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2015 Banking Outlook
Boosting profitability amidst new challenges

Deloitte Center for Financial Services

Contents

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, the 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, 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
In pursuit of growth

Our 2014 banking outlook — "Repositioning for growth: Agility in a re-regulated world" — emphasized how the industry would switch gears from defensive compliance remediation to a proactive search for revenue growth and further cost reduction.

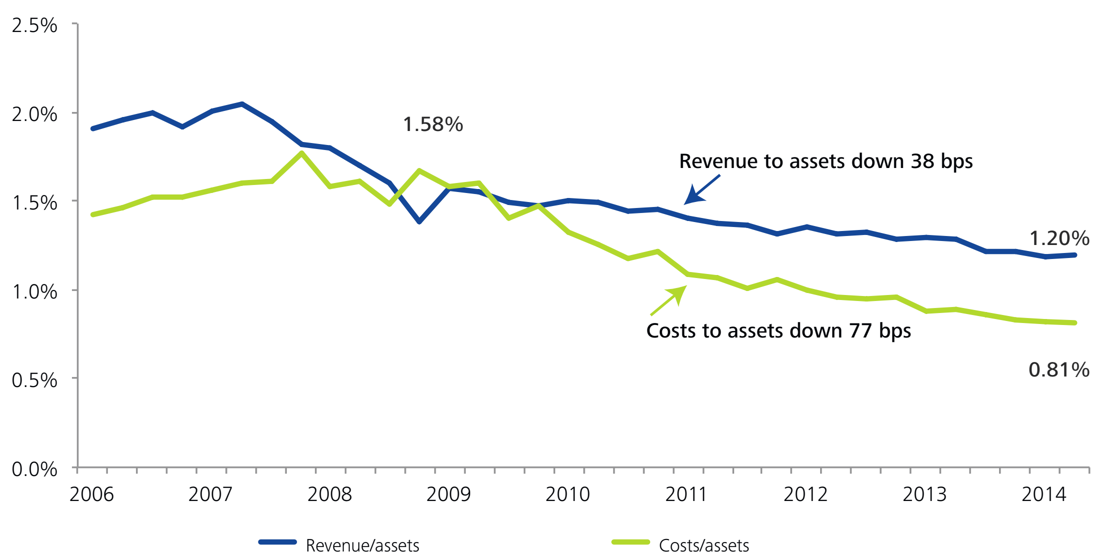
Looking back at 2014, most, if not all, banks pursued this repositioning. The industry sought to better acclimate to regulatory pressure by investing in compliance infrastructure and enhancing risk governance. As expected, some banks sought to settle outstanding mortgage-related lawsuits; however, the severity of the fines was greater than anticipated.

As topline revenue growth remained modest, banks focused on operational efficiencies as a way to drive financial performance. Banks continued to simplify operations, seek scale efficiencies, and rationalize their branch networks. For instance, the industry closed 1,614 branches over the 12 months ending in June 2014, the largest decline in more than two decades.[1] In spite of higher litigation expenses and technology investments in 2014, the banking industry made meaningful advances: costs as a percentage of assets have fallen 49 percent in the second quarter of 2014 from the first quarter of 2009 (Figure 1).

Meanwhile, banks' repositioning efforts resulted in the most active period of mergers and acquisitions (M&A) since 2008, with a total of 184 whole bank and branch deals in the first half of the year.[2] As we expected, large banks' efforts to specialize, regional banks' pursuit of asset generators, and community banks' consolidation were primary contributors to M&A.

Competition intensified in certain pockets, particularly in commercial and industrial (C&I) and commercial real estate lending, leading some banks to ease underwriting standards to remain competitive. Fee-based businesses such as wealth management were popular, sparking increased competition for these offerings.

Figure 1: Revenue and costs as a percent of assets
Banks focused on costs, as revenue declined



Revenue = Interest income, non-interest income, security gains
Cost = Interest expense, non-interest expenses, security losses, provisions

Source: Federal Deposit Insurance Corporation (FDIC) data for all insured institutions and Deloitte Center for Financial Services analysis

Banks, especially some larger institutions, expanded their use of analytics for deeper customer insights. Investments in mobile offerings continued to receive top priority, but upgrades to core systems were not as widespread a phenomenon as expected. Meanwhile, creating a fully differentiated customer experience remains an ongoing journey for most institutions.

As anticipated, banks began preparing for a higher interest rate environment in 2015, as the Federal Reserve signaled the end of quantitative easing. Banks increased held-to-maturity (HTM) portfolios to avoid unrealized losses hurting capital. Moreover, they continued to bolster capital levels and improve reporting infrastructures to drive better capital allocation decisions.

Improving cybersecurity was a major concern in the industry. Banks recruited more technology talent and made efforts to strengthen defense mechanisms against rising threats.

Early results of these strategic priorities were evident in industry performance. In the second quarter of 2014, loan balances grew at their fastest pace since 2007, while net income and asset quality improved from the previous year.[3]

Over the course of 2014, the banking industry made meaningful advances in repositioning for revenue growth amidst compliance and efficiency challenges. These initiatives should lead to better results as the economy improves in 2015.

Figure 2: Looking back at 2014

Regulations and compliance	Turned out as expected	Acclimating to regulatory pressure
	Partially turned out as expected	Improving risk governance and infrastructure
	Partially turned out as expected	Compliance pressure flowing to smaller institutions
	Did not turn out as expected or unresolved	Cost to resolve legal issues higher than expected
Competition	Turned out as expected	Specialization continues
	Turned out as expected	Consolidation increased
	Turned out as expected	Competition from nonbanks increased in business lending and payments
Customers and products	Turned out as expected	Reshuffling product mix
	Turned out as expected	More active investments in data and analytics
	Partially turned out as expected	Differentiating customer experience
Operational efficiencies	Turned out as expected	Cost efficiencies to drive profitability
	Did not turn out as expected or unresolved	Building agility into operations
Finance	Turned out as expected	Optimizing capital deployment
	Turned out as expected	Preparing for interest rate risk
	Partially turned out as expected	Improving financial reporting infrastructure
Technology	Turned out as expected	Escalation in cyber threats
	Partially turned out as expected	Increasing digitization of branch networks
	Partially turned out as expected	Core systems transformation continues

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
Boosting profitability

The U.S. banking industry is entering a new phase in its post-crisis journey, with a much sharper focus on boosting profitability. Although profits have surpassed historic records, return on equity (ROE) is still below pre-crisis levels (Figure 3) and has yet to reach double digits. This level of consistent growth is likely to be a multiyear process, but 2015 could be a turning point in achieving this goal, in spite of the new challenges banks will face.

As the U.S. economy gets stronger, with real GDP growth expected to increase from 1.9 percent in 2014 to 2.3 percent in 2015,[4] this will likely drive greater loan originations, particularly in C&I lending.

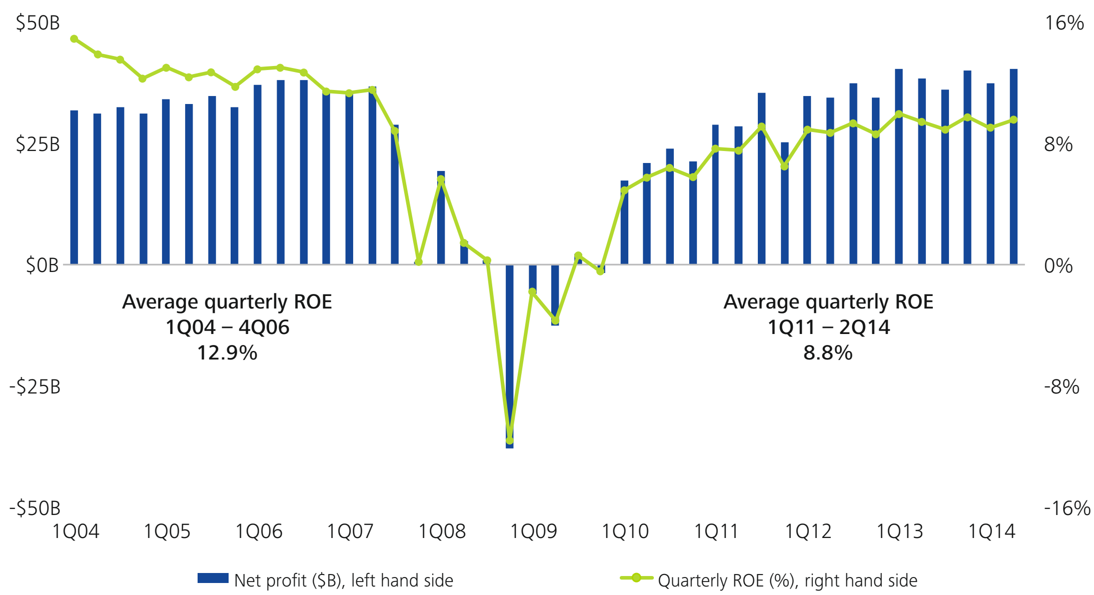
Extending retail mobile solutions to business customers may help banks differentiate their offerings. Competition from nontraditional players will increase as they seek growth of their own. Fee-based businesses, such as wealth management, will be used to support revenue growth.

However, lending growth alone won't boost profitability. Improved balance sheet management will be necessary, and yet become more complex in 2015. New liquidity requirements may force banks to hold additional low-yielding assets. To minimize margin pressure, banks will seek low-cost funding at a time when rising interest rates may draw deposits out of the bank or into higher interest accounts.

Further, new leverage standards may create additional capital burdens for some assets. These forces, together with increased lending competition, could put additional pressure on margins in 2015, despite rising interest rates.

Efforts to improve profitability will increase M&A activity in 2015. Both deal volume and deal size may increase as regional banks become more active. Large banks will continue to divest noncore businesses, while banks near the regulatory thresholds ($10 billion and $50 billion) could look for bigger deals to justify the higher compliance costs.

Figure 3: Earnings metrics
Profit returns, but profitability remains suppressed



Source: FDIC data for all insured institutions

Going into 2015, we are likely to see one of the most transformative periods for the payments industry. Improvements in the security and user experience could drive growth in contactless payments, marking the beginning of a shared ownership of the payments sector between banks and technology firms. This may lead to a reduction in revenue to banks, as they prepare for EMV (Europay, Mastercard, and Visa) migration.

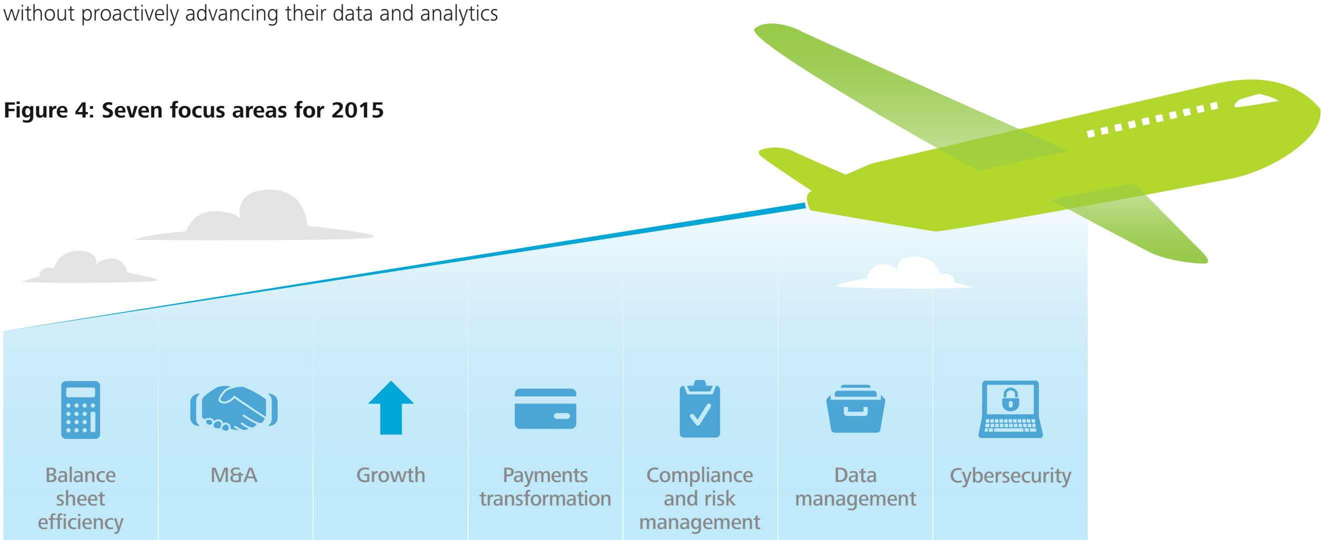
The pursuit of growth and profitability will have to be carried out against the backdrop of regulators' heightened expectations regarding risk management. Integrating risk and compliance into the ethical fabric of the organization will take on increased importance. Further, the Comprehensive Capital Analysis and Review (CCAR) process will require additional attention as the scope of this compliance exercise expands beyond capital adequacy.

Banks may not improve on any of the above initiatives without proactively advancing their data and analytics capabilities in 2015. There is a strong need for new approaches in this area. Institutions are attempting to integrate data across functions, such as finance, compliance and risk, and business lines, with better data governance. Chief data officers (CDOs) will play a crucial role in this transformation.

Lastly, bolstering cybersecurity will remain a top concern, with the more sophisticated institutions expanding their toolkits to include new ideas and skillsets from the defense and counter-intelligence communities. Given the considerable risks in this area, boards will take on a more proactive role in cybersecurity strategy.

All together, these trends will keep profitability front and center for 2015. Banks will leverage their new strategic positions and stronger economic growth, yet new pressures and increased competition may restrain profitability growth over the coming year.

Figure 4: Seven focus areas for 2015



Aiming for greater balance sheet efficiencies

Banks' balance sheets today are a far cry from what they looked like during the financial crisis. Capital levels are the strongest in recent history, risky assets have been minimized, and most banks are flush with deposits.

However, anemic economic growth and steep competition for quality borrowers have left banks challenged to deploy their funds. As a result, net interest margins (NIM) have narrowed and yield on earning assets has declined.

New regulatory requirements such as the liquidity coverage ratio (LCR) and the supplementary leverage ratio (SLR) were finalized in 2014 and will soon force banks to make changes to their balance sheets. The rising interest rate environment is another scenario banks have begun to address by managing deposit outflows and reclassifying some securities in their portfolio from available-for-sale (AFS) to held-to-maturity.[5]

Focus for 2015

Despite an improving economy, new liquidity and capital constraints will create major headwinds for profitability in 2015, making balance sheet optimization a top priority.

This is particularly so for the largest banks, which have to comply with the LCR rule in 2015. These institutions will have to hold enough liquid assets to weather 30 days of serious market stress. As a result, their balance sheets will be burdened with more low-yielding assets. This pressure and low loan originations have already resulted in a greater share of securities on banks' balance sheets, as shown in Figure 5.

To minimize the pressure on NIM, firms will look to control funding costs by replacing wholesale funds with retail deposits. Yet, as interest rates rise, we could see a reversal in recent trends with deposits flowing into higher interest accounts (Figure 6). This pattern may in turn lead to higher interest expenses.

These conflicting pressures in combination with the potential for lower asset yields may compress margins despite rising interest rates.[6]

To prepare for rising rates, banks will continue to reconfigure their securities portfolios by reclassifying some assets from AFS to HTM to avoid unrealized losses hitting capital. This effort to protect capital locks in yields on long-term securities which could reduce interest margins as rates rise.[8]

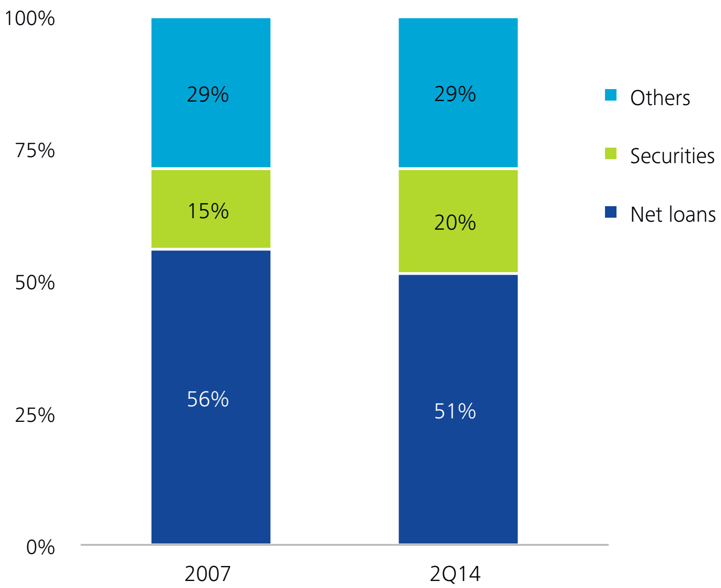
The SLR, an unweighted capital measure, adds additional complexity to balance sheet optimization by requiring firms to allocate capital to every asset. Higher SLR requirements for large banks will force those firms to reassess their capital deployment and asset allocation to meet profitability goals.

The optimal asset mix will be further influenced by multiple proposals under consideration, including the Net Stable Funding Ratio — a new longer-term funding standard — and additional capital surcharges for larger banks involved in capital markets businesses. The convergence of these many factors may spark fierce competition for liquid assets funded by retail deposits, and restrain NIM despite rising rates.

The bottom line

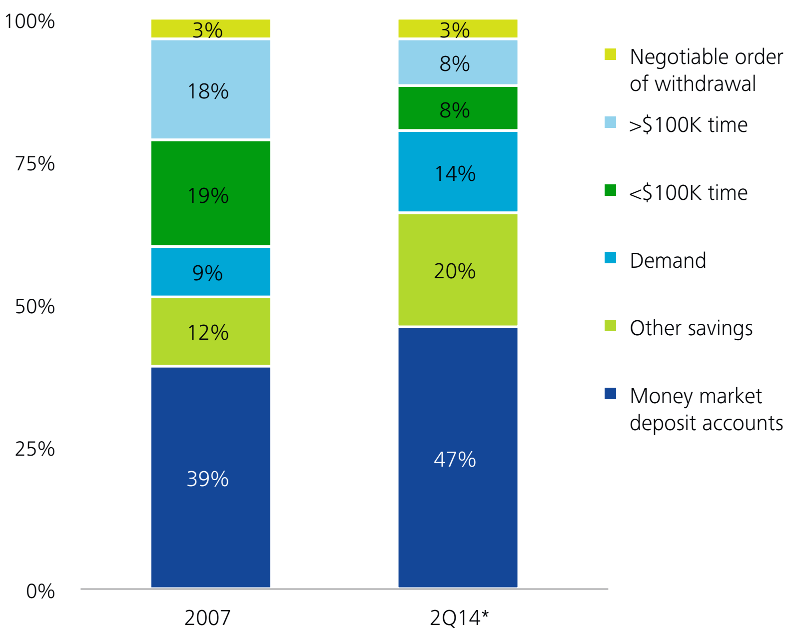
Achieving balance sheet efficiencies will be both critical and challenging amidst a deluge of regulatory and market forces. To retain deposits, banks should be ramping up their customer relationship programs, increasing cross-selling efforts, and investing in product lines that attract stable deposits. On the asset side, there will be a stronger need to assess the portfolio with a critical eye, as the impact of new rules plays out over 2015.

Figure 5: Changes in asset mix
A tepid loan demand has reduced the share of loan portfolio in asset mix



Source: SNL Financial

Figure 6: Changes in deposit mix
Deposit mix has tilted more toward flexible demand deposits amidst low interest rates



Source: SNL Financial

*Total does not add to 100 percent due to rounding

Regulatory pressures and growth prospects to drive M&A

Bank M&A accelerated in the first half of 2014 (1H14), with 133 bank and 51 branch deals, up 34 percent and 104 percent from the previous year, respectively.[9] The most active half-year period for bank M&A since the financial crisis was driven by bottom-up consolidation among community banks and branch divestitures by large institutions.

Buyers are becoming more confident about M&A, as shown by the proportion of deals between $100 to $500 million deal size that rose to 20 percent in 1H14, more than double the 9 percent in 1H13 (Figure 7).[10] Moreover, the increased interest by some regionals is an encouraging trend.[11]

Focus for 2015

The encouraging M&A activity seen in 2014 is likely to continue through 2015, driven by a number of factors: stronger balance sheets, the pursuit of stable deposit franchises, improving loan originations, revenue growth challenges, and limits to cost efficiencies.

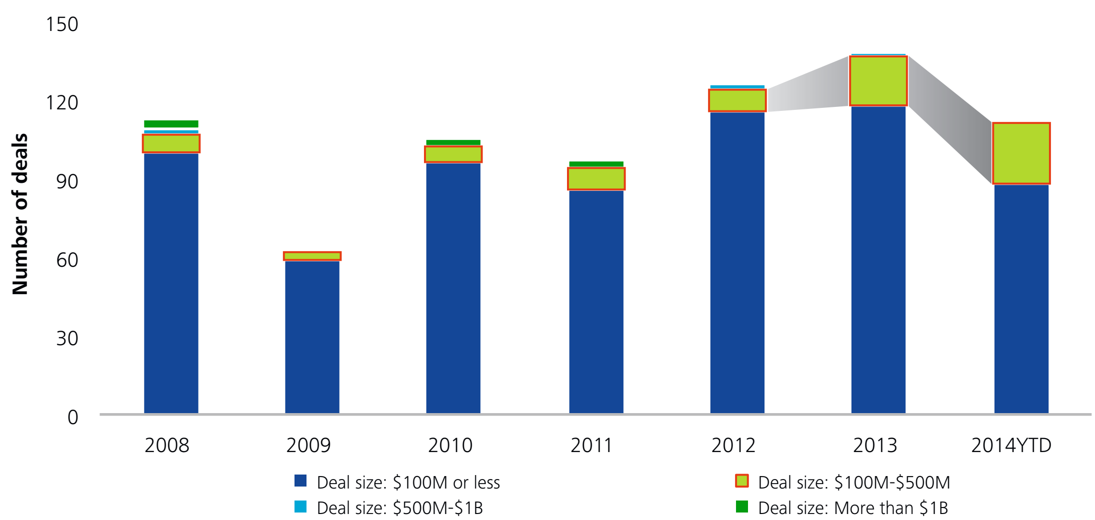
However, the extended regulatory approval process, scrutiny on issues such as anti-money laundering and the Bank Secrecy Act, and a cautious stance by well-capitalized buyers could present obstacles.

Pressure to improve living wills may drive further simplification at large banks.[12] Super regionals — banks between $100 and $500 billion in assets — may remain largely restrained from fear of regulatory scrutiny. However, some may seek acquisition opportunities in smaller strategic deals.[13] In contrast, small- and midsized regionals could show increased appetite for asset generators to buttress their core competencies or fill gaps in their portfolios.

Banks with assets nearing regulatory thresholds ($10 billion and $50 billion) may also consider bigger deals, like a merger of equals, to justify the rising operational and compliance costs. However, the lack of substantive potential targets may frustrate these efforts. In addition, LCR and higher interest rates put a premium on the sticky

Figure 7: Composition of whole bank deals

Deal size continues to trend up in whole bank M&A, especially in deals between $100-500 million



Source: SNL Financial and Deloitte Center for Financial Services analysis

*SNL database (last accessed on October 1, 2014); excludes private equity deals deposits that banks could gain with a string of smaller-to-midsized whole bank or branch deals (Figure 8).

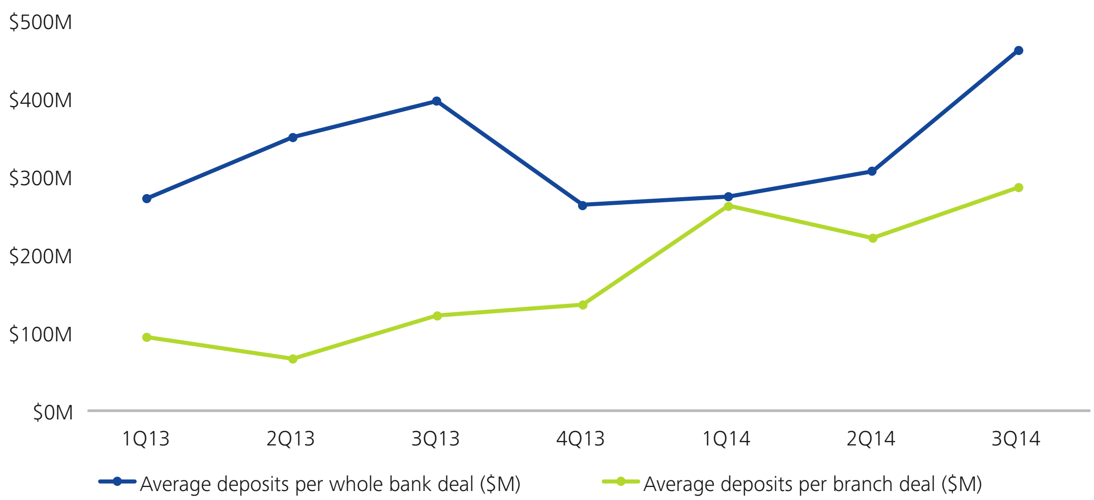
Smaller community banks, on the other hand, may continue to consolidate, driven by competitive pressures and increased compliance costs. Higher valuations will prove positive for small banks looking to sell.[14] For instance, whole bank deal buyers paid a premium of 38 percent over tangible common equity in 2Q14, up significantly from the 30 percent and 14 percent premiums in 2Q13 and 2Q12, respectively.[15]

The bottom line

The M&A market will continue to improve in 2015, although the strategic options will vary considerably by the size and balance sheet position of each bank. As banks move from a defensive to an offensive position to seek growth and scale, they should view M&A targets with a sharper focus on factors such as efficiencies, growth prospects, funding profile, technology, and compliance. Active engagement with regulators at the onset of M&A plans will be crucial. Finally, buyers on the $10 billion or $50 billion thresholds will need to ensure appropriate risk controls, systems, and processes are in place to withstand the stricter regulatory scrutiny such deals are likely to attract.[16]

Figure 8: Average deposits per bank deal*

More deposits targeted with every whole bank or branch deal



Source: SNL Financial and Deloitte Center for Financial Services analysis

*Excludes private equity deals

Seeking growth amidst increasing competition

Producing revenue and asset growth has been a major challenge for banks in recent years. Low loan demand, especially for mortgages, has depressed originations. Competition for fee-based businesses like wealth management has been fierce, and regulations have limited service fees.

Despite these pressures, some asset classes have shown signs of growth. C&I loan balances have increased nearly 40 percent from the first quarter of 2011, driving over half of the asset growth.[17] Multifamily real estate and auto loans have both increased 30 percent from 2011.[18] Yet, strong competition may have weakened underwriting standards.

Altogether these forces have put significant pressure on performance: NIM has fallen to 3.15 percent, the lowest level in 25 years and interest income has remained flat.[19] Moreover, the growth of noninterest income has slowed from the historic average of 10.1 percent to 2.0 percent over 2004 to 2Q 2014 (Figure 9).

Focus for 2015

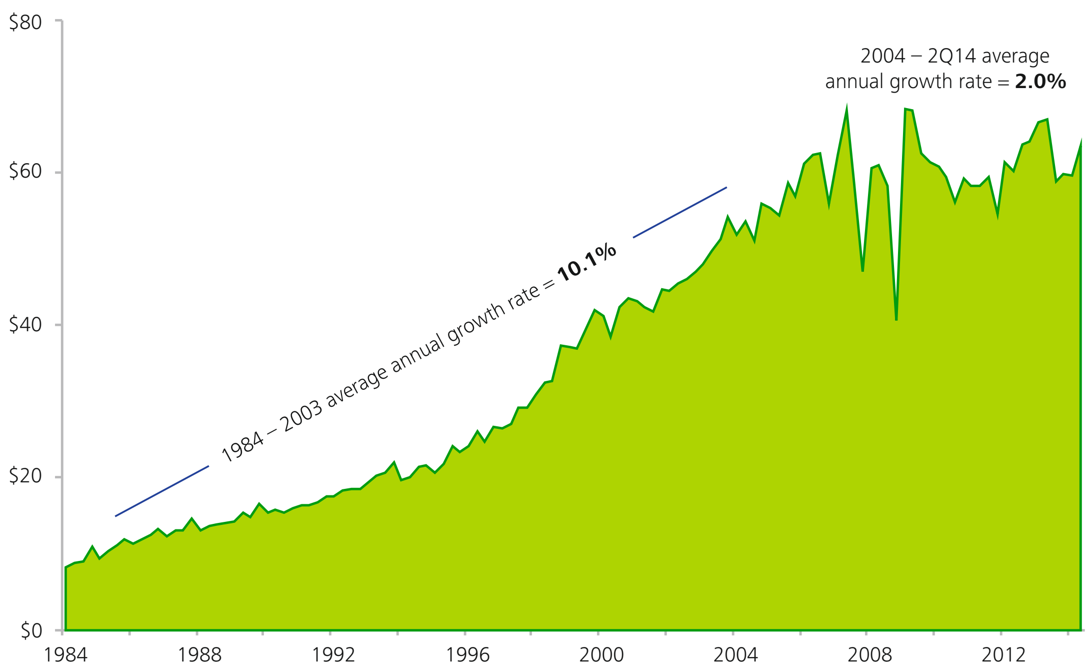
C&I lending is expected to remain a primary driver of growth as the economy improves. To be successful, banks should extend digital initiatives from consumers to business customers by adding mobile cash management tools and predictive analytics that anticipate and manage customers' short-term credit needs.

Mortgage lending is expected to remain depressed from the highs of the refinance boom, forcing banks to pursue growth through personal loans and credit to borrowers with imperfect payment histories.

Transaction banking businesses will develop a more disciplined approach to pricing and customer value while balancing rising compliance pressures for monitoring money laundering.

Nontraditional players may offer a new source of competition in 2015. Nonbank payment businesses are expanding into traditional products such as small business

Figure 9: Noninterest income ($M) growth slows



Source: FDIC data for all insured institutions loans and personal lines of credit. Startups are offering rapid loan fulfillment and alternative credit quality analysis that use social media and digital data.[20]

To date, most of these firms are focused on borrowers with little to no credit histories that may be too risky for banks. But as these players pursue growth of their own, they may begin to more directly compete for banks' existing customers.

To remain competitive, large banks will focus on deepening existing relationships and differentiation through their scale and technology. Adding lending capabilities and other value-added services to mobile apps may help monetize this channel and support growth.

Regional and small banks will seek growth through acquiring asset-generating businesses that fit their core expertise. These banks will likely use their agility to attract new books of business from larger competitors, while continuing to stress customer service.

Seeking growth in foreign markets could be a viable strategy for some banks. But given capital and governance requirements in some foreign jurisdictions, banks may consider strategic global partnerships that allow them to service clients in countries where they currently do not have a physical presence.

Lastly, given limited growth in other areas, banks of all stripes will target new offerings for the underbanked, especially given regulators' focus on this sector.

Winning in wealth management

The allure of fee-based income will continue to attract banks to wealth management, yet as scale becomes increasingly critical and competition intensifies, firms without the resources to compete may be forced to withdraw.

To make headway, firms should attempt to build holistic customer solutions by harnessing the power of all their business lines: consumer, commercial, and investment banking.

To attract a variety of customer segments, banks may consider managing a portfolio of advisory models and brands. This requires careful attention to product mix and differentiated service levels that can support growth.

Banks can also improve their use of technology and delivery channels to offer flexibility in their service models and also to drive down the cost of serving low-profit customers.

The bottom line

Growth will be a universal priority, yet strategies will vary by bank size and business line. Investment in customer analytics could help banks better devise targeted cross-selling strategies. Moreover, leveraging digital technologies to elevate customer experience in both business and retail banking could drive both interest and fee income.

However, banks should ensure prudent underwriting standards are not overlooked, otherwise they may need additional reserves to account for declining asset quality. Finally, learning from nonbank technology firms and establishing exclusive partnerships will be critical for innovation and a competitive edge.

Banks’ shrinking role in the evolution of payments

Historically, payments have been centralized within the financial services industry, driving a significant portion of annual bank revenue. Yet, many factors in 2014 set the stage for broaching change in both payments and banks’ role within the sector.

Banks and merchants are preparing to retire traditional cards and adopt the EMV standard of chip and PIN cards, already commonplace in many other countries. Eighty-six percent of financial institutions say they plan to begin issuing the new cards in the next two years.[21]

Nonbanks offered increased pressure in 2014, as technology companies, proprietary networks, and a host of P2P (peer-to-peer) and payment applications all aimed to create niche footholds in the market.

Focus for 2015

Seeds of change were planted in 2014 that will likely replace banks’ near exclusive grip on payments with a new shared-ownership model involving the industry and technology firms.

The introduction of the Apple Pay™ mobile payments solution will spark growth in contactless payments.[22] Additionally, host card emulation — a process of encrypting credentials into the software of the phone — will bring contactless payments to other phones and operating systems. As the payment experience shifts from the card to the phone, banks may see reduced interchange revenue and diminished brand recognition.

Despite these challenges, contactless payments usher in a new generation of security with biometrics and tokenization — the use of a unique code or “token” to initiate a transaction instead of the card number. Tokenization alleviates merchants’ costly and time-consuming obligation of protecting card numbers, a responsibility they will still face after converting to EMV-compatible terminals.

Merchants will likely be conflicted between more expensive terminals that offer both contact and contactless EMV payments, and, perhaps driven by anticipated future adoption of NFC-based mobile payments, leapfrogging contact EMV in preference for less expensive contactless-only terminals. Consumers interest in contactless payments, combined with its superior security and lower card-management costs for merchants, could slow the adoption of EMV, and may eventually replace EMV in the United States.

In the midst of these changes, banks should not lose sight of regulators’ interest in the future of payments. Regulatory scrutiny may restrain innovation at traditional banks over the near term; however, regulators’ interest in a real-time payments system will grow and require banks’ attention.

The adoption of distributed networks, such as Ripple, may help the industry realize faster processing, as well as greater efficiencies for global payments and correspondent banking.

The bottom line

2015 will be an evolutionary year for payments, with banks defending a smaller piece of the payments sector. The growth in contactless payments may secure banks’ role in the payments network, but may cut further into interchange revenue and brand recognition. Banks must look for new ways to be top of wallet and to differentiate customer experience, especially as contactless payments become more commoditized. To do so, banks should look for innovative ways to leverage customers’ spending data for specialized promotions and services.

Strengthening compliance and risk management

In 2014, the industry focused on acclimating to regulatory pressure. Banks sought to improve internal controls, bolster their compliance staff, and resolve outstanding legal and regulatory issues.

Regulators pressured banks to improve their risk governance. The Office of the Comptroller of the Currency issued its heightened expectations for large banks, and the Federal Reserve finalized its enhanced prudential supervision standards.

Consumer protection remained a compliance priority in 2014, particularly for mortgages, prepaid cards, and auto loans. The focus on risk management and compliance is expected to continue in 2015 and beyond.

Focus for 2015

New regulatory actions — including the heightened risk governance expectations and the enhanced prudential supervision rule — require improvements in firms' risk capabilities and culture.

William Dudley, the president of the Federal Reserve Bank of New York, spotlighted this issue stating, "There is evidence of deep-seated cultural and ethical failures at many large financial institutions. Whether this is due to size and complexity, bad incentives or some other issues is difficult to judge, but it is another critical problem that needs to be addressed."[23]

Recognizing that significant risk-based decisions are made throughout the organization on a daily basis, weaving risk-intelligent behavior into the fabric of the bank's culture will become the new benchmark of a mature governance program.

Risk and compliance functions must balance budget pressures when pursuing these efforts. Seeking cost efficiencies wherever possible will help realize goals to enhance the risk and compliance culture to complement the business strategy.

CCAR's expanding role

The Comprehensive Capital Adequacy Review started out as a periodic regulatory exercise, but, given concerns about "too big to fail," it is evolving into a powerful supervision and enforcement tool that requires ongoing attention.

Regulators are extending their focus, using CCAR as a tool to assess all the dimensions that could potentially impact the capital adequacy assessment: data quality, governance, model validation, finance controls, and risk exposures.

In addition to an expanded focus, regulators are continually raising their expectations. Banks must upgrade processes and improve the capability of their assessments continuously, as what is sufficient today may not be in the near future. For instance, analysis based in a spreadsheet may suffice today, but an automated data management system may be needed in future.

To meet rising expectations, management should invest in the infrastructure to convert CCAR from a periodic compliance activity into an ongoing strategic management tool that is integrated into firm-wide risk management systems.

Banks may need to rethink the governance for CCAR, including the creation of steering committees, documented effective challenge processes, quality controls, and data management. Staffing and technology should be appropriately resourced to ensure there are no gaps in the CCAR process.

While this may take time and investment, CCAR's significant regulatory "teeth," through its ability to restrict dividends and alter business plans, make these enhancements a top priority in 2015.

Shifting focus to different sizes of banks, regulatory attention is expected to flow down to regional and small banks, making 2015 a more transformative year for these institutions. These banks may need to recruit additional specialized risk and compliance talent and improve risk governance to meet heightened expectations.

Foreign banks operating in the United States face significant governance changes as they establish independent holding companies in 2015. These independent holding companies will not only require a board, an independently chaired U.S. risk committee and chief risk officer, but also a whole risk reporting and monitoring capability, which will likely be new for many of these institutions.

The bottom line

Meeting heightened regulatory expectations will require management to extend its focus from improving specific processes to fully integrating risk management, compliance, and ethics into the bank's culture. Impacting culture requires several actions. Banks should reinforce a strong "tone at the top" by cascading targeted messages down through each function and business line. Boards should effectively challenge senior management's risk assumptions and business plans, documenting such instances for future reference. Further, chief risk officers should pursue further collaboration with business lines as compliance and risk management continue to be an enterprise-wide focus. Lastly, risk management and compliance responsibilities should be reflected in performance management programs and reinforced in employee training.

Data and analytics: The next frontier

Banking regulators have recently stepped up their pressure on banks to address shortfalls in data management.[24] Although data management practices in the industry are significantly more mature than before, the reaction to regulatory pressure remains largely reactive and piecemeal.

This fact is reflected in the most recent survey by the Risk Management Association and Automated Financial Systems, Inc. on data quality: only 40 percent of the 37 global financial institutions surveyed felt the quality of their data was above average or excellent.[25]

This is one of the central problems the new breed of chief data officers is expected to solve. Many banks now have a CDO, and some have even created positions within business units as well. CDOs, responsible for managing data and analytics within the institution, have become a key interface between technology, operations, and the business functions.[26]

Focus for 2015

We expect the banking industry to pursue further data transformation with greater gusto in 2015. One main focus area will be strengthening data-enabled capabilities across front-line operations, business units, and functions, including finance, compliance, and risk.

Monetizing data to drive increased revenues could begin to become a reality, especially in more mature institutions that have put in place appropriate analytical capabilities and governance.

The role of the CDO must also evolve beyond immediate priorities such as data governance and data quality. For instance, seeking value creation through collaboration with the business lines and functional groups will increasingly become the hallmarks of success.

Moving toward a central regulatory management office (RMO)

Banks face a number of compliance challenges these days. The vast number of requirements, the time it takes to fully implement some of the rules, and regulators' expectations regarding increased data access are placing unprecedented demand on the compliance function.

Exacerbating this problem is a disjointed and uncoordinated regulatory reporting structure found in many organizations. Such a disparate structure often leads to slower responses, inefficiencies, and possible confusion. Beyond these, there exists the real risk of noncompliance and fines.

As a result of these issues, some of the leading organizations are looking to establish a central regulatory management office to drive consistency, streamline execution, and improve decision-making.

The centralization of regulatory reporting also helps to reduce costs through elimination of redundant work, and to identify common regulatory needs across the organization. Such a structure also strengthens the three lines of defense in risk management.

In addition, the integrated model can help the business lines to produce higher-fidelity contracts, help the relationship managers oversee performance with an eye toward compliance, and help the compliance team play a more active role in real-time vendor performance improvement (versus after-the-fact assessment).

But the success of the RMO will rest on a robust regulatory data warehouse, to be owned by the CDO, while the RMO is owned by the chief compliance officer.

As the next stage in the maturity of compliance management in the banking industry, we expect more banks to embrace the notion of a central RMO in 2015.

There will be a strong move toward a federated data management structure. CDOs embedded in the lines of business will seek to support the business agenda while also ensuring that data governance and quality standards are met.

Another priority will be the establishment of common platforms housing master data — about customers, employees, or counter-parties, for instance — to enable easy access across the enterprise. These efforts will increase operational efficiencies, and minimize any noncompliance with regulatory expectations.

Following these, banks will begin to solidify the integration of data management programs with information security programs, with strong linkages between the CDO and the chief information security officer (CISO) functions.

The bottom line

As the data and analytics function within banks evolves on multiple levels, banks should be shifting toward a proactive stance to ward off further regulatory pressure. For instance, the creation of a central RMO can help drive greater efficiencies, especially in large institutions burdened with disparate structures. Meanwhile, CDOs should take advantage of their new roles to establish tighter connections with front-office business functions and derive greater value from their data assets. Together these approaches will help distinguish leaders from followers in the data and analytics space.

Bolstering cybersecurity

Cybersecurity has rapidly risen to the top of the risk agenda at institutions of all sizes.[27] 2014 witnessed an acceleration in the number and severity of cyberattacks, and there is every reason to believe these threats will only become more pervasive, sophisticated, and disruptive going forward.[28]

Banks' integral role in the payment ecosystem leaves them entangled in the often messy aftermath of security breaches, experiencing both economic and reputational loss even in instances where they are not direct targets of cyberattacks.

With increasing realization that cybersecurity needs to be pursued with utmost vigilance, the banking industry is devoting considerable resources to this warfare.[29]

Focus for 2015

To improve cybersecurity efforts in 2015, banks will likely add new defensive and offensive measures to their toolkits, borrowing from military and government agencies — given their vast experience in defense and intelligence. Banks will be looking to attract specialized talent from these sectors.[30]

Encouraged by recent efforts, there will also be a greater emphasis on collaboration within the industry and with government agencies so that information can flow seamlessly as incidents happen. The Cybersecurity Information Sharing Act of 2014, if and when it becomes law, will further boost these actions.[31]

Recruiting and retaining both technical and managerial talent will continue to be a high priority. Fierce competition for specialized talent, especially with military and government backgrounds, will increase banks' compensation costs in this area.

Given the growing importance of cybersecurity, boards will be dedicating more efforts to better understand their institutions' vulnerabilities and be actively engaged in the oversight of cyber-defense infrastructure and protocols. As such, ensuring seamless and transparent communication with the board will increase in priority.

Proactively managing third-party vendors, to protect the threat surface exposed through them, will likely be another area of greater focus.

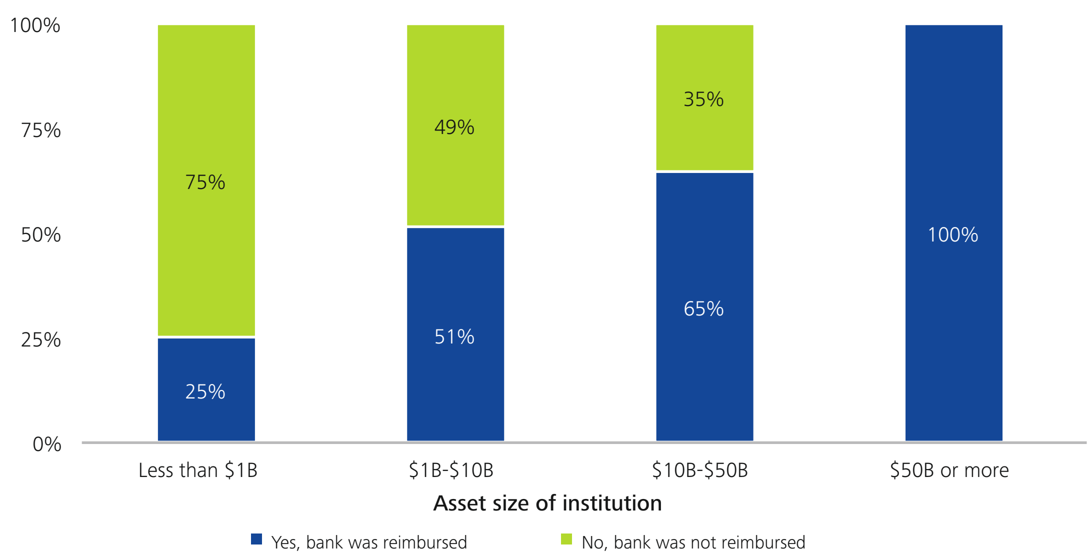
Smaller banks may be at a disadvantage given the extent of resources and specialized skills required to shore up their cybersecurity capabilities. For instance, given their scale, they already face lower cyberfraud reimbursement rates than those of larger institutions (Figure 10).

The bottom line

In 2015, banks will be forced to devote even greater resources to enhancing the security, vigilance, and resilience of their cybersecurity model.[32] Adopting new methods, such as war gaming, attracting specialized talent, and increasing collaboration with other members of the ecosystem will be critical. Beefing up the intelligence apparatus to detect new threats in a timely manner should also become a higher priority. Lastly, clear and prompt communications with the board will be necessary as the profile of the CISO expands within organizations.

Figure 10: Reimbursement rates for breaches between 2009 and 2014

Smaller banks faced lower reimbursement rate for previous breaches



Source: American Bankers Association's Target Breach Impact Survey, July 2014

What’s next?

As we contemplate the future of the banking industry, the temptation to merely focus on the immediate concerns is only natural. After all, the post-crisis experience, unlike any other period in recent history, has conditioned us to be myopic. But we might soon be reaching the endpoint of this chapter in the industry’s evolution, forcing us to take a longer-term view.

With remediation hopefully behind them, banks can intensify their focus on improving the economic fundamentals of their businesses. As highlighted in this report, banks, in making 2015 the year of boosting profitability, face a number of opportunities and challenges.

As the economy improves, banks cannot hope to just ride the wave, but instead will need to become more savvy — in their choice of target segments, product offerings, and pricing. Getting even better at data and analytics will clearly help here, as will the use of technology to redefine customer experience, both in the retail and commercial segments.

In attempting to boost profitability, banks will also have to ensure that ethics and a robust risk culture are embedded in the entire organization. This has to be more than mere lip service: Looking at this mainly as a compliance issue is missing the big picture.

In the short-term, greater competition from nontraditional players might feel like an additional burden, but there is quite a bit that banks can learn from technology firms and start-ups looking to disrupt banks’ dominant position, particularly in lending and payments.

In today’s environment where differentiation is increasingly less common, even a slight edge can yield positive results. This applies not just to customer-facing activities, but also to internal processes, including balance sheet management, risk, and compliance.

It looks like 2015 is shaping up to be the year the banking industry moves past remediation and “short-termism” to the resolute pursuit of profitability.

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