lead to the disappearance of hundreds of banks and the emergence of a handful of pan-European players by 2010.

Offshoring, which has become a competitive necessity over the past 10 years, will ramp up as firms recognize the improvement in quality they can realize through the well-qualified people and cost savings attainable by scaling up their operations, particularly in areas like India, the Philippines, Malaysia, China and other markets in Asia Pacific. Firms will continue to look beyond IT to actuarial services, human resources and other back-office functions. Increasingly, they will need to simplify and streamline their processes to realize the maximum benefits.

Which drivers of change will have the most impact on profits in your sector over the next three years?



Source: Economist Intelligence Unit. Up to three responses allowed.

China, in particular, will transform the financial services industry for years to come as growth opportunities slow in Japan and the West. Western banks and securities firms have already spent billions to acquire stakes in China's four national banks. Recently they have started to invest in midsized banks as well, including city banks. A large savings rate, growing middle and wealthy classes and a dearth of healthcare and pension systems make China a market that major asset management firms and insurance companies ignore at their peril. Though some have quickly achieved profitability on their China ventures, many investments are in the red, and success is seen as a long-term goal.

2. Refocus customer relationships through technology and innovation

As direct customer access and pricing pressures lead to commoditization, customer focus must become central to strategy. Financial institutions are increasingly focusing on delivering an innovative customer experience – one that is targeted to unique segments and emphasizes convenience, service and value.

Technology has empowered customers to loosen ties with financial services providers, but it can also be harnessed to rebuild and strengthen relationships. 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. On the institutional side, capital markets firms will develop more sophisticated client platforms that provide trading scenario analysis, risk modeling and performance management reporting.

3. Adopt a principle-based approach to regulatory compliance

Across all sectors and countries there is deep concern about the cost of regulatory compliance. No financial institution is immune: From Basel II, Solvency II and Sarbanes-Oxley to a country-by-country laundry list of new laws and tougher enforcement of old ones, firms face an expensive and confusing regulatory landscape.

Given the number and mandates of regulators, it is no longer possible to adopt a reactive, piecemeal approach to compliance. Instead, institutions are gaining a competitive advantage by introducing principle-based compliance into their governance and management culture and embedding it into the business, effectively training and deputizing every manager.

At the same time, by taking a strategic, disciplined approach to their formal compliance function, firms can avoid costly overlap and duplication of effort. Across geographies and business lines, firms need to adopt a uniform methodology for documenting compliance risks and controls and testing and implementing those controls, using evolving technology to assist.

4. Address risk in the context of an enterprise risk management framework

Operational risk is top of mind for financial services firms. More than half of those surveyed identified operational risk as harder to manage and an area of greater concern than market, credit and liquidity risk, perhaps because they already have a solid handle on those risk types. Similarly, reputational risk, which is intertwined with operational, compliance and other risks, is emerging as a central concern.

A strategic, holistic approach – through an enterprise risk management framework – can help mitigate risk across the board. Specific actions may range from vetting supply-chain organizations for potential reputational issues to developing a consistent internal and external communications strategy. More firms are employing enterprise risk management (ERM), which can provide a value proposition for the board and senior management.

5. Capture assets in the retirement market

In the graying markets of the US, Europe and much of Asia, payouts will soon begin on trillions of dollars in retirement assets. At the same time, responsibility for retirement security is increasingly shifting to the individual and away from governments and employers. To date, financial providers have pursued affluent baby boomers and early retirees. Future growth will come from helping retirees maintain a steady stream of income.

To achieve long-term success and differentiate themselves from the competition, now more than ever, financial institutions will have to foster relationships with individuals, provide advice and develop products that meet their needs at all stages of the lifecycle. As defined contribution plans continue to supplant defined benefit plans, the plan sponsor increasingly will be viewed as the conduit to the individual client rather than the client itself.

About the Survey

Purpose: To identify what the financial services industry views as the key transformative issues in the next three to five years.

Methodology: Using an online survey, we polled senior executives at global financial services firms. As a follow-up, 21 in-depth interviews were conducted.

Survey Demographics:

- The 175 respondents were comprised of board members, C-level executives, business unit heads and other senior executives at financial services firms.
- Participants were drawn from a mix of asset management firms (23%), banks (28%), insurance companies (27%) and securities firms (22%).
- Respondents were based in Asia-Pacific (25%), Europe (31%), Latin America (1%), Middle East and Africa (3%) and North America (40%).

The average asset size was $172 billion, with institutions over $250 billion in assets comprising the largest single category.

Embrace opportunities in new markets

Globalization is increasingly changing our world. Few large financial services providers will be able to grow quickly without embracing new markets across the globe – both "new" in the traditional sense of emerging markets and "new" to that particular institution. Four out of 10 survey respondents cited moves into new markets as a top driver of profits over the next three to five years.

Crossing borders and creating opportunities

Whether through M&A activity, offshoring or origination and distribution in new markets, financial services firms now have greater opportunity to cross borders than ever before. HSBC is aggressively growing its business in new markets – both developed and emerging. Over the next 25 years, it projects much of the world's growth coming from Asia, where it is making big investments in banking and insurance, and the Americas, encouraged by the NAFTA agreement.

BlackRock, which has $100 billion in international client assets out of a total $453 billion, is seeking to expand its global reach to keep up with the globalization of the capital markets and the growth of ideas. "We're trying to be less US-centric, to stop exporting Americans overseas, to become more global in manufacturing, client service and technology," says Laurence D. Fink, chairman and CEO. BlackRock sees opportunity in the Middle East, Asia and in the retirement business in Europe.

Firms looking at new markets must decide whether to make an acquisition, collaborate in a joint venture with a local entity or (where permitted) start operations from scratch. Regardless of the chosen approach, the message is clear: Embrace new markets, but only with a clear understanding of entry requirements and a carefully articulated strategy.

Many European financial institutions are examining merger and acquisition opportunities in other European countries as an entrée into new markets and an opportunity for expansion. The long-awaited cross-border consolidation of Europe's retail financial services firms likely will accelerate in the years ahead. Survey respondents see cross-border consolidation as the most important aspect of globalization over the next three years, with 44% citing the trend.

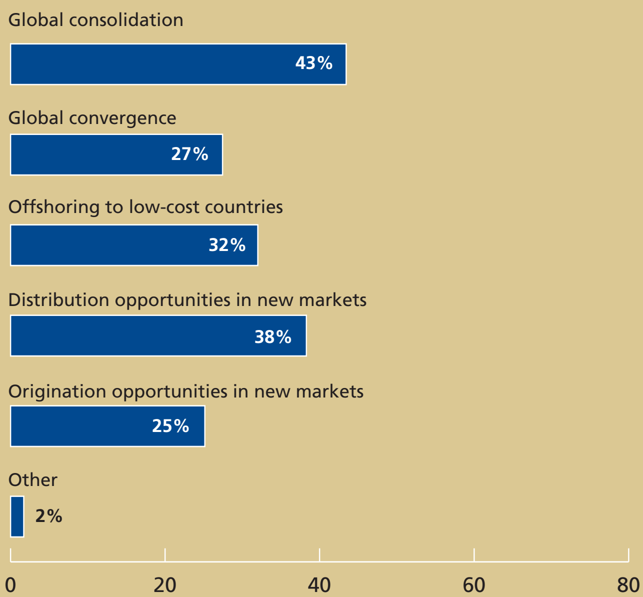
Eight of the 12 financial services mergers in the past two years with a European firm as the acquirer have been cross-border retail banking deals, including Grupo Santander's $15.8 billion acquisition of Abbey National in 2004 and UniCredito's 2005 nearly $19 billion purchase of HypoVereinsbank. By 2010, hundreds of banks may have vanished and a small group of pan-European giants may dominate the landscape, according to a recent Deloitte Research report, *A New Playing Field: Creating Global Champions.*

The political, regulatory and cultural obstacles that have blocked European mergers in the past are finally eroding. The European Union supports removal of regulatory barriers to such deals, UK and German regulators have raised no objections to recent deals, and some European courts have opposed discriminatory tax treatment of cross-border entities by national authorities. Favorable capital treatment for diversified businesses under Basel II may encourage more deals. Additionally, huge price discrepancies for banking services across Europe have created demand for lower prices and a climate ripe for more competition in certain markets at the expense of established national players.

Looking at new markets outside of Europe, most financial firms are choosing acquisitions or joint ventures to gain access to an established customer base. Numerous foreign entities have acquired stakes in Chinese banks, including Royal Bank of Scotland, ING, Deutsche Bank, HSBC, Citibank, Commonwealth Bank of Australia, Merrill Lynch, Goldman Sachs and Allianz.

HSBC's strategy melds organic growth and acquisition. HSBC has 12 branches in China and expects to own about 20 in 2010, according to *The Banker* magazine. In 2004, it bought a 19.9% stake in Bank of Communications, China's fifth largest bank, gaining access to 2,400 branches in 137 cities. Stephen Green, group chief executive of HSBC Holdings who will become group chairman on May 26, 2006, says that HSBC will

Within the category of globalization, what will have the most impact on profits in your sector over the next three years?



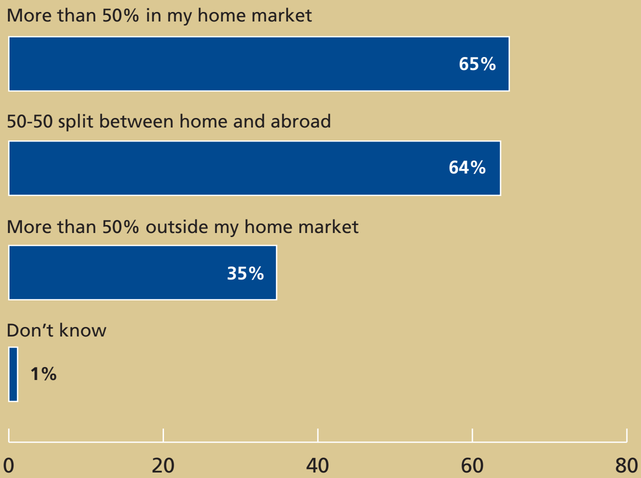
Source: Economist Intelligence Unit. Up to two responses allowed.

use its own network to provide commercial mid-market and high-net-worth banking services in major cities and work with the Bank of Communications network to serve the burgeoning domestic retail and consumer markets. HSBC has also acquired a 19.9% stake in Ping An, China's second largest life insurer.

Credit Suisse has identified six target Asian markets and tailored its growth strategy to each market. Together with Industrial and Commercial Bank of China (ICBC), it formed a joint venture to offer the first bank mutual fund in China, investing in stock and money markets. The other target markets are India, Hong Kong, Singapore, Taiwan and Korea, according to Clayton Coplestone, head of channel management and sales, non-Japan Asia, for Credit Suisse's asset management business.

No matter how big and global the institution, it must adapt its distribution strategy to individual markets. "I would call it 'glocalization,'" says Coplestone. "At the end of the day, what happens in Asia is very different from what's happening in Europe, which is very different from what's happening in the States. Globalization will affect the manufacturing end. I'm not sure it's going to have any significant impact at the distribution end."

In 2010, how will your company's business be apportioned?



Source: Economist Intelligence Unit.

Offshoring

Offshoring has become a competitive fact of life for financial institutions. A 2005 Deloitte Research report, *Global Financial Services Offshoring: Scaling the Heights,* indicates that the offshoring boom has expanded into many countries, perhaps most prominently India, the Philippines, Malaysia and China.

Our offshoring report estimates that there could be money left on the table. According to the findings, the industry as a whole could triple the cost savings from its offshore operations. Using the sample of Deloitte Touche Tohmatsu's Global Financial Services Industry annual benchmark, the participants could reduce their annual cost base by up to $16 billion – tripling current savings of around $5 billion. The additional benefits would come from two key sources. First, scaling headcount from around 3.5% of total headcount offshore with average cost savings of 38% to the current best practice of 6.7% of total headcount could yield 60% cost savings. Second, efficiency gains could be created by expanding the scope of operations to "full service," which means relocating all types of functions from IT and back office, to middle and front office activities.

Though some institutions have retreated from offshore call centers, companies generally add more functions, often full-service, after several years of offshoring a single function. Large institutions are naming heads of global offshoring or outsourcing, a sign that offshoring is maturing. Increasingly, the industry is moving away from outsourcing toward captive operations or a hybrid approach of captive and outsourced functions.

HSBC has expanded its offshoring beyond basic processing into research and IT development and has only captive operations, building up operation sectors in India, Malaysia, the Philippines, Sri Lanka and China. "The fact that activities are now done somewhere like India or Sri Lanka instead of the US, Canada or UK doesn't make it any less an integral part of our business," says HSBC's Stephen Green.

Language can be a barrier to large-scale offshoring. To save costs and centralize its internal systems development and back office, Fidelity has set up an English-language regional service hub in New Delhi and Bangalore. It may look elsewhere for a hub that can handle its Asian-language back office and is moving some functions to Sydney.

To succeed at offshoring, firms must manage four key elements: complexity, compliance, culture and cost. Focusing on these elements is the best way to maximize the performance and value of offshore operations.

Offshoring adds an element of geographic challenge to regulatory compliance and risk management that must be managed as effectively as onshore compliance. In focus groups on the potential for offshoring and outsourcing, clients of Charles Schwab have voiced concern about the security of money and records. "'This is my money, and I want to make sure my money and my records are safe and secure,' and they don't necessarily believe or know that those safeguards may be overseas or in somebody else's hands but they do look for that from us," says Christopher V. Dodds, Schwab executive vice president and CFO.

Our research indicates that offshore results often fall off sharply after the third year as firms start to take the benefits for granted. Institutions need to make sure they have strong managers building and running offshore operations and that the culture extends beyond traditional boundaries to include vendors and alliances. Additionally, rotating top staff can help maintain a mix of experienced management and fresh talent. Finally, to achieve ongoing efficiency and scale, firms must channel some of the savings from offshoring back into the operations.

The China card

Strong economic growth, rural-to-urban migration, a high savings rate, a burgeoning middle class and receding regulatory barriers all make China a most-compelling long-term target for foreign financial firms. Despite the risks posed by a fledgling regulatory regime, lax enforcement and a weak court system, more than 60% of survey respondents say that China will be important or very important to their organization in 2010.

According to the Chinese Academy of Social Sciences (CASS), middle-income Chinese accounted for 15% of China's population in 1999, rising by one percentage point per year to 19% – about 250 million people – in 2003. CASS projected this group will rise to 40% of the population by 2020. CASS defined middle-class as having family assets from about $18,000 to $36,000 per year. Using a higher threshold, BNP Paribas Peregrine estimated that there were 50 million "middle class" Chinese households in 2002, a figure expected to double by 2010.

Definitions of China's middle class and projections for its growth vary. But there is no doubt that the middle class is growing quickly, and that its potential dwarfs that of the aging populations of North America, Europe and Japan. The products needed span the spectrum from credit – which will spur further economic growth – to investment products and financial advice for retirement to auto, health and life insurance.

By December 2006, China must fulfill its World Trade Organization (WTO) commitment to dismantle barriers to foreign banks. That same agreement requests that China gradually open its fund management, securities and insurance sectors, permitting minority foreign joint ventures to engage in fund management; allowing foreign joint venture securities firms to underwrite domestic securities issues and trade in foreign currency denominated securities; and permitting foreign insurers to provide health, group and pension insurance, among other stipulations.

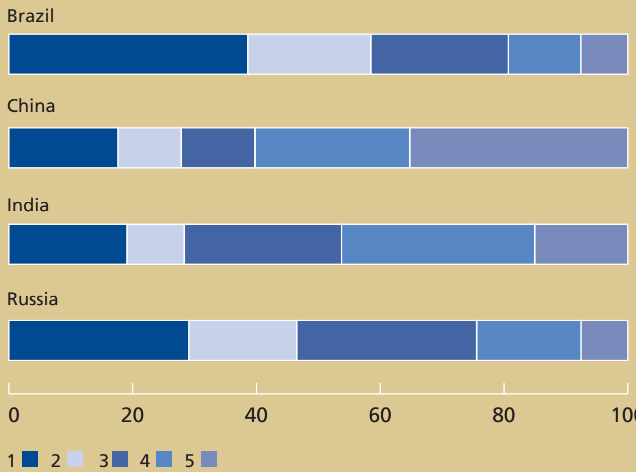
China is making substantial changes aimed at opening its financial markets. According to the *Wall Street Journal* ("Chinese Banks Defy Prediction," January 25, 2006), as of year-end 2005, foreign firms had spent more than $16 billion on minority stakes in China's four state-run national banks. Those banks were cleaning up non-performing loan portfolios. Over the past 18 months, their combined non-performing loans fell to 10.11% of total loans from 19.15%, still far above the usual US bank ratio of less than 1%. Three of the four either had or were planning to list their shares in Hong Kong. China Construction Bank was first in 2005; Bank of China is planning a move in 2006, and ICBC was set to follow. Those same foreign entities and others were looking to team with China's city-based commercial banks, formed in the past decade out of urban credit co-ops.

To encourage investment, China, with the aid of Western securities firms, is restructuring its banking system, securitizing and selling non-performing loans and injecting capital into state-owned banks. But many are concerned that the country's annual loan growth of around 20% will create new portfolio problems.

The road to profitability will be bumpy for some ventures. The *Financial Times* reported that several Western fund managers, including the UK's Schroder and the Netherlands' ING, recently revealed large losses in their China joint-venture funds. Additionally, barriers to entry still exist and the constraints on doing business confirm that it is not for everyone. "We currently do not believe that the conditions under which we would be able to enter the markets would be of benefit to us," contends Jonathan O'Brien, CFO and executive director of oversight for Fidelity Investments, Asia-Pacific Region. "If we're looking at a high-net-worth individual, the chances of their wanting to keep their money in China are fairly low – they want exposure to world markets. If we were to go into China right now, we would be a minority partner in a joint venture, and that's not something we will usually consider. I'm not convinced that the first-mover advantage in China is actually going to be an advantage."

Entities that expand into China – and other emerging markets – understand that they face geopolitical risks and structural market challenges. Recognizing that there will likely be obstacles along the way and addressing them head-on will considerably ease entry into new markets. Additionally, firms should focus on a long-term investment, as it could take several years to become profitable.

In 2010, how important will these markets be to your company?
Scale of 1 to 5, where 1 = unimportant and 5 = very important



Source: Economist Intelligence Unit.

Refocus relationships using technology and innovation

Technology has empowered customers, but at the expense of financial services providers. By strategically harnessing technology and innovation, financial institutions can provide better service and delivery and strengthen ties with customers. Over the next three to five years, financial services firms have an opportunity to deploy a combination of technology and personal contact to transform those relationships.

To win customer loyalty, financial providers must innovate in terms of service and distribution. In this way they can differentiate themselves from the competition, realizing the unfulfilled promise of customer relationship management and fueling future growth.

One-third of the survey respondents identified technology as a top profit driver over the next three to five years – especially the technology required to build strategic alliances with customers, partners and other stakeholders. Survey respondents also identified innovation as a significant driver of profits.

Innovative customer experiences drive growth

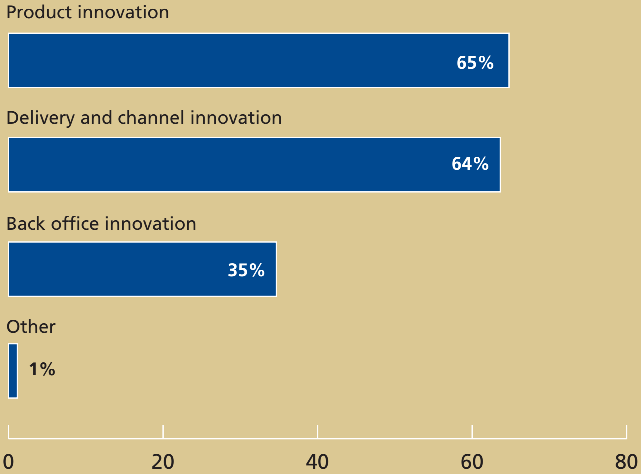
Retail product innovation has largely failed to deliver on the promise of sustainable growth. Our research estimates that the world's top 100 financial services companies together invest nearly $11 billion a year in product development. Yet products are rarely differentiated and competitors can quickly copy them.

Deloitte & Touche USA LLP's 2006 study, *Loyalty Quest: Enhancing the Retail Banking Experience to Drive Growth,* finds that US banks are adding checking account customers at an average rate of 17% a year, but are losing them at an annual rate of 15%. Only a few banks saw a net gain of more than 2% annually, and about half lost customers.

Financial institutions need to win customer loyalty by transforming into a customer-centric organization. This is a new way of looking at innovation. Rather than focusing on products alone, which are increasingly commoditized, the focus is on delivering a unique, innovative customer experience tailored to different segments. In an effort to drive growth, financial institutions are enhancing the customer experience by emphasizing convenience, value and service. Innovation is implicit in each dimension of that experience.

After years of shuttering branches, banks are opening new offices to attract, retain and cross-sell to customers and they appear to keep pushing in that direction. At one end of the spectrum is Commerce Bank, a US regional bank that uses mass-market retailing as a model. Commerce Bank targets high-traffic areas for branches, closes only four days a year, keeps extended branch hours, hires shift workers and reimburses customers for fees incurred at the ATMs of other banks. A number of banks, including Bank of America and Wachovia, have jump-started initiatives to add new branches with extended hours, vivid color schemes and prominent logos. Washington Mutual,

Within the category of innovation, what will have the most impact on profits in your sector over the next three years?



Source: Economist Intelligence Unit. Up to two responses allowed.

already well-known for inviting branch environments, has added enhancements like concierge desks and children's areas.

In other examples of customer innovation, Bank of America added a "Keep the Change" program in 2005, which allows enrolled customers to have debit purchases rounded to the nearest dollar and the difference deposited into a savings account. Citigroup plans to roll out a free service, "CitiMobile," which would let customers use cell phones to locate an ATM or branch, check their savings, checking and card balances, transfer funds and pay bills.

A technology awakening

Financial institutions are increasingly relying on technology – and working tirelessly to stay ahead of the curve – to enhance the customer experience. Credit Suisse's Coplestone sees an opportunity to provide advice and service through technology to a mass-market clientele. "It'll give mass-market retail investors access to what is largely the domain of high-net-worth individuals at the moment, and technology's the only mechanism to effectively and efficiently distribute that, compared to face-to-face meetings. Technology is huge, and it's generally underutilized in the financial services industry at the moment. I think it will be embraced in a big way in the not too distant future."

For institutional clients, sell-side firms have flocked to offer multi-product electronic trading platforms, featuring direct market access (DMA) and algorithmic trading. Lower commissions, anonymity, faster execution and improved communication have made DMA attractive to hedge funds and other buy-side institutions. Over the next three to five years, these platforms will evolve further, becoming more robust and providing sophisticated post-trade analysis, risk modeling and performance management reporting.

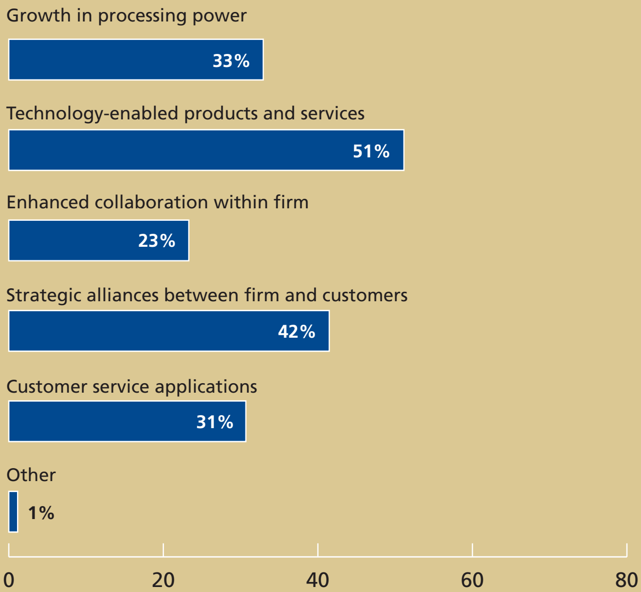
Even on the institutional side, technology should play a central role in client service and client communication. "We make clients' portfolios accessible to them 24 hours a day, seven days a week. If somebody is up at 3:00 a.m. and visiting somebody in Japan and a story comes across the wire that a company goes bankrupt, then they can go into a password-protected website at BlackRock and see if they own the stock or bonds of that company," says Ralph Schlosstein, president. "We're relatively unique in this respect. Three years from now I think that will be state of the practice. Most firms aren't set up to do that if for no other reason than they don't do compliance well enough to allow their clients to look through the window of the sausage factory."

Another emerging technology trend lies in navigation and personalization. Customers are increasingly choosing for themselves how they communicate with providers. At HSBC, for instance, more customers interact with the bank online and by phone than enter its branches. 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.

Charles Schwab sees a personalized and easily navigated web interface as a critical piece of its strategy over the next five years. "Personalization, ease of use and navigability are very, very high on our list of initiatives," says Dodds. "You can't necessarily make [the interaction] a personal experience because you're not dealing with a person. You are in fact dealing with your PC and servers and middleware. But you can personalize the experience through intelligent use of email and client relationship management systems to make customers feel, 'Wow, they actually know me!'"

Customer Relationship Management (CRM), an area in which many institutions have spent heavily, has offered a positive return on net investment to only a limited few. For others, it will be worth their while to keep trying. Successful implementers of CRM technology have figured out how to use the information extracted from the system to recognize customers and treat them consistently across the organization. Only in this way can organizations break through business and product silos and cross-sell effectively.

Within the category of technology, what will have the most impact on profits in your sector over the next three years?



Source: Economist Intelligence Unit. Up to two responses allowed.

For instance, Commonwealth Bank, one of Australia's "big four" banks, has implemented a new CRM system that allows a single customer view across all product lines, including those like insurance that come from separate silos. Externally, the system has helped the bank present a consistent face to the customer; internally, it has helped the bank to establish consistent performance measurements and comprehensive sales training.

Financial services firms must also look to technology to strengthen relationships with partners and intermediaries. Working together in a joint IT exercise to deliver a product or service can be challenging but spreads the cost burden. Similarly, intermediaries welcome technology that helps them operate more efficiently, reduces their costs and maximizes their profits. "We're also supportive of that. It's easier for us to operate when we can use technology to communicate and share information," says Thomas F. Motamed, Chubb vice chairman and chief operating officer. "If you give [partners] an application that makes it easier for them to do business, that strengthens the relationship."

Adopt a principle-based approach to regulatory compliance

Across all countries and industry sectors, expanding regulations, overlapping mandates and tighter enforcement have elevated the cost of compliance and increased the consequences of noncompliance. An uncoordinated and defensive approach to compliance will not work anymore. Instead, financial institutions need to adopt a unified, proactive approach to compliance, rolling out processes to monitor and document risks and implement training and controls throughout the organization.

Half of the executives responding to our survey cited regulation as one of the top influences on profits over the next three to five years. Within regulation, 77% cited the implementation cost of compliance as having the greatest impact on profits. More than half (57%) saw the risk of noncompliance as a top influencer of profits.

A disciplined approach

A principle-driven, enterprise-wide approach to policies, standards and systems can simplify compliance and transform it from a burden to a byproduct of sound business practices. Organizations with the right processes can turn compliance into a real professional advantage, while those that continue to layer on new rules will tie themselves in high-cost knots.

Regulators may eventually move to reward financial institutions that adopt a good-practices approach to compliance, much as Basel II will give favorable capital treatment to banks that have a sound risk profile and have implemented sophisticated risk assessment systems based on high-quality data. Such a move would potentially give an advantage to financial services providers that have already done the work.

"At the end of the day, no matter how good your processes are, if you don't have strong company values that are in the bloodstream of the organization, you will find it difficult to ensure consistent, continuous compliance with the spirit of the rules, of the law of the land and the regulations of our host countries," says HSBC's Green. "So we pay a lot of attention to, and place a lot of emphasis on, ensuring that our values are articulated clearly and shared through the system and constantly reinforced by management at all levels." Strong values and people cannot, of course, substitute for rigorous documentation and processes across the enterprise.

Our research and collective experiences indicate there are six key practices in implementing regulatory compliance:

- The board and top management set the tone.
- Responsibility and accountability are woven into the business.
- The compliance function collaborates with the business.
- Roles are clearly defined in the compliance function to eliminate overlap.
- A uniform methodology for documenting risks and controls is adopted and rigorous testing is implemented.
- The right local people are hired.

Tone at the top

Boards of directors and the top management of financial firms must set the tone for compliance and control throughout the organization. They need to define a consistent set of practices across the enterprise and make sure everyone knows what they are. Principles must be clearly articulated, incorporated into training and reinforced by management.

"When we started with Sarbanes [-Oxley] and a lot of these internal controls, we had a very open mind towards being as broad and deep as possible," says Chubb's Motamed. "We established a group to do it. It was their full-time job to make sure it happened."

Too often management pays lip service to the ideal of good-practice compliance, then chafes at the implementation cost and looks for ways to pass that cost onto the customer or slash the cost if revenues fail to keep pace. Adopting good practices will indeed raise costs at first. But longer-term benefits include avoiding the punitive costs of noncompliance, the escalating costs of a piecemeal approach and the lack of coordination between top-down and bottom-up compliance initiatives.

A principled tone at the top, together with rigorous controls, can go a long way toward convincing regulators that an organization is serious about compliance. In the current zero-tolerance environment, that is a significant advantage. If the regulators think everybody up and down the organization is trying to comply, they are more likely to give it the benefit of the doubt.

Imbedding compliance into the culture

While firms need well-trained compliance professionals more than ever, compliance must be built into oversight, systems and processes. Compliance cannot simply be turned over to the functional group; rather, it must be woven into the business and the process. Responsibility and accountability need to be enforced at all levels.

Businesses have to assess their own compliance risks, then design, engineer and document the processes to address them. "The same process that ensures compliance with a Reg D calculation may also ensure that we close a mortgage properly and we don't have an unrecorded document," says James L. Gertie, chief risk officer (CRO) at Commerce Bank. "I have a compliance team that consults, assists, monitors, but they don't manage compliance. The business runs it. That's part of the process of doing business every day. You don't comply after the fact. You build compliance into your process."

Compliance should be viewed as a business partner within this culture. Compliance officers add value by combining knowledge of the regulatory environment with a detailed understanding of the businesses with which they work. The job is not to be a police officer; it is to counsel businesses on compliance solutions that will enable business goals to be met.

Compliance departments should also 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 just before a launch can result in additional direct costs and even longer delays in the product's rollout.

Teaming to add value is not necessarily easy. Fidelity's Taiwan compliance unit, for example, was hampered by local requirements that effectively turned it into an expanded audit function. "What we're looking for is compliance as a business partner, which is able to say, 'You can't do that, but you can do something like this,'" says Fidelity's O'Brien. "Making judgment calls rather than sending out checklists, actually trying to add value to the business by preventing something from going wrong, by ensuring that our monitoring program is in place to control the risks that we've identified."

The right people, the right roles

Most institutions have increased the stature and visibility of their compliance functions. 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 compliance departments. Recent new hires in this space include Paul Roye, former director of the US Securities and Exchange Commission's (SEC) Division of Investment Management, who was hired by Capital Research and Management and Cynthia Fornelli, former deputy director of the SEC's Division of Investment Management, who is now a senior vice president and compliance executive for securities regulation and conflicts at Bank of America.

Within the category of regulation, what will have the most impact on profits in your sector over the next three years?

Source: Economist Intelligence Unit. Up to two responses allowed.

With so many implementation challenges looming in the years ahead, compliance areas will continue to grow. As firms increase their presence in new markets, they will need to hire trained and experienced staff to fill this key function. Unfortunately, in certain regions, such as parts of Asia, firms are having a hard time finding qualified staff. "In some jurisdictions it is extremely difficult to get people who we regard as competent. Being Fidelity, we can usually attract the best people, but in some locations it's extraordinarily difficult to find anybody," laments Fidellity's O'Brien.

In China, for example, Western firms are engaged in a price war for experienced compliance officers. There is an abundance of well-educated recent graduates. But experienced people are scarce, largely because the market is so new. Time will ameliorate the situation, but firms will struggle for several years to come.

Clearly identifying roles is equally as important as finding the right people. When roles are well defined and understood, there is less duplication of effort and more accountability, and costs tend to be lower.

Address risk through an enterprise risk management framework

The larger and more complex the organization, the greater the range of risks it faces. Every global organization should have an enterprise-wide risk management framework that encourages a consistent approach to managing risks strategically throughout the organization. More firms are raising the profile of the chief risk officer and turning to ERM as an approach that can address the complexity of the task.

Forty-six percent of survey respondents see risk as a top driver of profits over the next three to five years. Within the category of risk, market volatility is rated most likely to affect profits (52%). Most executives interviewed, however, viewed market risk as one that financial services firms were able to manage effectively through quantitative financial strategies and one where they could add the most value. Operational and reputational risk ranked as top concerns. Almost half of our survey respondents (49%) say that operational risk will be one of the most important over the next three years, and 44% believe reputational risk will have a major impact.

Operational risk challenges

The financial services industry has normally faced a high level of operational risk. A highly publicized operational failure – a trading scandal, for instance, or the theft of customer financial data – occurs at least once a year. The $335 million trade glitch in December 2005 by Japan's Mizuho Securities and the Tokyo Stock Exchange has underscored vulnerability to operational failures. In that case, the extent of the loss was compounded by errors on both sides.

The more complex an organization's technology and products, the more difficult it is to quantify and manage the risk. "The controls are not as well developed in operational risk," says Commerce's Gertie. "As we've gotten better at controlling credit and liquidity, we've squeezed those risks out of banks. In risk management, a lot of what we're doing is copying the development of controls we put in place for credit as we go into other areas."

In banking, Basel II provides a framework to address operational risk issues, improving the ability of banks to develop key risk indicators and quantify the risk of operational "loss events." Solvency II will do the same for insurance companies operating in Europe.

To comply with regulatory requirements related to anti-terrorist initiatives, money laundering, data privacy and fraud prevention, financial institutions today collect an unprecedented amount of data on their customers. Firms also collect and aggregate data as part of their initiatives to understand customers better and cross-sell products. These practices, as illustrated by recent losses of customer data by banks and credit card companies, make organizations especially vulnerable.

Customers view protection of their data as critical to their relationship with financial institutions. According to Deloitte & Touche USA's *Loyalty Quest* study, 86% of consumers identified keeping account information secure and protected as the most important factor in doing business with their main bank, well ahead of factors such as fees/rates, location and transaction accuracy.

Failure to manage the risk of information leakage will not only alienate customers; it could also invite tighter regulation. By year-end 2006, the Federal Financial Institutions Examination Council (FFIEC) in the US will require banks to add to the user ID and password another layer of authentication for customers seeking Internet access to accounts. Global standards for authentication and identity theft management are starting to emerge but will take years to develop and implement. In the meantime, financial services providers must look for solutions across the organization, while adapting to local market requirements and practices.

Another area of concern, the aggregation of customer data has increased the risk of abuse by employees. The US Federal Bureau of Investigation (FBI) identifies disgruntled employees and remote access to providers' systems as serious threats largely overlooked by organizations.

Corruption of employees by outside data thieves and the inadvertent misuse of data by current employees are also concerns. A 2005 FBI study of 49 insider breaches found that 86% of the insiders were system administrators, IT professionals, programmers and other technical employees, as reported in *American Banker* ("FBI Report Underscores Insider Data-Theft Threat," November 29, 2005). "For the last 20 years, we've been focused on the enemy outside, hackers and the like," notes Commerce's Gertie. "The external firewall side has gotten much better. Now we're more and more focused on employee misuse of customer data."

Financial institutions will need effective tools and systems to monitor employee access to and use of customer accounts. While software is constantly improving, enabling firms to detect and track suspicious activity, firms must also safeguard their systems. The FBI urged financial institutions to prevent insider breaches by setting up grievance procedures for employees; documenting employee misconduct and setting up ways to share that information; and layering security for remote access and monitoring failed remote logins.

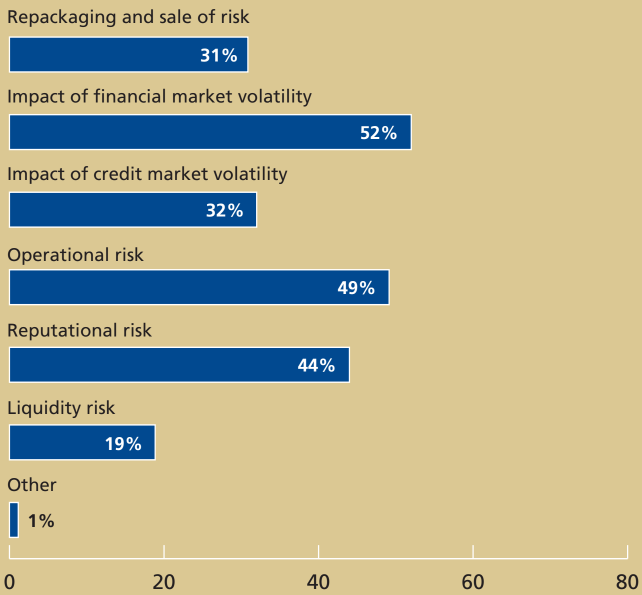
Reputational risk challenges

In interviews with senior executives, reputational risk was most often cited as the top concern in coming years. A credit default or botched trade can be expensive, but reputational problems can destroy a business. When a problem does arise, the ability of senior management to catch it early, deal with it decisively and learn from it can burnish a firm's reputation and enhance its value. 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.

"Managing our brand is operational; it's PR, and it's strategic," says Jonathan Russell, managing partner and global head of buyouts at London-based 3i. "Your brand is one of the most valuable assets you have. We make sure we have the checks and balances in place to make sure we don't do anything that could damage our brand. We spend a lot of time and effort trying to improve it."

A new global survey by the Economist Intelligence Unit, *Reputation: Risk of Risks,* found that 85% of top corporate executives feel their companies' reputations have come under greater threat over the past five years. Sixty-two percent of companies say reputational risk is harder to manage than other types of risk because it is difficult to categorize and measure and has no formal ownership in the organization.

Within the category of risk, what will have the most impact on profits in your sector over the next three years?



Source: Economist Intelligence Unit. Up to three responses allowed.

Edward M. Liddy, Allstate chairman and CEO, believes the insurance industry has to take a proactive approach to managing reputational risk, especially after Mississippi's move to sue insurance companies in the wake of Hurricane Katrina. "We can't be as passive as we have been in the past," he says. "And that will mean addressing some of the market risk aspects, so if they occur it doesn't look like the insurance industry is tucking its head between its legs and running out of town. We have a major public advocacy campaign on getting the country to take the necessary steps to prepare itself for natural disasters, for putting more resources to front-line responders, better education to consumers, and the creation of state-funded and federal-funded pools. The industry as a whole will need to do a lot more in this area."

Reputational risk is best addressed by having solid operational controls in place. Institutions generally should confirm that:

- The CEO and the board take the lead in managing reputation.
- The organization delivers on expectations and deals quickly and effectively with problems and complaints.
- An early-warning system is accessible – one that tracks information in the media and elsewhere as well as complaints and criticism from stakeholders.
- A crisis management plan is in place, ensuring fast and accurate communication and clearly defined responsibilities in a response team. The plan must be regularly updated and simulations and training should occur regularly.

An enterprise risk management framework

While operational and reputational risks are a critical area of focus for financial institutions, they must go further to assess and manage the spectrum of all risks across the organization and its interrelationships. More firms are turning to enterprise risk management, a holistic approach whose key components involve standardizing the risk management process, aggregating a view of all risks and relating risks to business objectives.

Assessing the Value of Enterprise Risk Management, a 2004 Deloitte white paper and survey, indicates that ERM can help an organization understand how the risks for which it is responsible are being managed on a day-to-day basis; aggregate risk information to create an enterprise-wide view of the firm's risk profile and its "in control" status; and proactively identify, assess and report on the control of significant financial and nonfinancial risks at any time within the context of the firm's business objectives.

We suggest using a framework to address risk governance, risk integration and business unit risk management. ERM offers a value proposition for financial institutions – one built around demonstrating its benefits beyond meeting minimum regulatory or rating agency expectations.

In a poll of risk management executives:

- 53% believed that the benefits of ERM already realized in their organizations were greater than the costs of implementation
- 33% did not believe that the benefits realized to date exceeded costs but believed they would eventually

In assessing the nature of the benefits achieved:

- 19% thought that tangible, or hard, benefits exceeded soft benefits
- 25% believed that intangible benefits exceeded tangible
- 38% thought they were about the same

Source: Deloitte Financial Services Risk Officers Forum, March 2004

A critical piece to building a successful ERM program is to hire a CRO to oversee risk within the organization. In some sectors, the CRO is a well-established position; in others, such as insurance, it is relatively new and the job description is evolving. To deal effectively with risk across the enterprise, organizations should confirm the CRO has the requisite authority, ideally working closely with the board of directors and the CFO.

By helping the board and top management gain a full picture of how all risks are handled, ERM can help organizations implement effective controls, improve strategic decision-making and risk-adjusted returns and minimize surprises. Rating agencies tend to reward effective risk management with higher ratings that will lower the cost of capital and may boost shareholder value.

Capture assets in the retirement market

Financial services firms are facing transformative demographic changes as much of the world's population ages, their target customers move from wealth accumulation to a lengthy retirement and responsibility for retirement security moves to the individual from government and employers. Financial institutions generally should adapt their product and service offerings to retain existing customers, as they move from asset accumulation to asset drawdown in retirement.

Asset accumulation

Individuals are taking more responsibility for their retirement as the world increasingly gravitates from a retirement system centered on defined benefit plans to one centered on defined contribution. According to the University of Pennsylvania's Pension Research Council, as recently as 1992, roughly 40% of US families had a participant enrolled in a defined benefit pension plan; just nine years later that figure had dropped to 20%. Families covered by defined contribution plans rose by 20% over the same period, from 38% to 58%.

The US is not alone. In Australia, assets in defined benefit plans fell by more than 50% from June 1995 to June 2004 while assets in defined contribution plans grew by more than 325% over the same time period, according to the Australian Prudential Regulation Authority's 2004 *Annual Superannuation Bulletin*. In Taiwan and Korea, recent legislation has created an opportunity and retirement assets are shifting into defined contribution plans. Providers are hopeful that Japan will soon pass legislation raising current contribution caps on defined contribution plans beyond the current $3,000 a year limit.

The UK has long had a significant defined contribution pension system, but on April 6, 2006, which has become known as A-day, a new simplified set of rules went into effect, shelving the eight previous tax frameworks for pensions. The changes, which among other things give savers greater freedom in how and when pension benefits are taken and result in extra retirement funding choices, including residential property and fine art, should help make defined contribution plans even more prevalent.

The shift to defined contribution plans presents an opportunity for financial service providers to capture assets, but only if they respond to market needs. Numerous studies show that individuals consistently underestimate the funds they will need for retirement. A 1994 survey by the Vanguard Center for Retirement Research found that "less than one-third of retirement investors are on track to maintain their current standard of living."

The Employee Benefit Research Institute's 2005 Retirement Confidence Survey found that while 39% of workers expect workplace and personal savings to provide the largest portion of their retirement income, only 13% of retirees actually achieve that goal. As for personal savings, in the US the rate exceeded 10% in the 1970s and 1980s, but has fallen to less than 1%, a near historic low level, according to a 2005 Merrill Lynch report, *Retirement Solutions for the 21st Century: Bridging America's Savings Gap*. Given these figures, it is not surprising that a 2005 survey of financial service advisors conducted by the Diversified Services Group (DSG) found that "a gap or needs analysis is the greatest perceived need for pre-retirees."

Success in the retirement market will hinge on more than simply offering a menu of investment alternatives; it will depend on providing useful advice on how to set retirement goals and helping clients achieve those goals. Charles Schwab is one firm that is investing in its advisory capabilities. "Our strategy has increasingly moved away from being a place to get good, cheap transactions," Dodds says. "We'll always be competitive in that area. Now we'll increasingly have people and systems that revolve around providing help, guidance and interactive tools for clients to think through some of their affairs."

Asset distribution

Once a worker retires, he moves from an asset accumulation phase during which he is saving for retirement to an asset distribution phase during which he needs to draw down his assets over an uncertain lifetime and in the face of uncertain expenses. As the population ages throughout the world, financial services firms face becoming irrelevant if they do not make the transition from aiding asset accumulation to providing a broader menu of services that aid retirees to secure a steady stream of income in retirement.

Though financial services firms are well aware of these upcoming demographic shifts, few have positioned themselves to take full advantage of the opportunities. They have yet to build an advisory capability or portfolio of lifecycle products that anticipates changing customer needs as they get closer to retirement and helps secure funds during retirement.

Of course, there are exceptions. With Japan's population starting to decline and Korea and Taiwan not far behind, Fidelity has launched lifecycle funds in Asia to serve the aging population and stem attrition as investors retire and move their money to annuities. Prudential's "Income Bridge Approach" is designed to help customers "bridge" income, providing income from their retirement date until they begin receiving Social Security payments, offering additional income with inflation protection. Charles Schwab's Retirement Income Fund helps those already retired by investing in a combination of funds, which provide monthly income and help investments grow.

A few others have also begun to focus on asset distribution, and the trend can be expected to accelerate. As Robert Reid, president of Wachovia's retirement and investment management group noted in the *American Banker* ("Advisers Seen as Holding Key to Retirement Assets," August 17,2005), "It's a very small group of players who are focused on that income planning/ decumulation side of the business…It's a relatively new trend and I don't think the market has jumped on it yet. Two years from now it will be more apparent."

Much of the focus has been on the mass affluent, those who have already acquired substantial retirement assets. However, most households have not accumulated this much wealth, and while there are challenges serving less affluent customers in a cost efficient manner, there are also substantial opportunities to develop products and services for households with less than $250,000 in retirement assets. For many such households, their house represents their largest single financial asset and reverse mortgages and other products that allow retirees to tap into the equity in their home provide a substantial opportunity to improve cash flow.

No matter how innovative a product, retirees will not buy it if it doesn't meet their needs. To bridge this gap, financial services providers must move from a product focus to a needs-based model based on an awareness of the needs of retirees as they draw down assets in retirement and how those needs change as retirees age and move through different stages of retirement. This also includes knowledge of medical and long-term care needs.

Retirees will also not buy products they do not understand, or if they have misperceptions about the market place. Without providing significant consumer education, financial services firms will have a difficult time making inroads with retirees. To take just one example, a 2005 study by the Pension Research Council, found that only 7% of US retirees hold annuities. Not only are annuities difficult products to understand, but numerous studies have shown that individuals tend to underestimate their longevity risk. That is, they are overly concerned about dying early and not collecting on the annuity for a long enough period of time. To ameliorate this problem, financial services firms need to educate consumers on the very real risks of outliving their savings.

Financial institutions also need to develop channels to reach retirees while they are in the distribution phase. The best time to do this is before retirement. Providers should form a bond with employees, who will have control of how to deploy their assets in retirement. Currently many providers view employers who provide defined contribution plans as their client. They need to preserve current market excellence by serving the institutional market well and strengthening the core business through service excellence and product enhancements. However, they also need to leverage the institutional relationship to gain access to the participant, build brand loyalty and create a retail relationship, so that in the long run, the employer becomes the channel to the participant rather than the client, allowing the provider to maintain the relationship beyond retirement.

Looking ahead

To sustain profitable growth and maintain a competitive advantage, financial services firms will need to embrace consolidation and seek opportunities in new markets, tailor cutting-edge technology and innovative practices to deliver a unique, focused customer experience, adapt an enterprise-wide approach to risk management, employ leading practices when addressing regulatory compliance and focus on meeting the needs of retirees.

How different will the financial services industry look in 2010?

It will be more global. The most successful players will hone their strategy and establish themselves profitably in key overseas markets. The European banking market will have seen increased consolidation and foreign firms will continue to build in China and other Asian markets. Greater scale in offshoring operations and development of full-service capabilities will bring further savings and more reliance on captives or captive/outsource hybrid models.

Technology will be the centerpiece of a customer-focused strategy. Personalization will become increasingly important as firms exploit technology to broaden and deepen the retail relationship, becoming more effective at offering and delivering useful products and services. Electronic trading for institutions will predominate, with platforms that provide trading scenario analysis, risk modeling and performance management reporting.

While the regulatory landscape will still be fragmented, the most successful firms will be able to manage compliance costs more efficiently. They will articulate, disseminate and enforce an ethical code throughout the business, starting at the top and encompassing all management. They will involve the compliance function in the business, clearly define roles in the compliance function to eliminate costly overlap, roll out a uniform methodology for documenting risks and testing controls and develop knowledgeable local talent.

ERM will be the standard framework for financial institutions in integrating a view of all risks and relating risks to business objectives. The CRO role will be closely aligned with senior management.

The baby boomer generation will have started to retire. For the majority, defined contribution plans, rather than defined benefit plans, will be the primary form of retirement savings. As this wave of retirees continues for the next 20 years, and as these retirees age, the need for advice and products to aid retirees drawing down assets in the face of uncertainty will grow more and more acute.

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