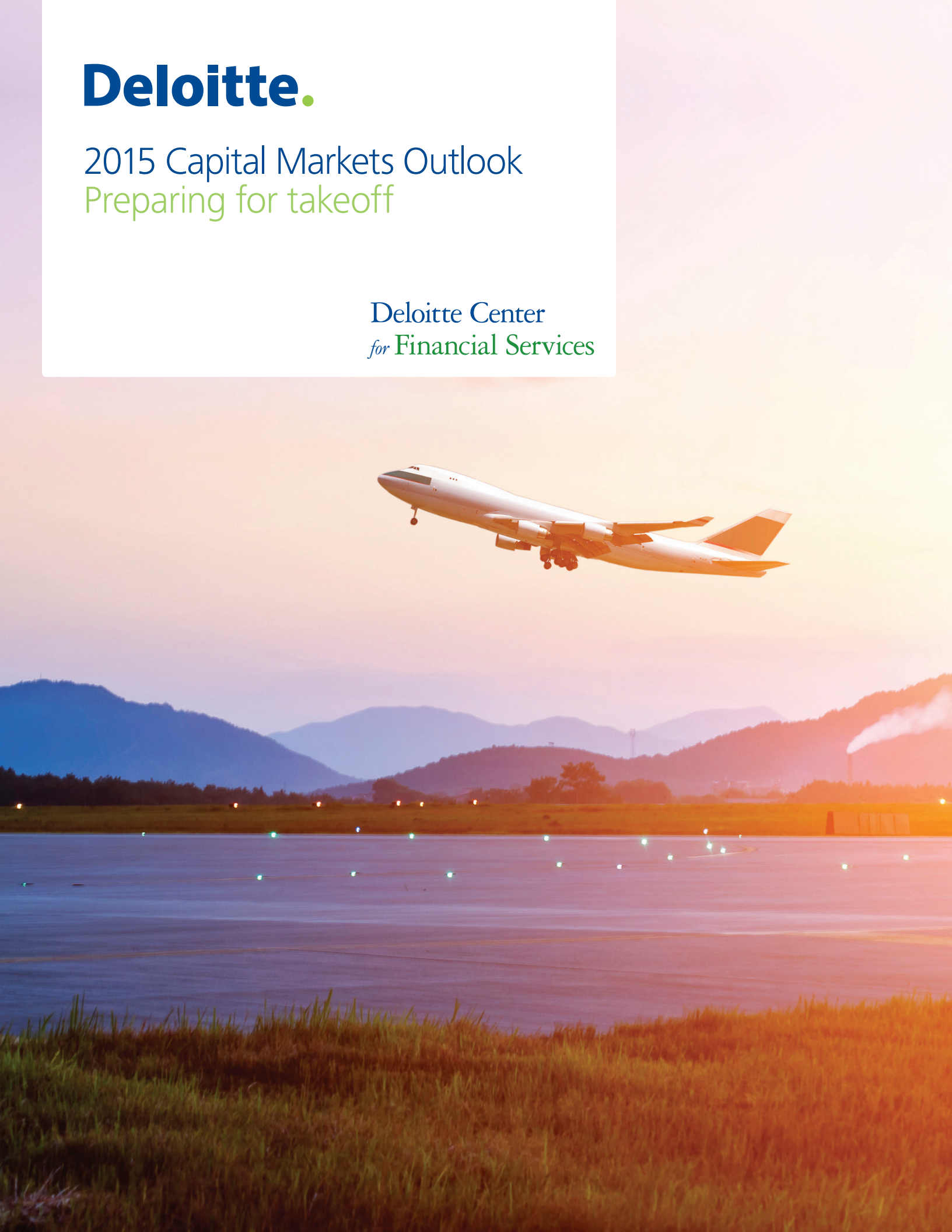




2015 Capital Markets Outlook

Preparing for takeoff

Deloitte Center
for Financial Services



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Foreword

Dear colleagues:

In many ways, the financial services industry is on more solid footing than it has been for quite some time. The U.S. economy continues to improve, although concerns remain in both Europe and some emerging markets. Investor sentiment is a bit cautious going into 2015, despite profitability being quite strong in many sectors.

But concerns — some new, some old — are keeping industry executives on their toes. Whether it's the evolving threat of cybercrime, rising cost of regulatory compliance, or pressure coming from nontraditional competitors, financial services leaders have challenges aplenty. Agility, innovation, and collaboration will be important to capitalize on new opportunities for growth in 2015.

Our views on industry trends and priorities for 2015 are based on the firsthand experience of many of Deloitte's leading practitioners, supplemented by research from the Deloitte Center for Financial Services.

Producing industry outlook reports has the result of exposing the authors to second-guessing; hindsight is 20/20. Nevertheless, we believe it is important to reflect on what we said a year ago, and put our prior prognostications to the test by analyzing what we got right — and perhaps not exactly right — in our 2014 outlook. You will find this "Looking back" analysis leading off this year's edition, followed by a "Looking forward" summary of our views on the coming year.

The bulk of the report will then explore a number of key issues of importance for the industry over the coming year, each including a specific look at the "Focus for 2015" and a "Bottom line" that provides some actionable takeaways for industry leaders to consider.

We hope you find this report insightful and informative as you consider your company's strategic decisions for 2015. Please share your feedback or questions with us. We welcome the opportunity to discuss the report directly with you and your team.

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Looking back

Another turbulent year

Our 2014 capital markets outlook — “Repositioning for growth: New models for a new era” — emphasized the need for fresh thinking in a world fraught with regulatory complexity and macroeconomic headwinds.

Looking at the past year, we believe most institutions inched toward steadier ground. They did so, some more successfully than others, in a gradually improving economy, even as monetary policy charted its course toward normalcy.

Renewed “taper tantrums,” feared by some investors with the winding down of the Federal Reserve’s asset purchase program, did not occur, and rate behavior was largely benign through the year. In the first half of 2014, equity indices scaled new heights, bond markets kept credit spreads at post-crisis lows (Figure 1), and volatility stayed well below its long-term average (Figure 2). That said, recent concerns over global growth and geopolitical turmoil in Europe and the Middle East have caused equity

market slides and a spike in volatility, adding a dose of caution to investor sentiment.

On the regulatory front, as expected, there was greater clarity. The finalization of new capital and liquidity measures, progress on the margining of uncleared swap transactions, and the adoption of new securitization rules all shed light on the future direction of capital markets firms. However, litigation pressure intensified, leading many firms to pay record fines to settle matters in a number of areas.

Capital markets firms have sometimes found the ups and downs in navigating this landscape akin to the child’s game of Chutes and Ladders (Figure 3). Strong equity markets and reduced uncertainty propped up M&A activity, marked by the return of large deals. Equities trading revenues have also remained largely either stable or improved.

Figure 1: Credit spreads



Source: Bank of America Merrill Lynch (via Federal Reserve Economic Data, St. Louis Fed.)

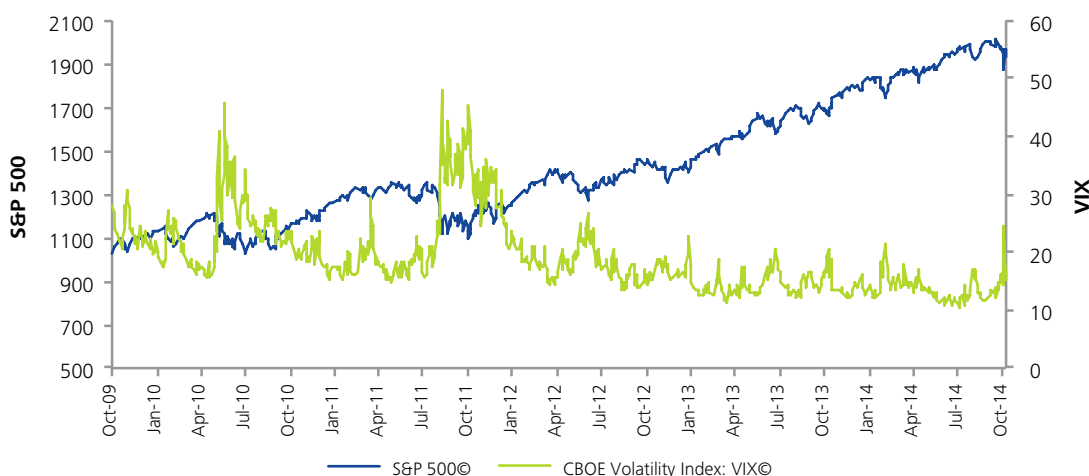
Yet this upbeat narrative was tempered by muted revenues from fixed income trading, a traditional bastion of investment bank earnings, as cyclically low volatility amplified already intense pressure from capital constraints — another trend we got right. Derivatives desks have also seen sluggish volume. However, the recent revival in volatility, if sustained, may boost future volumes.

Actions by capital markets firms in 2014 suggest that they sought to make structural adjustments while coping with, or exploiting, cyclical shifts. As Deloitte suggested, investment banks continued to specialize by trimming noncore businesses, and became more selective about

their product offerings, geographies, and, perhaps for the first time, their clients. Deleveraging and retrenchment, particularly by European banks, left a market composed of fewer, but stronger, players.

In a similar vein, exchanges pursued consolidation across the value chain with traditional revenue streams remaining under pressure. Their fight for derivatives clearing volumes is also gradually intensifying, even as nontraditional players took on roles as swap execution facilities (SEFs). Progress on implementing derivatives reforms continued through the year, and regulatory examinations of dealer operating models and data governance capabilities commenced.

Figure 2: S&P 500 and volatility



Source: Federal Reserve Economic Data, St. Louis Fed.

We noted that operational risk challenges posed by cyber-security vulnerabilities would merit special attention in 2014, and it's safe to say that assertion was an understatement.

The escalation of the issues above has made continued investment in risk management and compliance capabilities a must for most firms. Yet the integration of siloed risk management systems and resources, something we believed would gather steam, did not come to fruition.

Last of all, the importance of talent management, whether for investment banking, technology, risk management, or compliance, came to the forefront, with firms seeking innovative approaches to attract and retain the best minds.

In short, institutions that were able to find firmer footing by positioning themselves with new business and operating models have a significant head start in 2015.

Figure 3: Looking back at 2014

Strategy	● Investment banks continue to shed noncore businesses
	● Exchanges pursue continued diversification and strategic acquisitions
Revenues	● Fixed income, commodities, and currencies (FICC) trading revenues face structural pressure
	● M&A advisory business picks up
	● Derivatives players move toward implementation of reforms
Risk management and compliance	● Firms embrace larger role for risk managers
	● Firms harmonize data and practices across operating lines
	● Compliance reporting becomes better integrated with risk reporting tools
Technology and operations	● Firms seek to mitigate operational risk by revamping systems
	● Cyber threats gain prominence, forcing investment in infrastructure and operations
Balance sheet	● Chief financial officers (CFOs) take on a more strategic role
	● Increased attention to funding sources

Key

- Turned out as expected
- Partially turned out as expected
- Did not turn out as expected or unresolved

Source: Deloitte Center for Financial Services analysis

Looking forward

Preparing for takeoff

Capital markets firms are getting ready to move on after yet another year of intense change. Signs suggest acceleration may be near. According to Deloitte's baseline projections, the U.S. economy will step into higher gear next year and bring along with it the long-foreseen rise in interest rates (Figure 4).

A steady recovery similar to our baseline forecast will likely prove positive for near-term capital markets revenue. The resurgence in M&A — fueling investment banking results in 2014 — may continue on the back of strong economic indicators. Likewise, traders, exchanges, and other market intermediaries could benefit from renewed volatility accompanying monetary policy shifts.

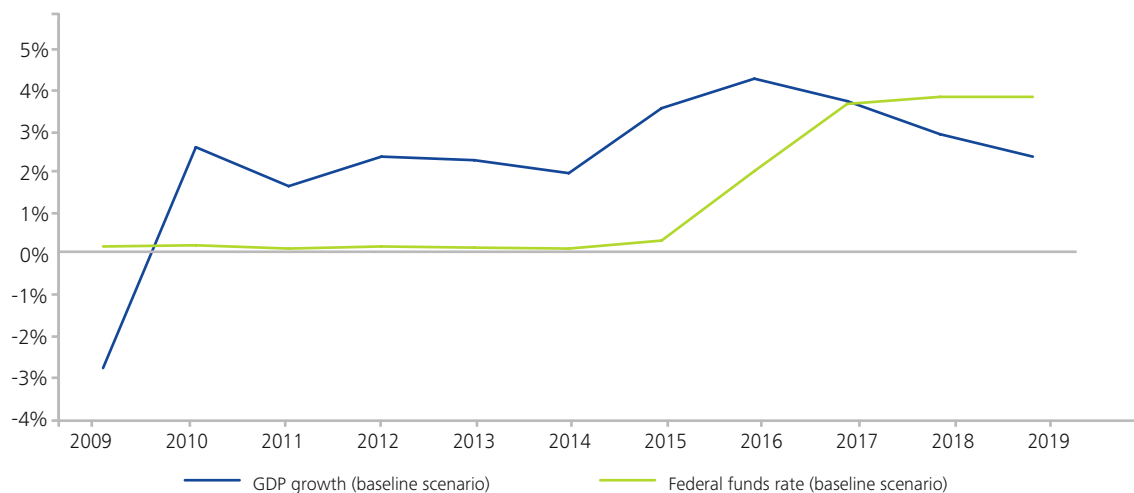
While the shorter-run prospects may be brighter due to a revival in volatility, in the longer term, the sustainability of FICC trading, a key driver of capital markets results, remains

in question for all but the largest firms, given higher capital requirements and lower margins.

Even as firms see modest revenue growth, they will have to keep close tabs on continuing regulatory efforts to increase transparency and encourage a level playing field. More transparency may lead to increased pricing pressure, making streamlining operations and efficiently integrating compliance requirements into revamped operating models a priority.

After years of trimming noncore business lines and geographic markets, firms' efforts to prepare themselves for growth will take a hard look at client profitability. Better data, improved segmentation, and realignment of sales incentives can help ensure current relationships are economically valuable — especially in capital-heavy business lines.

Figure 4: GDP growth and interest rate projections



Source: Deloitte U.S. Economic Forecast

This effort will highlight a broader trend among capital markets firms. Technology, always a powerful differentiator, continues to gain increased competitive relevance. With this potential in mind, institutions will continue to redesign their technology and data management architecture by fully embracing modernization and simplification of aging or siloed systems.

The same principles should be applied to risk management and compliance infrastructure. Modernization and integration could bring significant gains, both in terms of efficiency and preparedness for increasingly severe cyber risks.

But all these investments will prove ineffective without a strong culture of risk-minded, ethical behavior. Ongoing litigation in a number of areas reinforces this issue, with firms possibly facing additional settlement costs and reputational risk.

Driving all these priorities, of course, is the constant and careful attention to balance sheets required by rising funding costs, more restrictive capital regulation, and new liquidity measures. These hurdles can only be overcome by continued and rigorous assessment of the economic viability of each business line in the overall product portfolio. This evaluation will be a key step in capital markets firms' preparation for takeoff.

Figure 5: Six focus areas for 2015



Changing prospects for revenue streams



2014 marked a divergence from the capital markets revenue trends of the last few years. The traditional revenue driver at many investment banks, FICC trading, was undercut by declining volatility.¹ Fortunately, the surge in merger activity (Figure 6) helped offset the slowdown elsewhere. In the meantime, exchanges and other market intermediaries have had to reexamine business models facing increasing challenges.

In the background, of course, are the broader regulatory forces and strategic trends. Firms focused on their core strengths by targeting specific customers, business lines, and geographies, but this concentration leaves them vulnerable to market cycles.² And the capital and profitability pressures that forced these tough choices in the first place haven't lost any of their strength.

Focus for 2015

The continued recovery of the economy and long-awaited interest-rate hikes will clearly drive change. The difficulty is knowing what kind of change.

Trying to predict the path of M&A and initial public offering (IPO) activity illustrates the problem. The 2014 surge probably reflected pent-up demand after years of

repressed dealmaking, so participants might expect activity to tail off in 2015 — especially once rates rise, increasing debt costs and potentially dampening valuations. But, on the other hand, the level of growth that would permit rising rates should be enough to keep M&A revenues robust, if not quite at the levels seen in 2014.

To keep this M&A engine humming, firms will continue to revamp their talent strategy. Measures introduced to improve working conditions of junior employees have helped image and retention concerns, but competition with technology and other sectors will continue to impact talent management strategies.

FICC trading, a core revenue driver, has even more uncertain prospects. The recent increase in volatility may provide a temporary boost, but broader questions on the sustainability of firms' reliance on fixed income trading remain valid because of the changes to its regulatory underpinnings. As rates rise, the cost of funding inventory will also increase, putting pressure on trading yields. New regulations, especially capital and liquidity rules, mean the business will likely continue to move toward dominance by a smaller number of strong firms.

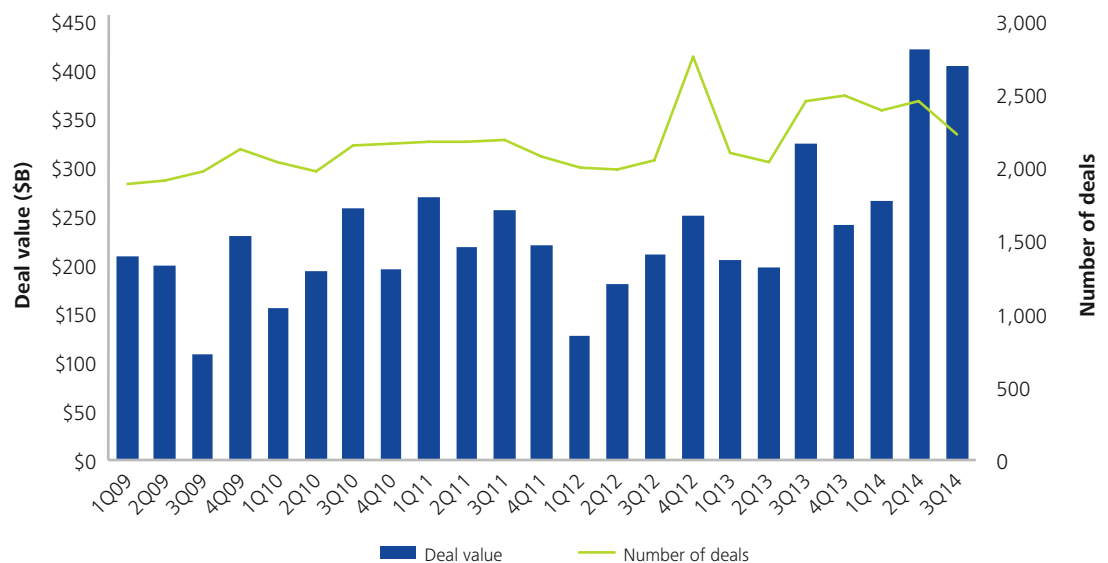
The upshot of this challenge will be continued transition to a model relying more on capital-light, expertise-driven businesses. Some, such as investment and wealth management, have the added attractiveness of being less cyclical than trading or traditional investment banking. But as many institutions compete for similar clients, stability may come with a profitability tradeoff.

Exchanges will pursue further broadening of revenue streams, as core transactional revenues, particularly in equities, continue to erode. The main immediate opportunities will likely be in vertical integration, especially in derivatives clearing. New margin rules may also provide new opportunities in collateral management. Leading firms will also start to explore further afield for new ways to leverage their roles as market intermediaries.

The bottom line

In a shifting environment dominated by tighter capital and liquidity constraints and the prospect of changing monetary policy, capital markets firms must be nimble. Versatile operating models that allow firms to quickly scale in growth areas will play an important role. But expertise-driven opportunities mean that having the right talent will be crucial to revenue generation. Both broker-dealers and market intermediaries must go outside their comfort zones to find new growth by looking to ease clients' pain points: collateral management, data services, regulatory reporting, and other similar solutions may be fertile ground in this regard.

Figure 6: Announced M&A (U.S.)



Source: Thomson Reuters

A new playbook for balance sheet efficiency



Through 2014, capital markets firms have continued to grapple with several shifts: reduced risk appetite, heightened regulation, and a constant push for transparency. Most have coped by striving to align their balance sheets with areas of core competitiveness.

This structural adjustment is likely to continue in 2015, amid a number of important considerations, including ongoing focus on Comprehensive Capital Analysis and Review (CCAR) stress testing and living wills, a likely rise in interest rates, and the introduction of new capital and liquidity measures.

Specifically, the obvious outcomes of steeper rates are losses on fixed income assets and costlier short-term funding. Additional constraints imposed by recently finalized capital and liquidity measures could make this upward swing of the rate cycle trickier to navigate.

In this context, positioning the balance sheet to derive maximum efficiency has to remain a fundamental strategic objective for capital markets firms.

Focus for 2015

A relentless search for profitability may take center stage in 2015, as the largest banks³ with capital markets franchises seek to comfortably meet the enhanced supplementary leverage ratio (SLR) requirement. An unweighted solvency measure designed to limit model risk,⁴ the SLR could drive CFOs to reexamine each asset closely, to determine whether returns warrant the required capital commitment. Assets related to prime-brokerage operations and securities financing may face especially close scrutiny.

The amplified premium on capital efficiency will also motivate firms to reassess capital-consuming business lines such as fixed income trading — already weakened due to the Volcker Rule. Coupled with a desire to limit cyclicity in earnings, this reassessment may drive a further shift toward asset-light businesses with relatively stable revenues such as asset management.

Funding quality was not a competitive differentiator in a period of low rates. However, this will likely change as short-term rates rise. The industry has made progress in this area as demonstrated by the increased maturity of tri-party repo transactions collateralized by risk assets (Figure 7).⁵ Even so, firms with greater reliance on short-term, wholesale sources are likely to feel a sharper pinch, especially considering the newly mandated margin requirements in derivatives trading.

The liquidity coverage ratio (LCR), applicable starting in 2015 to the largest banks,⁶ incentivizes firms to tilt their liability structures toward more stable and long-term sources. Accompanied by the possible imposition of higher capital surcharges for more volatile funding,⁷ the LCR may spur firms to further pursue businesses such as wealth management, which can deliver a relatively sticky base of core liabilities. The rules also make it imperative for firms with banking franchises to accurately price existing core deposits, especially since they now fund a material share of low-yielding liquid reserves.

The breadth of the challenges that firms face — and the scale of actions necessary to address them — once again underscores our view of CFOs as strategic drivers and catalysts for change within institutions.

The bottom line

Capital markets firms should prioritize the overall positioning of the firm franchise, leaning toward areas where they can retain a competitive advantage even in an altered regulatory and monetary environment, as they weigh tough balance sheet choices. Institutions would be well served by meshing asset profitability assessments with internal CCAR exercises. Doing so may enable greater clarity and consistency in communications with both regulators and shareholders. In addition, constructing playbooks that define optimal balance sheet structures for a given set of market conditions can help boost preparedness by improving response time in an evolving scenario.

Figure 7: Weighted average maturity for tri-party repo trades collateralized by risk assets



Source: Federal Reserve Bank of New York

Adjusting to increased market structure scrutiny



Regulatory action in the past few years has touched almost every capital market activity — ranging from over-the-counter (OTC) derivatives and equity market structure to securitization. Some of these measures have had pointed objectives, including ensuring a fair marketplace and curbing systemic risk.

However, almost all regulation has sought to address one demand: greater transparency. Higher compliance costs from these rules have forced firms to rethink the best way to thrive in the new environment.

Focus for 2015

In 2015, market structure scrutiny will intensify. First, firms' efforts to comply with the technology, control, and security requirements of the U.S. Securities and Exchange Commission's (SEC's) proposed Regulation Systems Compliance and Integrity (Reg SCI) will gain pace through investment in the necessary reporting infrastructure.

Second, high-frequency trader registration, improved disclosure of dark pool activity, and examinations of exchange pricing models will all be under consideration.⁸ Last, pilot programs proposed to spur liquidity in the trading of small stocks by altering tick-sizes will be conducted.⁹ Together, these actions could drive fundamental shifts in firms' trading algorithms and technology control environments.

In addition, surveillance platforms are drawing increasing attention — with particular focus on the quality of platform design and consistency of performance. Moving from report-based to exception-based surveillance reporting is another critical gap for firms to traverse. Going beyond mandated capabilities by investing in analytics and visualization tools to gain insight into participant activities and risk profiles can facilitate third-party risk discussions with regulators.

The focus on operationalizing derivatives reforms over the past few years will extend into 2015, as firms continue the dialogue with regulators and begin to address findings from supervisory examinations.¹⁰ Further compliance with Dodd-Frank Title VII requirements will impose additional operating costs. The most established players may therefore seek efficiencies by leveraging both regulatory compliance and operational competence to become the industry gold standard.

Recently proposed rules imposing margins on uncleared swap transactions are likely to lead to greater use of more standardized centrally cleared derivatives. Consequently, competition among clearinghouses to gain the first mover advantage by delivering new services to fill this need is likely to pick up.

Firms must also brace for nontraditional competitors seeking to exploit their core competencies. For instance, consider moves by asset managers or data providers to create swap execution facilities. Even as existing players face off against such new entrants, insufficient volume may drive consolidation of some swap execution facilities.¹¹

Finally, securitization, a critical piece of the post-crisis reform puzzle, has witnessed some progress. Regulation AB II, recently finalized by the SEC, requires disclosure of loan level information, as well as certifications on the accuracy of disclosures during issuance.¹² 2015 could also see the implementation of the key risk retention rules that intend to align incentives through the securitization chain.

Regulatory constraints are raising the total cost of serving clients and necessitating significant investments in compliance capabilities across the value chain.

The bottom line

In 2015, capital markets firms will be finalizing a number of strategies and programs to respond to new regulations. In equity markets, although precise specifications of Consolidated Audit Trail (CAT) systems have yet to be confirmed, firms should begin to identify gaps in existing infrastructure, consolidate reporting systems, and assess existing customer data. Swap dealers, on the other hand, will need to quickly adjust their business and operating models in the still-evolving industry structure to drive returns on their investments. Meanwhile, securitization players can only hope recent regulations will lead to a resurgence in the private-label mortgage-backed securities market.

Consolidated Audit Trail

The implementation of SEC Rule 613, the CAT, is likely to see greater clarity once the National Market System plan is finalized late in 2014.¹³ The rule significantly heightens reporting obligations and will merit large investments in data management resources by both broker-dealers and exchanges. In their approach to CAT, institutions must be careful not to view this as just another onerous compliance process. Viewed objectively, the enormous volume of trade life cycle data generated will allow new insight into client and market behavior like never before — and could potentially become a powerful competitive tool.

Integrating risk management and fostering risk culture



Risk management and the broader concerns of risk culture and business ethics have generated innumerable initiatives, campaigns, and reorganizations. But still-common oversights, operational disruptions, and regulatory penalties create a clear need for continuing reform.

Regulatory mandates add to this pressure. Enhanced prudential standards, effective January 1, 2015, and heightened standards from the Office of the Comptroller of the Currency (OCC), require adjustments to banks' risk governance and practices. Meanwhile, rules like the Basel risk data standards for global systemically important banks (G-SIBs)¹⁴ and the SEC's Reg SCI, which focuses on operational risk, will require substantial technology investments for capital markets participants.¹⁵

Risk management needs to go beyond compliance with regulatory requirements, however. Top regulators have signaled that qualitative issues like risk culture are increasingly important to their assessments.¹⁶ Judgment lapses in areas like trading and product design strongly suggest that renewed focus on culture is warranted. Firms should bring risk management responsibility out of its dedicated function and make it a firm-wide priority.

Focus for 2015

Efforts to improve risk management in 2015 will likely fall under two broad headings: rationalizing risk management practices and fostering an ethical, risk-minded culture.

The first, integrating and improving risk management systems, will likely dominate budgets. Effective management depends on holistic understanding of risk exposures across business lines, but many firms haven't sufficiently integrated the array of data and technology solutions they've developed to meet narrow reporting needs. This process will need to begin soon.

Firms will also seek an automated, aggregated, and real-time view of risk exposures at the time of execution and through the trade cycle. This goal will require a fresh approach to the vexing problem of data aggregation, where separate functions such as finance, risk, and regulatory reporting all draw upon the same common, core data set, instead of maintaining separate data marts. However, for these data to come alive, there needs to be a commensurate investment in analytics as well.

Redesigned systems may also help address firms' operational vulnerabilities. Institutions will seek more automated risk analytics and aggregation capabilities to reduce potential issues in their risk analysis and estimation processes (such as the qualitative considerations applied to the CCAR processes). Improvements made to CCAR can also become strategic tools if combined with war-gaming techniques, turning a compliance obligation into a strategic asset.

Importantly, firms are also strengthening their capabilities to reduce vulnerability to cyber risk. The scale of the cybersecurity challenge, demonstrated by recent attacks on leading financial firms, merits forward-looking assessments of potential losses. Scenario testing may aid design of risk management systems to help manage this vulnerability.

However, none of these efforts can succeed without sustained cultivation of business ethics and risk culture. Calls to set the right "tone at the top" became cliché years ago, but many executives and boards have yet to prove they can communicate a coherent risk management philosophy to their firms.

Culture also plays an important role in instilling responsibility throughout the organization. By bringing ethics and risk concerns into everyday business choices, firms may be able to head off costly poor decisions before they create problems.

The bottom line

Capital markets firms' top priorities in risk management will be aggregation of risk across the trade life cycle, investment in analytics, and strengthening ethical, risk-minded culture. As they pursue these objectives, firms should invest with an eye toward increasingly important issues such as cyber risk and risk data. And, in fostering an ethical and risk-oriented environment, firms should put money behind words by integrating risk management and ethical goals into compensation.

Technology and operations

Time for an upgrade



Over the past few years, technology has radically transformed the way capital markets firms operate and interact with counterparties and clients — almost every step is more automated and data-driven.

However, some of these advances, such as high-frequency trading and the shift toward off-exchange trading,¹⁷ have given rise to transparency and fairness concerns. For instance, pretrade price transparency in the fixed-income space, especially for retail investors, is becoming a focal issue.¹⁸

Capital markets firms are also being cautioned about inadequate data management practices — a case in point being the recent Office of Financial Research (OFR) warning regarding lack of data clarity on depth and extent of exposures in securities lending and repo transactions.¹⁹

Additionally, regulatory reforms in the OTC derivatives market require further enhancements to technology infrastructure to ensure a seamless shift to electronic trading and effective trade repository reporting.²⁰ In short, the transformation to a simpler, more modern digital

technology architecture will be critical to adapting to the new underlying economic structure of capital markets products.

Focus for 2015

Capital markets firms will need to step up efforts to modernize their trading infrastructure across the trade life cycle. Empowering traders with better decision tools and critical analytics is one key area. Better information can facilitate quicker and more efficient workflow in back-office functions. This can go a long way toward automating settlement and clearing functions, enabling real-time processing, and reserving manual involvement to exception management. Modernization efforts will also free up resources for more value-added activities.

A good example of this concept is the pricing of noncleared trades, where accurate and quick calculation of appropriate margins and valuations will be a competitive advantage.²¹ These changes will undoubtedly also require modifications to the rule engines and workflows behind many trading processes.

Improving operational effectiveness through vertical disintegration

Over the past few years, piecemeal efforts to improve operational efficiency have not fully met expectations. Reducing friction and streamlining processes may be enough in some cases, but others demand a more comprehensive attempt to eliminate steps entirely by restructuring operating models.

Several essential tasks, especially in the back office, are neither prudent nor competitive differentiators. Given this problem, it's no surprise that many industry participants and observers are increasingly eager to explore "utilities" that can standardize and centralize routine processes.

This transition, often called industrialization or vertical disintegration, will gain pace in 2015. The aspects of operations that cut across asset classes with small variation, such as know-your-customer (KYC) and reference data needs, will likely be the first priority, but settlement instructions and corporate actions may also attract interest.

An important point is that new utilities need not be external. Large, globally diversified firms may see significant gains from centralizing and standardizing common internal processes after years of growth and scattershot restructuring. Market intermediaries and data providers will all likely seek to exploit niches by developing such enabling solutions for capital markets clients.

As firms reimagine their operating models, they should be looking not just to reduce friction but also to cut out processes that do not enhance competitiveness. Doing so will allow them to focus on their core strengths.

Increasingly, regulatory requirements such as CAT will provide capital markets firms with vast amounts of granular transaction-level data. These can be leveraged to manufacture “smart data” around positions, exposures, and liquidity at the point of execution. This change can substantially reduce ambiguity and the need for judgment in trading decisions.

Many of the levers of simplification — such as demand management, capacity reduction, and outsourcing to design simpler ways to operate — have been explored. However, as technology is increasingly used to help with the changing economic structure of underlying products and customer needs, further drive toward simplification will likely become an overarching strategic goal for 2015. Determining how more can be done with less, and which additional processes can be standardized to optimize resource utilization, will be key questions.

In the same vein, expect centralized regulatory data repositories to become more common and replace the fragmented structure that exists today. However, the trick for firms will be to figure out how to leverage data generated across functions and client units to drive value creation.

Of course, all these initiatives have two common components: enhanced user experiences and increased automation, both in the front office to deliver superior customer experience and in the back office, where there is an urgent need for more efficient processes all around.

The bottom line

Capital markets institutions should be redesigning their technology architecture by fully embracing the notions of modernization, simplification, and automation. Adopting new approaches to data governance and deploying data analytics techniques to drive business value will become more important across the trade life cycle. Equally important is greater focus on smooth integration of legacy systems to fully realize the benefits of new technology investments, a problem that capital markets firms have wrestled with for years. A new breed of technology leadership, more in tune with the business agenda, may be required to accelerate this transformation.

Client value optimization

A new approach



Client relationships have long been considered sacrosanct for capital markets firms. There is a natural bias to preserving the status quo, notwithstanding the fact many of these relationships are fairly tenuous because many capital markets businesses are highly price sensitive.

Driven by incentive models favoring revenue growth and new client acquisition over costs, providers have been willing to take on relationship costs (like onboarding, KYC, and complex booking models) without much consideration of overall client profitability.

Consequently, many firms generate the vast majority of their revenues from a small proportion of their clients, leaving them with a long tail of potentially unjustified client relationships. The inability to separate accounts that have genuine long-term potential from those that are a drag on costs only exacerbates this problem.

But all this is set to change. Regulatory and market forces compel firms to reassess their client relationships in the same way they have rationalized their business lines and geographic presence. While it is of course important to address clients' demands for greater value and transparency, it is equally critical that the relationship contributes meaningful value to the firm. The more sophisticated firms are beginning to pay greater attention to this issue.

Focus for 2015

Capital markets players will take a much harder look at the economic value being derived from clients, particularly for businesses requiring significant capital commitments, such as prime brokerage and securities lending.²²

In the past, resistance to change in this area stemmed from two main factors: first, a lack of sound data, particularly on the cost to serve clients; and second, the belief that front-office staff would not support any cost-cutting initiatives that could threaten client relationships.

Of the two, the data problem might prove the easier to solve, as regulatory reporting requirements already require granular client-level data. Data capture methods and data quality are improving to meet regulatory requirements associated with anti-money laundering (AML) and KYC as well as risk aggregation and reporting needs. Combining data with in-house transaction information, including cost to serve clients and predictive analytics, will help firms gain a more detailed understanding of client profitability.

Better data will also enable a more refined approach to client segmentation. A one-size-fits-all solution never made much economic sense, even in easier times. It makes less sense in an environment of constrained profitability. Devising appropriate service delivery models for different client segments is essential. Refined segmentation based on objective data can also become a valuable tool in providing a consistent client experience and executing optimal pricing strategies.

But changes to client profitability analysis and segmentation will only get so far without a concurrent shift in the incentive structures. Typically, salespeople and front-office staff are incentivized to bring in as many clients as possible, as the reward structure is based on total revenue generated. But a lack of discipline in this area also expands the cost base — causing firms to spend on things like AML, onboarding, and relationship maintenance. This misalignment can lead to friction between groups. A revamped firm-wide incentive structure based on overall client profitability and risk can minimize this problem as well. Bringing incentives for these two groups in line — enabled by greater understanding of the data — will be a key goal.

The bottom line

Client value optimization is increasingly becoming critical for capital markets firms, especially in businesses burdened with high compliance costs and capital pressures, such as securities lending and financing. Institutions that tackle this challenge aggressively will likely capture the most benefits. The timing for these actions is right; regulatory demands are propelling many firms to refine client data and analytics. A reexamination of client profitability must also be used to guide the level of customization offered in product solutions and service delivery models.

A new flight plan



As the capital markets industry heads into 2015, it finds itself at a critical juncture. After years of painful restructuring, firms are now getting ready to take off in new directions.



Deep structural changes wrought by regulations and the impending shifts in monetary policy continue to pose a fundamental question: how can capital markets firms optimize their business portfolio to create a sustainable and profitable model? Many institutions have yet to arrive at a conclusive answer.



One thing does appear to be clear — there is no single model that meets every firm's needs. Different firms will pursue different approaches, based on their core strengths and risk appetite. This is especially likely as there is increasing convergence in the industry, with many institutions going beyond their traditional roles to provide new sources of value to the marketplace.



But success in tomorrow's capital markets — whether in securities trading, M&A advisory, collateral management, or clearing — will require both strategic foresight and a higher level of operational excellence. This goes further than market expertise, extending to optimal resource deployment, including financial capital, technology, or some other asset.

Talent, in particular, may come to the fore. As capital markets become more complex and require more evidence-based decision-making, there will be a stronger need for people who can thrive in this highly demanding environment.

This report seeks to highlight key items on capital markets firms' agendas for 2015, but we know that making predictions is hard. However, one thing we can say with near certainty is that capital markets firms are united in their hope that 2015 is the year they take off toward a better future.

Endnotes

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