2013 Financial Services Industry Outlooks

A consolidated digest of our 2013 industry outlooks for the asset management, banking & securities, commercial real estate and insurance sectors.

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Deloitte Center for Financial Services
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2013 Hedge fund outlook
Some gains, more pain
They say what doesn’t break you makes you stronger. For hedge funds, 2012 was a backbreaking year to put it mildly. Heightened market volatility, stressed global macroeconomic conditions, and underperformance relative to traditional investing vehicles were just a few of the factors that challenged hedge funds in 2012. Add the extra weight of an increasing regulatory burden, and many fund leaders might have been forgiven for packing it in.

But something telling happened instead — the industry emerged from 2012 stronger than it went in, surpassing the records it set in 2007 for assets under management (AuM) and absolute number of funds.1 Those that remained settled into a more measured and sustainable pace of growth, with money flowing mainly to hedge funds who altered their routines by adjusting to new demands from regulators and investors while looking for new ways to streamline back-office operations.

The coming year will be no less challenging. With the Securities and Exchange Commission (SEC) registration now behind them, hedge funds will be subject to ongoing Form PF reporting and, for the first time, risk-based examinations. We also expect there to be some additional clarity on other pending matters on the regulatory front. Additionally, institutional investors, whose hedge fund allocations have increased five-fold since 2003, will continue to exert pressure on companies for greater transparency and customized fee arrangements, more closely aligning manager and investor interests.2

Despite these ongoing challenges, we believe the industry is positioned to grow opportunistically in 2013. Institutional investors’ appetite for alternatives continues to increase as bond yields hover near all-time lows, public pension underfunding approaches record levels, and equity market volatility upends more traditional investments. The average institutional allocation in hedge funds is about 10 percent and is expected to double by 2016.3 Those numbers could in fact be low if hedge funds return to historic performance levels, just 43 percent of hedge funds had reached their high-water marks by the end of September.4

Make no mistake: The coming year will be an important one for performance if firms hope to return to earning more than just management fees. We expect hedge funds to engage in the following three strategies as they seek to close this performance gap and position themselves for increased allocations in 2013:

• Fostering a compliance culture
• Competing for new assets with targeted strategies
• Addressing fee pressure through operational streamlining

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1 As per HFR as of 2Q12.

Compliance has become a top priority for hedge fund executives given the increasing regulatory burden and push by investors for additional transparency. The implications of new rules stemming from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the Foreign Account Tax Compliance Act (FATCA), and the Alternative Investment Fund Managers Directive (AIFMD), are far from settled, but there is a general recognition among hedge fund leaders of the need to fortify their compliance policies, procedures, and personnel in order to stay agile and responsive in this dynamic regulatory environment. This awareness extends to the need to ensure that hedge funds maintain adequate oversight of service providers, who are taking on more responsibility in performing regulatory functions.

Back-office resources were severely tested in 2012 by two key compliance hurdles: SEC registration and Form PF. According to a Hedge Fund Alert article, Bank of America estimates, some large hedge funds spent upwards of $500,000 just in completing a first-year Form PF.5

What's new for 2013

With more than 1,500 new private fund advisers registered with the SEC in late 2012, hedge funds will open their doors in 2013 to the new SEC inspection regime.6 In advance of these risk-based “presence exams,” the SEC has told fund advisers that it will be focused on five key compliance areas: marketing, portfolio management, conflicts of interest, the safety of client assets, and valuation.7

Some in the industry have expressed concern about the agency’s level of sophistication when it comes to hedge funds, but we believe regulators have strengthened their hand by enhancing their capabilities in some important ways. For example, SEC examiners are increasingly incorporating data analytics to identify aberrational trading or performance and detect instances of insider trading.8

We believe 2013 will also bring increased clarity on several other compliance-related topics among hedge funds, including FATCA, Commodities Futures Trading Commission (CFTC) registration, AIFMD, and tax legislation reform.

In addition to stepped-up pressure from regulators, we also expect institutional investors to expand their demands for greater transparency into new areas such as cyber security and fraud prevention programs.

Bottom line

Given the reputational harm that can come from an enforcement case, compliance is now a critical component of a hedge fund’s culture, perhaps as important to their survival as investment performance.

The problem is that many pending regulatory matters remain unresolved. Dodd-Frank is a prime example, with roughly two-thirds of its rules not yet finalized. In addition, the role certain regulatory bodies will eventually play has yet to be determined. And then there is the arrival of Elisse Walter at the helm of the SEC, and the question of how dramatically the agency’s priorities may change as a result.

One thing is for certain: Pressure from regulators won’t abate anytime soon. This year will bring increased emphasis on managing the compliance burden in a manner that integrates governance, controls, supervision, operations, and technology. A dedicated chief compliance officer is recommended for firms that have registered or plan to register with the SEC in 2013. A chief financial officer or chief operations officer might have been able to handle the added responsibilities before, but those days are clearly over.

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2013 financial services industry outlooks 3
Despite the increased scrutiny from regulators, the industry’s AuM broke through the $2 trillion barrier and may be poised to rise even higher as institutional investors shift more of their investments toward risk-driven classifications and expand the pie of their alternative asset allocations.

Still, we recognize the near-term growth outlook is not that rosy. The industry’s relative underperformance during the last few years has some investors questioning the value add of hedge funds and they are exerting downward pressure on fees as a result. “Two-and-twenty” is no longer sacred, and fee flexibility is becoming the new normal.

For certain, some hedge funds will inevitably generate outsized returns in 2013 and offset these kinds of pressures, but the search for alpha will likely remain elusive for most. As such, we do not expect the industry to snap out of its lull overnight.

Nevertheless, we do believe certain hedge funds are positioned to grow opportunistically in 2013, particularly those that offer investment strategies emanating from emerging global trends.

What’s new for 2013

The balance of power may firmly remain in the hands of investors, but we believe this will be an area of opportunity for hedge funds in the coming year, specifically those with diverse investment capabilities and robust operational infrastructures. For example, we expect certain big-ticket institutional investors with dry powder and focused investment priorities to increasingly seek customized solutions in 2013. These could include bespoke investment or co-investment strategies, and might require tailored reporting capabilities and managed account platforms. These opportunities favor large hedge funds in particular.

Additionally, resolution of challenges tied to the JOBS Act may give hedge funds access to high-net-worth individuals through wealth management platforms. Congress intended for the law to help lift advertising restrictions on the industry, and it will likely pressure the SEC to rule on hedge funds’ responsibilities for verifying qualified investors. A positive ruling could reshape the way hedge funds market and attract new assets.

With the hedge fund industry maturing, competition is intensifying from traditional and non-traditional asset managers in the industry. New entrants are accelerating industry convergence by blurring the lines in some cases between hedge funds, private equity funds, and mutual funds. Hedge funds are also playing a part in this evolution, with some funds pursuing new investment strategies and distribution channels involving private equity, mutual funds, and other domestic or foreign registered products such as UCITS.

We expect these diversification strategies to continue in 2013, with some firms also expanding geographically, into emerging or even frontier markets, or into new asset classes such as European credit. Alpha opportunities may also be found in certain asset classes like real estate or distressed debt.

For those hedge funds that are not interested in expanding into a diverse mix of strategies, we see other opportunities in 2013. For instance, we believe certain emerging managers will revert to the industry’s entrepreneurial roots by generating alpha through niche strategies such as structured credit, frontier market debt, or other illiquid fixed income instruments.

If 2013 turns out to be as challenging as the previous few years, expect more interest around the topic of succession. If the past is any indication of the future, then we may see more large, well established hedge fund founders pass the baton on to the next generation of managers, leaving a younger, less road weary group to deal with demanding investors and regulators.

Bottom line

Large hedge funds are in some cases better positioned for growth in 2013 by being able to leverage broad-based competitive advantages across investments, distribution, and operations. However, in an industry where performance ultimately drives success, scalable smaller managers and niche hedge fund strategists should have plenty of opportunities in the year ahead.
The combination of limited top-line growth and operational cost creep has put many hedge funds in the prickly position of grappling for productivity gains. Compliance costs are rising, institutional investors are increasingly seeking customized service levels, and alpha generation has grown more challenging. We see 2013 as a year in which hedge funds consolidate these efficiency gains while digging deeper into their organizations looking for more cost-cutting opportunities.

What’s new for 2013
We believe hedge funds will increasingly turn to outsourcing, process efficiencies, enhanced data management, and technology solutions to help alleviate these operational strains in 2013. These strategies will be particularly important to those hedge funds that patched together temporary fixes to deal with new compliance burdens in 2012, while postponing the implementation of long-term solutions.

Outsourced service providers will likely play a growing role in support of data-intensive regulatory-driven initiatives (e.g., Form PF reporting) and compliance programs. Middle-office functions such as trade processing or corporate actions processing, or even certain activities like collateral management that are closer to the front office, could also be prime outsourcing candidates. While retaining oversight responsibilities in-house, hedge funds will turn to new outsourcing models that transfer resource-intensive operational, regulatory, and technology activities to external partners with scale advantages. This approach will help comfort those who fear losing control through outsourcing relationships while alleviating significant cost pressures and increasing fee transparency with fund investors.

The industry’s views on technology will also continue to evolve, as more chief information officers embrace creative ways to reduce costs and risks by better integrating service provider connectivity, enhancing risk analytics, leveraging data management, and offloading certain commoditized trading activities, among other opportunities. Hedge funds both small and large are increasingly scrutinizing the escalating costs of market data. Larger hedge funds with internal operational infrastructures will arguably benefit more from this technology rethink, but smaller funds will be able to generate technology-driven efficiencies either directly or through service provider relationships. Hedge funds lacking a streamlined data warehouse may adopt specialized bolt-on systems to help them address the inflexibility of legacy technologies in dealing with increasing demands from regulators and investors. Others will migrate to cloud-based software solutions, given the increased sophistication and security protections they offer for front- and back-office functions.

Bottom line
The increasing regulatory burden, combined with investor pressure to provide greater transparency and reduce fees, amounts to a new operating reality for hedge funds. It may be difficult for all but the largest funds to justify the investments needed to sustain an institutional-grade operation while confronting increasing operational demands. Ongoing industry consolidation is one ramification of this difficulty. But we believe that some may be able to alleviate this pressure and level the playing field by turning to partnership strategies that incorporate a blend of outsourcing and technology.
The hedge fund industry faces no shortage of challenges, but we see its current struggles as a form of resistance training. Hedge funds are being forced to invest in their infrastructure to shoulder the growing strain of regulatory and investor demands. When those demands lessen, hedge funds will emerge as stronger and more structurally capable of winning investors’ confidence.

In the meantime, the industry will have to do what it can to manage the added burden while delivering alpha. We see cause for optimism in this respect. Leading head funds are getting ahead of regulatory uncertainty by fortifying their compliance policies, procedures, and personnel. Others are adjusting to downward pressure on revenue by instituting new fee structures and exploring new distribution channels. And many more are tapping process efficiencies and technology solutions to streamline their operations.

We have every confidence that these changes — and more to come — will position the industry to effectively manage this increasingly dynamic and challenging environment in the year ahead.

Conclusion

The question now is whether hedge funds can find alpha with the extra weight of increasing investor and regulator demands.
2013 Mutual fund outlook
Shifting gears for future growth
For nearly a decade, the mutual fund industry has moved within the broader market’s slipstream, oscillating between exuberance and retrenchment. This well-worn track has seen fund firms through many peaks and valleys, with the market’s recent recovery bringing assets under management (AuM) close to pre-crisis levels at $12.7 trillion.1

Market volatility is likely to extend into 2013, continuing to create pressures of its own, particularly in the cost-cutting arena. But 2013 also offers mutual fund firms opportunities for growth. Among other options, fund firms may decide now is the time to capitalize on growing investor demand for exchange traded funds (ETFs). ETF assets are expected to reach $2 trillion by 2015,2 and fund firms will decide going forward whether they should enter or expand into the ETF marketplace. Firms may also look to strengthen their distribution channels by taking advantage of investors’ increasing use of registered investment advisers (RIAs).

Whether or not they choose to embark on these paths to potential growth, fund firms may face greater headwinds on the regulatory front. Much will depend in 2013 on the actions of the incoming chairperson of the Securities and Exchange Commission (SEC) and the Financial Stability Oversight Council (FSOC).

We expect the industry to condition itself for whatever may come by shifting some of its attention back to the operations side of the business. Extending outsourcing to certain middle-office functions, consolidating technology platforms, and reassessing their location strategies are but a few of the ways we see fund companies working to cut costs and better manage risk in the months to come.

As mutual fund firms look forward, we believe that three core strategies will shape their approach in 2013:
- Adapting to an evolving regulatory landscape
- Tactically pursuing growth opportunities amidst challenging market conditions
- A shift back to focusing on operational excellence

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1 2012 ICI Factbook as of October 2012. Mutual fund assets at the end of 2007 were $12.9 trillion.

Adapting to an evolving regulatory landscape

Unlike hedge and private equity funds, mutual funds emerged from the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) relatively unscathed, and the regulatory landscape for mutual funds as a consequence has remained relatively quiet. The significant exception, of course, is money market funds, which regulators continue to target for additional oversight. The months ahead may also see the FSOC labeling one or more large mutual funds as systemically important financial institutions (SIFIs), making them subject to additional regulatory requirements. Finally, the new chairperson of the SEC may decide to vault mutual funds back on top of the agency’s agenda.

What’s new for 2013
Money market funds will almost certainly remain a focal point for regulators in 2013. The FSOC believes investor-led runs on money market funds could be a systemic risk to the financial system. It has issued a formal proposal urging the SEC to establish new standards for these funds, likely cementing action on money market funds in 2013.

All told, regulators and industry participants are addressing several options for money market funds, including:

- Requiring a floating rate net asset value
- Instituting a capital buffer
- Having a minimum balance at risk for fund investors
- Putting in place a temporary gate on redemptions and/or redemption fees

At present, it is unclear if regulators and the industry will reach a consensus on these options, or whether mutual fund firms will take their objections to the courts.

For large mutual funds, SIFI designation by the FSOC now looms as a potentially significant change. Funds designated as SIFIs will likely be burdened with higher operating costs as they seek to comply with the FSOC’s additional oversight requirements, potentially putting them at a competitive disadvantage to other funds.

Recently, the mutual fund industry sought to challenge the Commodity Futures Trading Commission’s (CFTC’s) new rule that would require certain investment companies to register as commodity pool operators. The lawsuit was not successful: The U.S. District Court for the District of Columbia decided in favor of the CFTC, and it is unclear what further actions may be taken. Bolstered by the court’s decision, the CFTC may look to hasten its efforts to finalize adoption of the harmonization rule changes.

The arrival of Elisse Walter at the helm of the SEC will drive the agency’s treatment of the mutual fund industry in the coming months. Walter has previously supported changes in money market fund regulations. Since joining the SEC in 2008, Walter has also supported a broker-dealer fiduciary standard, specific disclosure requirements about mutual fund investments by broker-dealers at the time of sale, and further consideration of a self-regulatory organization for investment advisers. Apart from the outcome on money market funds, mutual fund distribution agreements could see the most change if action is taken on broker-dealer-related initiatives.

Bottom line
Other SEC initiatives in 2013 could result in the adoption of new requirements for target date funds. For SEC inspections, we expect securities valuations, fund directors, and the oversight of omnibus intermediaries to remain in the spotlight. And, we expect the SEC’s enforcement staff to continue its vigilance in bringing asset management cases in 2013, including those potentially involving mutual funds.

4 Based on the definition of SIFI released by the FSOC in April 2012.
Even with the prospect of increased regulatory scrutiny for the mutual fund industry, there are opportunities for strategic growth in 2013 and beyond. With investors purposefully pulling assets from stock mutual funds in 2012 in search of more predictable returns, the industry’s outlook may hinge on how successful fund managers are in expanding into ETFs, sharpening their fund selection criteria, and penetrating the RIA distribution channel.

What’s new for 2013
We expect that fund firms will continue to enter the ETF market as a growth play in 2013. After all, investors are drawn to ETFs for their low costs, tax efficiencies, and exposures to different asset classes. Even though there are more than 1,400 U.S. exchange traded products today, there is still a backlog of ETF registrations awaiting approval by the SEC. The SEC staff’s decision to process exemptions for actively managed ETFs that use derivatives will alleviate some of this backlog and open the door to even greater ETF market penetration.

One thing firms should keep in mind when expanding into the ETF space is the downward pressure larger firms will likely continue to exert on profit margins. In 2012, the industry saw several ETFs shut down due to fee pressures and declining investor interest in the investment offering. For many, survival in the ETF space will depend on scale as firms with more AuM will have an easier time offsetting fee reductions. However, a fund with a niche offering, favorable name recognition, or a good track record can overcome size and margin constraints. Fund firms may choose to transfer their expertise in one investment area into ETF form or convert an existing mutual fund to this structure. No matter the method, smaller mutual fund groups need to determine if they can be competitive in a lower-fee environment.

Looking beyond ETFs, we expect fund companies to gauge investor appetite more closely before proceeding with any new fund launches. Most companies no longer have the luxury of launching multiple funds in hopes that they will be successful. Given the costs of starting new funds, those initiated in the coming months will need to have a sharper focus to lure investors looking to act in the near term.

Should the macroeconomic situation mirror 2012, we expect to see the introduction of more balanced and fixed income funds. These help fulfill investors’ demands for reduced risks and alleviate concerns around the equity markets. Additionally, as investors seek alpha and downside protection on parallel tracks, fund firms offering alternative, hedge fund-like strategies are likely to attract inflows. By some estimates, these funds are expected to double their assets between 2011–2016.

Mutual fund groups will also need to hone their distribution strategies in 2013. Historically, fund firms have focused on high-volume brokerage networks for reaching investors, but RIAs offer another tempting avenue for growth. RIAs were not as challenged during the economic downturn as other distribution channels, and their future appears bright. The SEC expects RIAs with more than $100M in clients assets will likely double client assets between 2011 and 2021. Fund firms need to ensure they have adequate resources dedicated to building and maintaining relationships with these ever more influential gatekeepers.

Bottom line
As the U.S. economy continues to recover, mutual fund leaders will look to reenergize growth strategies in 2013. They will need to consider judiciously launching new funds — including ETFs — with an eye toward meeting specific investor needs and taking advantage of their portfolio managers’ strengths. Moreover, fund firms will need to be thoughtful and creative in their distribution strategies by cultivating relationships with RIAs.

A shift back to focusing on operational excellence

With AuM growth likely to continue, we believe fund companies will shift part of their focus back to the operations side of the business in 2013. Leading up to 2008, many firms generated multiple new fund offerings and paid less attention to operational improvements as they rushed to attract assets. With the onset of the financial downturn, cost cutting took center stage, and operations and technology investments took a backseat.

Now, the industry is shifting again, as fund companies are reevaluating the importance of risk, cost, scale, and flexibility. Firms are taking up some of the discretionary process and technology investments they previously put off to further reduce costs and bring greater sophistication to their risk management programs.

What’s new for 2013
The need to address manual workarounds, spreadsheet dependent processes, and key person risks are starting to creep back onto mutual fund priority lists. While regulatory mandates will continue to steer the majority of investment dollars, firms are starting to allocate more of their budgets towards more fundamental operational restructuring initiatives.

Outsourcing is one such area. Mutual fund firms are taking a hard look at outsourcing functions closer to the front office, in addition to the more traditional accounting and shareholder-facing tasks. Middle-office outsourcing, for instance, is finally gaining traction, as firms consider offloading functions ranging from corporate actions and foreign exchange to securities lending and collateral management.

Many fund groups are considering consolidating their technology platforms, as they have yet to merge the many applications they added during the period of growth and acquisitions before the downturn. These systems may now be compromising their cost structure, scale, and flexibility. In addition, the current situation makes reporting more difficult, particularly pertaining to risks. Fund firms are beginning to evaluate the capital expenditures they will need to bring these platforms together so they can eliminate redundancy and operate more efficiently. New technology upgrades are also on the table. Two common goals across the industry are better data — namely, consistent single-sourced data with clear ownership — and more streamlined processes in which people can focus more on exceptions instead of routine clerical tasks.

Just as mutual fund firms will need to be more careful regarding new fund launches in 2013, fund firms will also need to rationalize their current product offerings. Many firms have overlapping products such as separate accounts, fund types, classes, or brands. Products, not AuM, drive operational complexities and volume and, therefore, costs. Fund firms are starting to approach product rationalization as a means of further driving down costs.

Many firms are also in the midst of examining their location strategy in trying to figure out how to migrate from single low-cost processing centers to more sophisticated uses of multiple locations in different regions of the world. India continues to be a major offshore location because of the cost savings, the talent pool, and time zone considerations. Other locations in Europe, South America, and Asia Pacific are also growing rapidly as viable operational centers. At the same time, firms that have resisted low-cost centers are starting to realize they will need them to stay competitive.

Finally, many mutual fund firms are looking to strategically simplify their operating models and organizational design after years of tactical changes. In addition to evaluating outsourcing options, the pendulum seems to have shifted back to centralization and shared services as a means to improve controls and costs. Most importantly, firms are moving towards hybrid models that leverage the advantages of both centralized shared services as well as local client service.

Bottom line
While operational excellence has been a hallmark of the mutual fund industry since its inception, it’s been less emphasized in recent years. We are optimistic, however, that a shift is occurring that is bringing more attention back to the operations side of the business. This renewed focus will help fund firms streamline their operations so they can be more nimble in seizing the new opportunities ahead.
Conclusion

With AuM now approaching pre-crisis levels, the mutual fund industry has plenty of positive momentum heading into 2013. To date, many fund companies have persevered simply by staying abreast of their contemporaries, a strategy that has helped them reclaim lost ground since the global downturn.

But now some fund managers are considering strategies that would put them in the passing lane. Some will enter the ETF marketplace. Others will refine their selection criteria to improve their chances for solid fund launches. And many more will focus on retooling their back- and middle-office support functions in a bid for operational excellence.

Of course, some key uncertainties linger, particularly on the regulatory front. But uncertainty is nothing new to this industry, and these uncertainties seem unlikely to push fund leaders off the road. Rather, we expect fund leaders will dig in and drive the kinds of changes that have made mutual funds one of the most investor friendly and profitable investment vehicles around.

The question now is whether mutual funds will seek to stay on their current trajectory or switch gears in search of future growth opportunities.
2013 Private equity fund outlook
In search of firm footing
As 2013 approaches, private equity firms find themselves navigating new ground as limited partners (LPs), regulators, legislators, the public, and equity shareholders dissect the industry’s business practices and look for changes. The industry is fielding tough questions from regulators on operational areas like marketing documents, the safety of client assets, and various conflicts of interest. It is being thrown into the political debate as legislators and the public scrutinize fee structures and profitability as part of the tax debate. In addition, LPs are demanding better alignment of terms, more insight into distribution and expense allocations, and customized relationships.

Complicating matters further, deal making remains elusive as competition for quality investments remains high and those willing to sell are demanding bigger valuations. Continued economic weakness and market volatility is clouding the investment environment, slowing the pace of initial public offerings, and making it more difficult for prior investments to recover their value.

And yet, the industry continues on its upward trek. Assets under management (AuM) climbed to a record $3 trillion in 2012, and LPs are still attracted to private equity given the industry’s historic ability to generate returns across various economic environments.

We expect the industry to continue attracting fresh capital during 2013, but we expect that growth to be uneven. Investors are being increasingly selective about where they’re putting cash. While a handful of general partners (GPs) will likely raise significant capital, we believe much of the industry may struggle to raise new funds. Their success will likely hinge on their ability to tap emerging opportunities in age-old industries like oil and gas, expand hybrid offerings that access traded instruments such as bank debt and other distressed assets, open new cash veins with public equity investors and corporations, and offer LPs customized solutions such as separate account mandates and co-investment strategies.

In short, GPs will have to rethink their business and operating models in 2013 in the following ways:
• Managing regulatory, compliance, and tax uncertainties
• Pursuing new growth opportunities amidst elusive exits
• Identifying operational efficiencies to combat cost pressures

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2 AuM is calculated as the sum of uncalled commitments ($1 trillion) and the market value of portfolio companies ($2 trillion).

Managing regulatory, compliance, and tax uncertainties

Private equity funds are facing intense scrutiny over regulatory, compliance, and tax issues as LPs and regulators take a closer look at the industry’s practices. Self-governance has historically been the industry’s preferred approach, but those days are now over.

Private equity advisers are confronting many of the same tax and regulatory developments faced by hedge funds. Focus areas in 2012 included the Securities and Exchange Commission’s (SEC) registration and Form PF — both mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) — the Foreign Account Tax Compliance Act (FATCA), and the Alternative Investment Fund Managers Directive (AIFMD).

Greater regulatory and compliance demands have been especially challenging and costly for many private equity managers who have yet to fully achieve their target compliance program to meet the new standards. Firms are also preparing for potentially higher tax burdens on portfolio and management companies, but struggling to pick the right path because there are many unanswered questions about potential tax legislation reform.

What’s new for 2013
The pace of regulatory- and compliance-driven investments will likely accelerate in 2013 as firms strive to meet demands from regulators, LPs, and tax legislators.

While the SEC’s regulatory focus may shift as a new chairperson takes over, some details are firming up with the recent examinations’ focus on waterfalls and the release of agency guidance on its upcoming “presence exams.” Still, many private equity advisers have limited experience sharing operational information with regulators and might not be prepared to manage comprehensive SEC investigations without the right level of support.

In the months ahead, we expect some private equity advisers will continue to enhance their compliance strategies by investing in infrastructure and personnel, fortifying their controls, training employees, and developing robust compliance policies. Others lacking effective in-house compliance policies or controls, will likely turn to service providers to quickly ramp up compliance infrastructures.

Increasingly sophisticated LPs are also prompting private equity shops to improve their compliance capabilities by asking for improved transparency and customized reporting. Due diligence is no longer an afterthought for LPs, which are instead prolonging the process and more comprehensively digging into a firm’s operational and organizational infrastructure to assess its resilience.

Tax compliance and optimization strategies are also attracting attention in the industry as private equity managers prepare for potential tax changes, including the expiration of Bush-era tax cuts, an increase in the self-employment tax rate, and a new Medicare Contribution Tax. The industry may face additional tax-driven challenges and opportunities as the government tries to reduce public debt levels through tax policy reforms. For example, some legislators continue to consider carried interest legislation a priority.

At the portfolio company level, tax burdens may increase in certain jurisdictions as governments face pressure to raise tax revenues in response to economic weakness. The New York Attorney General recently announced an investigation over the use of management fee waivers as a tax optimization strategy, creating even more uncertainty around policy changes.4

In light of all these changes, private equity advisers will need to increasingly pursue strategies to mitigate tax risks at both the management company and portfolio company level.

Bottom line
Following in the footsteps of the hedge fund industry in recent years, we believe private equity is set to face more scrutiny in 2013 and beyond. Firms are girding for additional oversight by putting in place more robust compliance infrastructures and hiring experienced people to manage them. Creating a culture of compliance, especially among senior executives, takes time, but it will be key to attracting assets in the future as investors pay more attention to this hot-button issue.

Private equity funds are grappling with the increasing regulatory burden at a time when returns are getting harder to unearth. Deals dried up last year as the market for initial public offerings slowed. Additionally, many investments made during the investment heydays of 2006 to 2008 are not performing as well as projected, thanks to the ripple effects of the global financial crisis and lingering economic weakness. Still, the bond market remains healthy, even as credit terms have tightened and equity contributions have increased. The revival of dividend recapitalizations funded by Payment In Kind (PIK) toggle bonds offers evidence of this.5

With public pension underfunding approaching record levels and bond yields near all-time lows, we believe the private equity industry is well positioned to tactically seize growth opportunities in 2013. LPs are still attracted to private equity given the industry’s historic ability to generate returns across various economic environments. Private equity firms with the strongest track records, or those that are willing to support customized relationships, will likely see a greater share of new asset growth in what is likely to be an uneven year for the industry’s development.

What’s new for 2013

Deal activity is likely to pick up in 2013 as private equity managers put more capital to work. Sectors such as oil and gas, real estate, healthcare, distressed debt, and infrastructure may be ripe areas to mine for opportunity in the year ahead. Despite rising volatility and inflation risks, investments should also pick up in emerging markets like China, India, and Brazil.

Exit activity always depends on market conditions, and if those conditions remain tight many firms may look to alternative strategies. Some may choose to exit certain investments earlier and at lower than anticipated valuations than they had originally envisioned given pressure to give cash back to LPs. Selling portfolio companies to other private equity firms may also be a popular avenue in this regard.

Another option firms may pursue is to solicit cash infusions from public equity investors or corporations, where cash stockpiles continue to mount. This may be a sound strategy for companies who have seen their home currencies appreciate, such as those based in Japan; Japanese corporations hold about $2.5 trillion in cash, surpassing the estimated $2 trillion held by U.S. firms.6

Customization may offer another viable route to fundraising. We expect LPs to ratchet up their demands in 2013 for separate account mandates, co-investment strategies, or secondary market fund investments. Such customized relationships can also help solidify ongoing collaboration between LPs and GPs. Certain municipal pension funds may use customization to channel investment dollars into their local economies.

Some established private equity firms will likely continue moving to a broader mix of asset management products. This strategy allows them to expand on their existing relationships and make better use of their established distribution channels. In fact, some are on their way to becoming diversified financial service providers, leveraging strong performance records, close LP relationships, and in some cases a permanent capital base from public equity markets to expand their offerings.

Taking advantage of new rules that restrict traditional banking activities, many private equity firms have hired talented traders and are planning to grow hedge fund, mutual fund, and even exchange traded fund AuM in 2013. Certain private equity advisers may expand through real estate investment trusts or by adding capital markets capabilities. Diversification could be a meaningful growth engine in 2013, especially for established private equity advisers with strong track records.

Bottom line

With growth expected to be uneven in the private equity industry in 2013, we believe executives will be selective about where they choose to invest their time and resources. For some more experienced firms, adding new assets will be a top priority. Others will be more focused on putting cash to work and successfully liquidating legacy investments.

Identifying operational efficiencies to combat cost pressures

A volatile geopolitical backdrop in the United States, Europe, and emerging markets like China and India is squeezing the private equity industry’s top-line revenue growth, which is highly geared to economic developments. The industry cannot rely on the coattails of GDP growth, multiple expansion, or leverage to drive alpha — at least not for the foreseeable future.

Private equity firms will therefore need to find efficiencies in their own operations as well as their portfolio companies to help generate returns. Emerging capabilities in data management, accounting, customer relationship management (CRM), and waterfall automation technologies are providing alternatives for private equity managers as they consider changes to their operating model and underlying infrastructure.

What’s new for 2013
Private equity firms looking to boost the performance of their operations in 2013 will likely look to two areas: third-party administration, and process and technology improvements.

The outsourcing of back-office functions has helped private equity shops become more comfortable with using third-party administrators, and we expect these relationships to expand to more ancillary services, such as investor reporting portals, in the coming years.

Meanwhile, the industry will continue to adopt improving technology capabilities in fund accounting, CRM, waterfall automation, data management, tax databases, and document management systems to control deal flow. While many of these technologies have existed for years, the push to improve, automate, and control the manual processes prevalent in the private equity industry is driving late adopters to reconsider their benefits.

The increasing costs associated with investor demands for information and transparency, as well as new compliance requirements driven from Dodd-Frank, FATCA, and AIFMD, are also prompting private equity managers to reevaluate the skills sets and processes they need in-house to fulfill these requirements. A fresh look at people, processes, and enabling technologies will continue to drive gains in efficiencies and improvements in the capabilities of private equity managers.

Portfolio company managers are also likely to focus on improving operations, given the lackluster growth that continues to challenge many geographies and industries. This focus will be especially apparent in the middle market, where some managers are developing sophisticated cross-functional operations expertise.

Bottom line
With firms challenged to deliver top-line growth, the focus is shifting back to the operations side of the business. Prior successes in outsourcing back-office services to third-party providers are paving the way for firms to expand such relationships as well as firms that currently operate in-house to consider leveraging an outsourcing partner. While some in the industry have yet to tap the full benefits of improved technology capabilities, many will likely make up lost ground in 2013 as cost efficiencies emerge as a tangible lever to deliver alpha.

Of course, gains in operational efficiency don’t materialize overnight. We believe private equity executives will increasingly embrace a longer time horizon when evaluating streamlining opportunities during 2013, because challenging conditions may persist for an extended period of time.
Conclusion

The private equity industry faces an unprecedented level of uncertainty around deal making, fundraising, regulatory developments, tax legislation, and increasing operational demands. These challenges are prompting investors to be more selective about who they partner with as they try to navigate the slippery surface the markets have become. They are looking for GPs with proven track records for managing uncertainty and delivering returns in difficult times. But they’re also on the hunt for private equity firms who will work with them to offer a customized level of service that aligns with their complex needs.

As we look across the terrain, we see the potential for bifurcation between firms who are reaching new heights by taking these demands seriously and changing their ways, and those who are standing still and not pursuing new paths. We believe there are plenty of opportunities for the industry to narrow this gap in the year to come, if they shift their focus and adapt to the new market realities.

The question now is whether private equity funds can reach new heights while balancing increasing demands from LPs, regulators, and shareholders.
2013 Banking industry outlook
Moving forward in the age of re-regulation
Macro issues expected to affect the banking industry in 2013

The banking environment for the coming year likely contains equal parts resolution of past challenges and introduction of new ones. The economy in the United States is showing evidence of continued recovery, with jobless rates continuing their slow decline and the housing market showing evidence of some recovery.

However, fast on the heels of the U.S. elections in November 2012 will come the need for a swift resolution to the fiscal challenges that are looming in January. The combination of the spending cuts mandated by the Budget Control Act of 2011, known as “sequestration” and the expiration of several tax cuts could severely damage that recovery if not dealt with (see Exhibit 1).

At the same time, the weakening of the European economy continues. Stopgap measures have been passed over the recent months, but a long-term resolution of the economic instability in Portugal, Ireland, Italy, Greece, and Spain is not evident. Speculation can lead one to many potential outcomes, including the potential dissolution of the European Union. But whatever the outcome is, it is not likely to be quickly implemented, nor will it come without significant pain.

China, too, has seen somewhat of a slowdown in its previously accelerated growth. Reduced economic activity, with consequential reductions in demand for commodities to fuel that output, could have a knock-on effect on many economies throughout the world.

Returning to the United States, bankers likely will continue to be challenged to find profit in an environment of low interest rates, and thus low net interest margins. Continued quantitative easing by the U.S. Treasury and Federal Reserve – the so-called QE3 – is the latest effort undertaken by the central bank to spur demand for loans and overall economic growth. We are seeing some increase in loan demand – particularly among middle-market corporate borrowers – but many consumers are continuing to deleverage their household balance sheets and so a broad-based return of consumer loan demand is unlikely in the coming year.

Finally: regulation.

The aftermath of the financial crisis spurred the creation of the most comprehensive set of new regulations in the last 70 years. During the last year in particular, bankers adopted a “wait and see” attitude about these regulations, as the detailed implementation procedures had not yet been written. 2013 looks to be a year of implementation for the U.S. banking industry as much of the regulatory uncertainty has been resolved and industry leaders assess their organizational structures and capabilities in the face of narrow margins, increased capital requirements, and consumer protection.

Exhibit 1. Effects of fiscal cliff

![Exhibit 1. Effects of fiscal cliff](image_url)

Source: Congressional Budget Office
The list of 10

As we turn our attention to 2013, there are a series of interdependent issues that senior-level bankers should consider (see Exhibit 2). We have chosen to present these issues in a way that reflects the relative impact and priority of these issues specifically for the coming year. That is, while most of the items discussed are not appearing on a list of this sort for the first time, some are moving more quickly than others over the next 12 months. Therefore, executives should pay closer attention to those more rapidly evolving concerns and make plans accordingly.

These issues exhibit some regional dynamism, in that the list of priorities and their relative degree of change for the coming year will differ depending on the individual country or region. For example, bankers in growth economies in Asia or Latin America are anticipated to be more concerned with growth-oriented initiatives, while those in Europe and the U.S. are likely to be more focused on determining appropriate uses of capital as a way to drive strategic imperatives and operational restructuring.

These issues are presented below, arranged in pairs from most critical and rapidly evolving, to those that are the more evergreen challenges that bank leaders face. Starting the list are two issues that are fundamental and upon which all the other issues are based. From there, we will explore topics in four major themes: industrialized operations, asset protection, delivery transformation, and return on capital.
Fundamental issues

Making hard decisions about where to compete
Bankers in the United States put a hold on making any meaningful changes in leadership, organizational structure, and operational processes in the aftermath of the financial crisis. Certainly, they were focused on ensuring the survival of their institutions, and rightly so. They were also waiting for the process of re-regulation of the industry to progress to a point where the implications for their business operations became clearer. Rulemaking has now progressed to a point where the impacts should be well enough understood by industry leaders. This should allow bankers to shift their focus toward implementing new strategies and organizational structures that will enable them to be more competitive going forward. According to Bob Contri, vice chairman of Deloitte LLP’s banking and securities sector, “The market is starting to get away from being frozen by regulation… and so there is likely going to be a big push to get more strategically focused around where organizations think that they have the best ability to compete and win.”

At the head of the list of drivers are the new rules around capital adequacy, driven by Basel II and III mandates, as well as the living will procedures embedded in the Dodd-Frank Act. Investor demands for return on equity are not to be underestimated as well. Finally, there is some remaining uncertainty about the direction of regulatory action that is associated with the outcome of November’s elections.

What’s new for 2013
What may be different for banks in the coming year is the movement from analysis to action. As stated above, many initiatives were put on hold as legislative and regulatory actions were promulgated. Now that the impacts of these changes are better understood, banks are likely to begin a refresh of long-term strategic planning.

Building the data-centric organization
Regulators are demanding greater transparency; customers are seeking a more relevant and targeted experience, and bank management is looking for growth opportunities. The common element in all of these is data. Effective data management has been elusive for the banking industry, and with good reason. Technology silos and exploding volumes of data make this a daunting effort.

Some banks are beginning to fundamentally reshape their data management capabilities, from the lowest levels of data architecture to the more sophisticated uses of analytics for customer decisioning and risk management. These initiatives are likely to continue to grow within the industry: too many forces are combining to compel bankers to move in this direction. Indeed, for many, their very survival depends on it.

What’s new for 2013
“Big data” has been the most popular new trend in financial services technology over the last 12 to 18 months. More than ever, look for bank leaders increasingly to embrace the massive effort involved in restructuring their ability to manage and utilize data. Master data management, data hygiene, and the application of increasingly more sophisticated analytical tools should continue to be important initiatives for leading banks in the coming year.

Bottom line
The financial services industry is becoming a technology business, whether leaders care to admit it or not. As such, the effective and creative utilization of the massive amounts of data that banks have could become a characteristic of future winners and losers in the industry.

Bottom line
Banks should consider the strategic repositioning of their organizations. It’s one thing to say that focus has returned, and that leadership has charted a new path to growth. But without complete execution of restructuring initiatives, these efforts may result in nothing more than window-dressing.

Industrialized operations

Earning back the trust
The economic environment has spurred the elimination of “free” checking products as well as limits on debit card fees imposed by the Durbin Amendment, the creation of more standardized mortgage products, and a massive effort to resolve bad debt and reduce loan loss provisions. Many of these efforts have helped banks improve their profitability, but have done nothing good with respect to their reputation in the minds of their clients. To compensate, banks have increased their push to improve service as a way to recapture the public’s trust. This is not a new strategy, but there are new forces emerging that bring the need for attention to service into high relief.

What’s new for 2013
With the advent of the Consumer Financial Protection Bureau’s (CFPB) complaints database, good customer service is not just good business, it’s also become essentially a regulatory mandate. The attention to fee-based products and services, which services and products to offer, the creation of the concept of a “qualified” mortgage, and the continued use of social platforms as a very public outlet for client dissatisfaction are forcing bankers to raise their game. The coming year likely will see increased efforts around the development and delivery of clear disclosures, streamlined and consistent processes, and development of training and compensation to reinforce proper sales behaviors.

Bottom line
Banking executives should deal with the current reality that their product set is commoditized, and most of the low-hanging fruit related to cost containment has been captured. As such, bank leaders should focus on driving differentiation – and excellence – in servicing clients in 2013. This will not only support banks’ need to comply with consumer protection regulations, but also can help retain and grow their customer base on a zero-sum market.

Investing in improved operations at reduced cost
As with previous economic downturns, executives have doubled down on cost reduction to protect margins. Unfortunately for them, previous attempts to streamline through reengineering and outsourcing have virtually eliminated many of the more obvious opportunities to reduce cost.

That said, technology-based strategies are gaining favor not only to improve margins, but also to improve overall performance. For example, analytic and workflow technologies are being applied in commercial and mortgage lending operations to reduce manual handling. Case management tools allow client-service staff to more efficiently serve a larger number of inquiries. And new technology platforms are gaining favor as a way to enable new capabilities quickly at lower cost.

It’s not as if bank executives haven’t thought about this issue. In Deloitte & Touche LLP partner Carol Larson’s view, “They are stuck with an IT nightmare. It is just so costly both in dollars and process disruption to make a big change, and by the time you have done it, there is something new and different and better. And so long-term, they should consider how their IT strategy enables or obstructs the enterprise’s strategic vision, how much are they willing to spend, how important is it to get to that vision and how will they go about doing that?” Additionally, bankers likely need to pay attention to risk management as it pertains to its technology vendors, as this has also come under some scrutiny from regulators.

What’s new for 2013
Cloud computing is increasingly becoming accepted as a platform for delivery of services within the banking industry. As senior bank technology leaders consider their platforms within the context of business strategy, they will make decisions regarding those solutions that are key differentiators for their business, and retain those in-house. Meanwhile, technology platforms that support important, but not strategic, capabilities are expected to be delivered by third parties through software as a service (SaaS) and other cloud-based delivery platforms.

Bottom line
Irate customers, aggressive regulators, and the realities of their own bottom line could likely drive bank executives to reenergize efforts around performance improvement. Investments will be required to meet compliance mandates, repair damaged reputations, and intelligently restructure.
Asset protection

Compliance: A business as usual approach
As the implications of the passage of Dodd-Frank and its attendant focus on bank safety and soundness become more clear, banks will look to move to compliance as a “business as usual” activity, rather than a series of isolated regulatory responses. This is part of a larger effort to improve business and operational performance that has been an ongoing initiative for at least the past few decades.

With that as the backdrop, there are more current and pressing challenges. Chief among these is the establishment of the CFPB. This agency will compel banks to spend a great deal of time and resources in the coming year on all aspects of consumer protection: that product disclosures are clearly worded, that customer complaints are addressed in a fair and expeditious manner, and that employees are empowered to make decisions in the best interest of the customer.

What’s new for 2013
In conversations with bank leaders, we have found that the CFPB is one of their chief concerns heading into 2013. Already, civil money penalties and customer restitution requirements have been assessed on lenders, and the establishment of the Consumer Complaints Database will likely spur an increase in activity over the next year. “The CFPB is going to drastically affect the processes by which products are sold, the service of inquiries is handled, and by which punishment is extended… and I think it’s going to be pretty radical,” says Adam Schneider, principal, Deloitte Consulting LLP and chief advisor to the Deloitte Center for Financial Services.

Securing the foundation to move forward
Market realities and regulation is expected to continue to force banks to address weaknesses in their risk management capabilities. This is being driven now by ongoing regulatory initiatives regarding stress testing and the development of recovery and resolution plans—so-called “living wills.” Alongside regulatory compliance mandates, recent fraud incidents that are internal to the bank require increased focus on three-tiered risk management approaches.

Loss or theft of customer data continues to challenge bank leadership. Measures to combat identity theft have a shelf life of weeks until a new attack vector has been identified. On the credit risk front, slow but steady increases in demand for consumer loans mandate improved credit underwriting capabilities, hopefully building upon lessons learned from the past. With regard to counterparty risk, the search for broader, more profitable relationships with corporate customers entails a more holistic view of the client’s stability. Risk management will therefore continue to be a major program for investment in the coming year.

What’s new for 2013
The need for more effective management of technology-based risk is becoming apparent. On the back end, banks continue to operate fragile, undocumented legacy systems that are increasingly prone to operational failure. On the front end, bank websites have experienced a rash of service interruptions due to a variety of attacks, whether motivated by political agendas or the more typical theft of customer data. Bank technology and business leaders should take action to secure the operational stability of their operating platforms in the face of these risks.

Bottom line
The combination of the enforcement actions coming from the CFPB and the “operationalizing” of compliance in general should be viewed by banks as an opportunity to gather more voice-of-the-customer input, redesign processes to improve client experience, and reduce the “fire drill” aspects of regulatory compliance.

Bottom line
Bank leadership should take appropriate steps to embed and operationalize a more risk-intelligent culture throughout their organizations. “In light of everything that’s happened, most organizations now, at least culturally, understand that risk management is not solely the responsibility of the risk management function, it is a bank-wide responsibility,” says Scott Baret, partner at Deloitte & Touche LLP.
Dealing with disruptors in the payments business
Processing of payment transactions for both corporate and retail customers has increasingly become electronic over the past several years. This has reduced margins while increasing operational and fraud risk. At the same time, new competitors – both large firms like Apple and Google, as well as smaller startups like Square and Dwolla – are looking to disrupt the status quo. For defensive reasons, if not in search of new markets, more banks are likely to invest in emerging electronic payment platforms such as person-to-person (P2P) payments, supply chain finance, and mobile POS payment technologies.

What’s new for 2013
While not new per se, bankers’ interest in the potential for mobile payments is expected to continue to grow in 2013. We have seen a number of initiatives develop between banks, mobile network operators, technology firms, and even emerging innovators. Banks are therefore anticipated to increase the level of investment in mobile payments in many of its form factors: P2P, near-field communications-based payments at the point of sale, mobile wallet technologies, mobile remote deposit capture, and bill pay applications.

Creating the digital bank
No discussion of operational transformation and data governance is complete without the accompanying effort to rationalize and streamline the overall technology infrastructure. Many large banks have ignored the reality that they are supporting a combination of redundant applications, aging technologies, and systems that support a declining level of usage (think: check reader/sorters) that are the result of incomplete merger acquisitions and a prevailing “if it isn’t broken, don’t fix it” mentality.

These inefficiencies should be rationalized, not only in recognition of the narrower margins in the business, but also because these systems in many cases do not support the kinds of front-office digital services that their customers are demanding from them.

What’s new for 2013
According to Max Bercum, a principal at Deloitte Consulting LLP, “20 million new customers are expected to be entering the system over the next three to four years, looking to establish banking relationships. These customers use their mobile devices (smart phones and tablets) constantly to text, browse, and navigate their worlds.” Unfortunately, many executives are expected to favor adoption of a “wait and see” approach to many digital services. However, some leading institutions are making meaningful investments in this area, and may begin to reap the benefits in the coming year.

There are banks that are beginning to utilize Facebook in a number of different ways, even to the point of allowing their customers to check balances, make transfers, and pay bills via a banking plug-in to their Facebook account.

Bottom line
Mobile payments have the potential to disrupt the traditional triumvirate of card issuers, payment networks, and merchant acquirers that has long been dominated by the banks. This should increase the need for banks to forge partnerships with a new kind of third party, quite different from the traditional outsourcers with whom they have become used to dealing.

Bottom line
Bankers should think about how to intelligently rationalize their technology costs so that they can build the bank of the future while maintaining an efficient bank of the present.
Return on capital

Remodeling business structures
A careful assessment of the impact of regulation, combined with strategic repositioning, may drive a variety of mergers and divestitures across the banking asset scale. A number of banks have spent the last decade acquiring assets, and entire businesses, that are now being re-evaluated for their long-term attractiveness. Now it is possible that many of these acquisitions will be deemed non-core and thus the pace of divestitures – and acquisitions – likely will reshape the competitive landscape as a result. Larger, more complex firms are thus anticipated to become more streamlined and focused, while mid-tier institutions may add products and/or geographies to build scale. Deborah Bailey, banking and securities regulatory managing director at Deloitte & Touche LLP, notes, “I am more convinced about strategic dominance in certain areas by financial institutions. In the foreseeable future, banks may move away from the strategy of being everything to everybody.”

But remodeling is not limited to the choices pertaining to lines of business or geographies. Already there have been leadership changes at the top of many banks, and this trend may continue in 2013. The resulting emergence of new perspectives may allow these new leaders to reenergize their organizations, engage with regulators and clients, and set the longer-term strategy for growth.

What’s new for 2013
At the lower end of the market, the pressures of increased capital requirements and costs of compliance may drive community banks to sell out, thereby resulting in an unintended consequence of new regulations. According to Brian Johnston, banking and securities consulting lead and principal, Deloitte Consulting LLP, “As the cost of regulatory compliance continues to take its toll, some community banks and smaller regional banks may decide to consolidate or sell out.” Additionally, the equity markets have indicated their opinions as to the value of individual banks, as some institutions are still trading far below book value. These valuations may also contribute to consolidation.

Desperately seeking growth
The opportunities for growth are likely to remain constrained for the coming year. However, some bright spots may emerge. As the economy improves, the corporate and institutional markets may provide some opportunity for revenue growth. For example, growth in demand for middle-market commercial lending and corporate transaction services continue to be a bright spot.

In the retail segment, banks continue to focus on their best customers – the mass affluent – with a variety of high-touch and self-service products and tools. The caution here is that many banks are turning their focus to the top 20 percent of the retail client base, the competition for which likely will drive down margins for everyone.

What’s new for 2013
An emerging rebound in the real estate market could also drive some growth in residential mortgage lending. However, there is a concern among bankers that in the push to simplify mortgage products, the establishment of a “qualified” mortgage by the CFPB might, in fact, compel some lenders to exit the business. Kevin Blakely, senior advisor to Deloitte & Touche LLP, sees that “there is extreme nervousness within the industry about the definition of a qualified mortgage, which I think is going to have a significant impact on consumer borrowing in 2013 and beyond.”

Bottom line
Growth is likely to be hard to come by in 2013. Much depends on the state of the U.S. economy and the prospects for a resolution to the European economic situation. Absent a more broad-based recovery, then, banks should continue their efforts in understanding their clients better and developing combined offerings to capture a greater share of the relationship. Unfortunately, this is a zero-sum game and thus significant movement may be unlikely to occur.

Bottom line
A return of focus within the banking industry will necessarily result in some level of self-inflicted disruption. But institutions that have a clear strategy and a strong balance sheet may be able to take advantage of market disruption to separate themselves from the competition.
Not one of the actions listed above is new, with the possible exception of the disruptive challenges of new innovators in the mobility sector. For many banks, the coming year may see merely a re-attempt at old strategies that were used during previous economic downturns: cost cutting, a focus on more profitable customers, and investments in compliance. Jim Reichbach, Deloitte Touche Tohmatsu Limited global banking and securities leader and a principal at Deloitte Consulting LLP, puts it this way: "I think the banks have to decide, is this cyclical or is this structural, and if you think that it is structural based on their unique business mix, then act like it. Do something, be more dramatic."

We will be able to discern the emergence of a few institutions that really do take on the hard work of legitimate restructuring, repositioning, and rebranding — perhaps not in all areas, nor all at once. Those few may by their actions and resulting competitive success, lead the more conservative fast-followers.
2013 Capital markets outlook
It’s the end of the world as we know it
Macro issues expected to affect the capital markets industry in 2013

Twenty-five years ago, the American rock group R.E.M. introduced a song that detailed, in rapid fire, a litany of pop culture references that summarized the concerns of a generation in its title – “It’s the End of the World as We Know It (And I Feel Fine).”

For those who work in the 21st century capital markets sector, including many professionals who grew up listening to those lyrics, the recent combination of economic turmoil, regulatory reaction, and technological advances may, indeed, make it seem like it is the end of the world as the industry knows it.

Uncertainty and risk stemming from the slower-than-desired pace of economic recovery, looming end-of-year “fiscal cliff,” and continued economic shockwaves emanating from Europe make this an especially challenging time for capital markets firms around the world.

In front of this backdrop, a number of critical developments, both regulatory and technological, are driving significant changes in the capital markets sector. These include:

**The demise of proprietary trading.** As a result of the Dodd-Frank Act’s Volcker Rule, firms that once generated substantial income by trading for their own account can no longer count on this activity for much, if any, revenue. To offset this loss of income, firms are considering new business models that focus on opportunities in wealth management, emerging markets, and other areas that offer growth potential.

**Taming derivatives’ Wild West.** As unregulated derivatives trades begin to migrate to over-the-counter exchanges offering greater transparency, profit margins are likely to shrink and capital markets firms will likely need to look elsewhere for new revenues to make up for these diminished returns.

**High-powered electronic trading.** As more hedge funds, institutional investors, and high-frequency traders rely on their own quantitative specialists to help set strategy, will the traditional research-and-service brokerage model go the way of paper confirmations?

**Regulatory overhang.** In many ways, the foundational issue challenging the industry is the need for restructuring and realignment to work toward compliance with the evolving regulatory landscape. Derivatives trading is but one example: firms will likely need significant investment to trade derivatives through a central clearing platform to get to a level of transparency that is required.
We expect 2013 to be a year of adaptation to a rapidly evolving capital markets landscape. In this report, we cover 10 major challenges to the industry; for each, we present an overview, new developments likely to emerge in the coming year, and a bottom-line recommendation for industry professionals.

The top 10 issues sell-side firms face in 2013 are presented below, in two major groupings (see Exhibit 1). The first, which we are calling “Transformational,” have the potential to fundamentally alter the strategies, revenue model, and structure of individual firms and the industry as a whole. Of course, these transformations will only happen if executives determine that responses to the situation in which they currently find themselves is something greater than merely a typical fluctuation in the business cycle.

We view the second grouping of issues as being more “transitional” in two ways: First, that changes in industry practices have been building over time, and are likely to continue to evolve. The development of electronic trading, as an example, has been building for decades and that trend should continue. Second, that some of these issues, and the bottom-line recommendations we are making, are in fact suggestive of a combination of cyclical dynamics and evolutionary global trends around wealth and populations that exist outside of the industry.
Group one: The transformative issues

Regulatory landscape: The devil may be in the details, but the regulators have yet to provide them
In the two-plus years since Dodd-Frank was enacted, capital markets firms are still waiting for clarification on many important issues. In the United States, there is continued uncertainty surrounding the impacts of regulatory actions like living wills and the Volcker Rule. Combined with potential actions related to high frequency trading and the shifting of derivatives processing to more transparent exchanges, capital markets executives lack a solid foundation upon which to make decisions. In the near term, as mentioned above, firms should also allocate budget to infrastructure projects to improve their ability to keep pace with regulatory reporting requirements.

This issue is compounded for firms operating more globally, as the uneven jurisdictional treatment of the industry adds to the uncertainty. Indeed, this regulatory unevenness has the potential to incent firms to move operations to more accommodating jurisdictions. Specifically, Ricardo Martinez, principal at Deloitte & Touche LLP, expects that “there may be a migration of activity from some of the most traditional markets, including the New York and London markets, to markets in Asia and other regions.”

What's new for 2013
Actions from regulators and legislators, including the Volcker Rule, the living will process, and opinions like the Turner Report from the U.K.’s Financial Services Authority have the potential to force the separation of banking from capital markets once again. These issues will likely resolve in the coming year and are likely to accelerate restructuring of the industry in a once-in-a-lifetime way.

Defining and finalizing the business strategy
Bulge bracket capital markets firms as standalone entities ceased to exist in the aftermath of the global financial crisis. Kevin O’Reilly, a vice chairman and consulting partner at Deloitte MCS Limited in the U.K., sees fundamental change occurring: “It is a change in the landscape, a change in the profitability, a change in the human capital profile of the industry, so it is an industry in transition. And it affects all the participants in various ways.”

Therefore, with regulatory and market forces obliging bank holding companies to examine their use of capital and sources of profit, executives are expected to conduct a fundamental review of their portfolio of businesses.

What’s new for 2013
Alongside the potential for breakup of the banking/brokerage model discussed above, momentum should continue to build around the fundamental restructuring of capital markets firms in specific, and the industry as a whole. Deleveraging activities continue, and firms are anticipated to make some significant decisions about which of their businesses to maintain and grow, and which may be candidates for divestiture. These decisions are likely to result in the emergence of an industry where firms choose to focus their energies at either end of the spectrum. Some can continue to push their advantage as global, full-service firms offering institutional asset management, sales and trading, and investment banking services, while many others may need to rationalize their business models to focus on their specific institutional strengths.

Bottom line
Capital markets firms have put a lot of decisions on hold waiting for different rules and regulations to be finalized and, perhaps more importantly, waiting for the 2012 election cycle to conclude. The wait should be over: according to Jocelyn Cunningham, principal at Deloitte Consulting LLP, “The biggest issue for the entire industry has to do with figuring out what it will look like in the future, because the traditional business model has changed due to regulation, but at the grass roots level, there is likely no margin left in this business anymore.”
Repairing the reputation: dovetailing of reputational and operational risk
Managing risk continues to be a prime driver for executives in the coming year. Of course, risk management never goes away as a major concern: Not only the standard array of market, credit, and counterparty risk, but also compliance failure, cyber-attacks, and other forms of operational risk. But in the coming year, Rajiv Shah, a principal at Deloitte Consulting LLP, suggests that “there is an issue around safety and soundness. I think it has been neglected – how do you safeguard client interest, shareholder interest, and regulatory interest?”

Headlines have featured an array of issues: trading scandals, price fixing, and “flash crashes” among others. An effective way to lower the volume on this populist backlash is to increase focus on correcting weaknesses in operational processes and their supporting technologies.

What’s new for 2013
In 2013, firms should be consumed with taking action to limit fraud and liquidity risk, each of which can lead to severe challenges. When capital markets firms collapse, it is usually not because they fail to value financial instruments properly or have weaknesses in their technology infrastructure. Rather, firms collapse because counterparties won’t trade with them. In an age where the pace of business is now measured in milliseconds, reputation matters, perhaps more than ever.

Bottom line
As capital markets firms look to reshape strategy, reallocate capital, and return to growth, damage to their reputation—as employers, as counterparties, and as regulated entities—should be unacceptable. Therefore, investments in oversight of operational processes, analysis of funding sources, and de-risking of the client base should receive attention in the coming year.

Market structure: the age of specialization
Deregulation and the need for differentiation have driven the development of alternative exchanges and dark pools, as well as the rise of new trading strategies. For example, in an effort to achieve the favorable transactional pricing for their clients, capital markets firms are creating their own central limit-order books. Firms can then first attempt to match buyers and sellers from their own order flows, or from order flows of other privately managed “dark pools” before going through exchanges, where spreads are narrower.

In addition, through the use of algorithmic trading models, the size of institutional orders is shrinking from thousands of shares to hundreds of shares. By placing multiple small orders, investors buying or selling large positions are more likely to achieve the price they are targeting without moving the market. Finally, ultra-low latency high frequency trading has taken a significant share of volume, pushing the competitive envelope in search of additional milliseconds of advantage.

What’s new for 2013
Firms should address the challenges of fragmentation by applying their resources toward reducing the complexity of their own environments. In many cases there are multiple instances of software that are in different versions based on geographic region or product. Combining the new compliance reporting mandates with the fragmentation issue, firms can focus on efforts to reduce and simplify their legacy back-end trading platforms.

Bottom line
The fundamental business model for sales and trading will need to change as capital markets firms transition from the more traditional high-touch trading to much leaner electronic platforms. Deloitte Consulting LLP principal Larry Albin observes that, “because the traditional business still exists and the high-frequency business exists, financial institutions have to pay for the infrastructure of two channels. While the volumes are moving towards electronic, it doesn’t negate the need to do business the traditional way. So I think that it only adds more complexity to the system.”
Group two: The transitional issues

The conflict between transparency and margin
As stated above, there is increased scrutiny of the over-the-counter (OTC) derivatives market, resembling some principles typically associated with exchanges (e.g., standardization, electronic and anonymous execution, and clearing). The establishment of a central clearing counterparty (CCP) is expected to gain momentum in the coming year as a result. Several players could be considered for this role, including the Intercontinental Exchange and the London Clearinghouse.

In a larger sense, the creation of such industry utilities for the provisioning of non-value-added activities could provide a huge benefit in that there is significant potential for cost take-out from individual firms. However, the increased transparency of these products will likely have the knock-on effect of lowering their profitability. Firms should examine the degree to which they participate in these markets in 2013, and derive strategies to improve their margins if they elect to continue offering derivatives products.

What’s new for 2013
The transformation of the derivatives market is expected to continue over the next several years. “Dodd-Frank is driving a level of transparency in derivatives trading and that is changing the way securities are cleared,” says Larry Albin. Firms should consider investing in process and technology to more efficiently work with these emerging CCPs. Despite this evolution, however, there is likely still a need for OTC and non-standardized products for hedging purposes. The market is not going away; it is just going to transform itself.

Bottom line
The creation of more standardized and shared utilities for initiation, clearing, and settlement of trades will not be the responsibility of a single firm. Indeed, some larger firms will try to corral trading volume in order to lower their costs. But for the industry as a whole, the establishment of these utilities could be a major contributor to the creation of a smaller, but more profitable industry.

Using wealth management offerings as a growth platform
Growth in the affluent sectors is likely to continue in 2013 as capital markets firms seek to leverage their position among consumers who may be the first to benefit from economic recovery, both domestically and globally. Indeed, as Deloitte’s research has shown, the projected growth rate of “millionaire households” around the world affords attractive opportunities on most continents. However, this will be a competitive marketplace. As is often the case during economic downturns, financial services firms of all types focus their efforts on attracting more profitable relationships.

We have already seen sell-side firms increase their investment in private banking and wealth management platforms, and we expect that trend to continue in 2013. While these businesses – particularly private wealth management – tend to consume capital, they also deliver a more predictable base of income. In today’s revenue-challenged environment, that has a great deal of appeal.

What’s new for 2013
The challenge for capital markets firms as they shift from margin-based “alpha” businesses to a more fee-based income stream, is how to get leverage across these businesses. Retail and wholesale investment platforms evince a common set of processes and technologies, from order management systems to clearing and settlement. At the same time, there is a lack of agreement as to the desirability of allowing retail customers access to the same spreads and pricing that are offered to institutional clients. This channel conflict should be resolved if firms decide to embrace wealth management and build a cost-effective common infrastructure.

Bottom line
The shift away from margin-based businesses to ones that generate fees suggest meaningful changes to operational structures, capital allocations, and human capital planning. As in previous crises, firm executives should decide whether these shifts are merely cyclical in nature, or part of a more fundamental realignment of industry revenue potential.

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Globalization: go to emerging markets or go home?

With stagnation in the developed markets of the U.S. and Europe, many global firms are looking to emerging markets for growth. Much has been made about the increasing population of wealthy individuals and families in emerging market countries, which is part of the reason for the focus on private wealth businesses discussed above. But growth in these economies also offers opportunities for other offerings.

Economic liberalization in Asia, as an example, will create more demand for support of mergers and acquisitions. Similarly, overall economic growth creates demand for institutional asset management. Because of their combination of expertise and sophisticated technology platforms, many U.S. and European firms should be well-positioned to take advantage of these opportunities.

What’s new for 2013

Beyond even the pursuit of growth in traditional services, capital markets firms are also turning to global markets for other reasons. “Some firms are putting front-office people in charge of regulatory arbitrage to help clients achieve cross-border efficiencies,” says Kevin O’Reilly. “So it isn’t just about regulatory compliance – it is also about regulatory-driven opportunities.”

At the same time, some firms are also exploring the turmoil in Europe and other developed markets as a way to create new products that support financial institutions’ need for capital and the attendant restructuring and divestitures that are a source of liquidity.

Bottom line

Despite economic stagnation, the market for wealth management services in the U.S. is still quite robust. But growth in other business lines is challenged – trading volumes and profitability are down, and mergers and acquisitions are at a relative standstill. Firms may look to emerging markets, but should consider their overall strategy and competitive strengths as they chase revenue around the globe.

Tying the operating model to the shift to electronic trading

The growth of electronic trading has not been accompanied by a change in the business model. Most firms still maintain a more expensive, sales and research-based model for their trading businesses alongside newer technology-based trading platforms.

In addition, firms are being required to provide end-to-end regulatory reporting throughout the trade life cycle. The speed of electronic trading creates more risk in the marketplace from “flash crashes” and other events. Regulators want firms to be able to monitor and report on transactions even as they course through their technology systems in nanoseconds. Moreover, because of the business model rationalization and restructuring discussed above, capital markets firms should increase their attention on efforts to drive cost transparency in their operations. As volumes shift and product strategies evolve, operations leaders should be prepared to up- or downsize their infrastructures/data centers to drive a more flexible, variable-cost operating platform.

What’s new for 2013

One of the principal regulatory changes that capital markets firms will need to begin addressing in 2013 is the Securities and Exchange Commission’s new Rule 613, which supplants the Financial Industry Regulatory Authority’s Order Audit Trail System. Rule 613 establishes a market-wide consolidated audit trail designed to enhance end-to-end trade monitoring. Rule 613 will apply to large firms in 2013 and smaller firms in subsequent years.

Bottom line

Regulations prescribing improved trade monitoring certainly put pressure on the industry. At the same time, clients continue to emphasize the need for best execution at the lowest cost. These requirements should demand ongoing and significant investment in information systems – many of which operate in a patchwork fashion over legacy infrastructures – as well as a robust capability to parse and analyze the underlying data. Firms should confirm that they have the appropriate resources in place to develop and enhance these mission-critical systems.
Innovation: The return of financial engineering?
For years, Wall Street was synonymous with product innovation, though not always in a positive light. Collateralized debt obligations and other structured asset-based securities may have generated profits for capital markets firms and investors, but they ultimately came to represent what some believe to be the worst of speculative excesses.

Despite the public outcry against this “financial engineering,” the reality is that innovation in product and process still offers a way forward for capital markets firms. It is expected that many firms will allocate some attention to the development of new offerings that are designed to support mergers-and-acquisitions activities and new OTC products that may offer greater margins. There is also the potential to see firms implementing product ideas that have been on the back burner for the past few years. There is a caveat: recent history suggests that innovation in data management and analytics, supporting traditional margin-based products, has been the preferred method to grow. As capital markets firms shift to a fee-based revenue model, they may need to learn how to adapt their innovative approaches to processes and service levels that offer some level of differentiation in these businesses.

What’s new for 2013
Innovation is not the sole property of the firms themselves. In the ongoing competition to capture more trade flow, other industry participants are beginning to be a bit more creative in terms of the trade process itself. Custodial firms are expanding outsourcing support, market data providers are looking for ways to increase their fees, and exchanges are developing co-location offerings to high-frequency traders.

Bottom line
In an industry as competitive and dynamic as financial services, any business that ceases to innovate ceases to grow. Extensive product innovation will likely be more difficult in the short term as new demands for transparency will both take time to operationalize and will reduce product margins. For capital markets firms, the focus on innovation may shift, even if just temporarily, from product to process as the industry adapts to a new regulatory environment.

New compensation models and luring the talent of tomorrow
As stated above, the reputation of the financial services industry has suffered over the past several years. According to a recent tracking study by Harris Interactive, just 17 percent of 17,000 respondents have a positive view of Wall Street – a score that ranks the largest financial services firms ahead of only the tobacco industry and government. As a result, there is increasing pressure to change compensation models, which may contribute to an exodus of talent from traditional sell-side firms to other segments of the industry.

For chief human resources officers (CHROs), the negative perception that prospective employees may have towards the financial services industry also makes the job of attracting and retaining top talent even harder. Coupled with public pressure to reduce discretionary bonuses at a time when many people are experiencing financial hardships, many CHROs are struggling themselves to reduce voluntary turnover, especially among members of the millennial generation, on whom capital markets firms are counting to succeed the baby boomers nearing retirement.

What’s new for 2013
As economic conditions slowly begin to improve in 2013 and beyond, the financial services industry may be looking to replace some of the positions that were eliminated over the past several years. The leading candidates will have more career opportunities from which to choose – including opportunities in technology and other non-financial services sectors.

Bottom line
Capital markets firms should prepare for a more competitive talent market by examining both their corporate culture and their compensation policies to make sure that the environment and rewards that they offer prospective employees are commensurate, if not ahead of, those offered by other employers vying for the same talent.

Moving forward...

It’s no secret that the financial crisis fundamentally altered the structure of the capital markets business that had been developed over the previous decades. At the same time, increasing technology capacity and sophistication is fragmenting the market and forcing participants to compete more aggressively for a millisecond’s advantage.

Today’s industry faces overcapacity, profit margins that are slim to none at all, and a damaged reputation that attracts regulation and repels leading talent to join in its redevelopment. Firms are expected to be challenged to redesign their industry—and themselves—but reality suggests there is no other way out.

True, some opportunity for innovation in product and process may offer some glimmer of hope, but it may be that the best way out is by going backward.

The larger impetus of Dodd-Frank, the Volcker Rule, and Basel III could do worse for the industry than to force its expulsion from the control of bank holding companies, return to privately held status, and allow its leaders to make the best longer-term decisions to strengthen the industry and firms’ balance sheets.

Perhaps capital markets firms should consider revisiting the concept that launched this industry—the vision of independent, privately held firms whose core business is really promoting the development of capital and applying that capital to business growth—rather than trading on the margin for a millisecond advantage.

For the capital markets industry, 2013 may not be the end of the world, but, instead, a new beginning.
Commercial real estate outlook: Top ten issues in 2013
As the Slow Recovery Continues, Innovation to Drive CRE Growth
Commercial Real Estate Outlook: As the Slow Recovery Continues, Innovation to Drive CRE Growth

This report, the fourteenth in Deloitte’s series on critical issues affecting real estate, examines United States (U.S.) commercial real estate (CRE) market trends and developments, with a focus on potential solutions to help CRE players favorably position themselves in the medium-to-long term future.

Specifically, this report examines what we believe are the top ten issues facing U.S. CRE in 2013, and how innovation can drive industry growth during this period of slowed CRE recovery.

The top ten issues for commercial real estate in 2013 are:
1. Macroeconomic Fundamentals
2. CRE Fundamentals
3. CRE Lending
4. Real Estate Investment Trusts (REITs) and Private Equity Real Estate (PERE)
5. CRE Deal Flow
6. Single-family Homes
7. Globalization of CRE
8. Sustainability
9. Technology
10. Analytics
Executive Summary
The U.S. CRE recovery, although slow, has been visible in improved fundamentals, capital availability, asset pricing, and transactions. In fact, REITs as an asset class continues to outperform others, primarily due to higher liquidity and relatively easy access to capital markets. However, the CRE recovery appears to be unsteady, with increased “caution” given the nation’s stalled economic recovery, which is due, in part, to sovereign debt problems and economic stagnation in Europe as well as slowing growth in emerging markets such as China and India. In addition, the minimal development activity taking place does not bode well for long-term growth. Given the limited support from the external environment, CRE players should focus on alternate mechanisms to grow revenues, margins and retain tenants (Figure 1).

Foreclosed single-family homes, which are emerging as an alternate asset class, are increasingly viewed as an investment option to capitalize on the dislocation in the U.S. housing markets. There is also increasing interest in opportunistic acquisitions in select European, Asian and emerging markets in pursuit of growth and diversification of investments.

CRE players may benefit from a continued focus on sustainability, given that it tends to influence investors’ and customers’ commercial property decisions. In addition, CRE stakeholders can navigate these challenging times and prepare for long-term growth by capturing the benefits of technologies such as advanced analytics, cloud computing, social media, and enterprise mobility.

Figure 1: Potential focus areas to drive growth

Source: Deloitte Analysis
Issue One: Macroeconomic Fundamentals

The European economy’s recession, which began in 2Q12, and the 89.0 percent correlation between U.S. and Eurozone economic growth over the past decade,¹ has stunted the United States’ own recovery from recession. In addition, the U.S. economy is plagued by other issues, such as deepening of the liquidity trap, labor market structural problems, lack of new business formation, and deleveraging² by large private sector entities. Hence, continued slow macroeconomic growth (Figure 2) could potentially stem CRE expansion, given that it is dependent on healthy macroeconomic growth.

U.S. GDP grew 1.5 percent in 2Q12, slower than the 1.9 percent growth in 1Q12, though modestly better than expectations. The slow growth is attributed to deceleration in private consumption as consumers increase savings over spending. In addition, new non-U.S. residential investments were sluggish amidst the European slowdown and uncertainty about U.S. fiscal policy pending the outcome of the November Presidential elections.

Outlook: Economist Intelligence Unit estimates GDP growth to average 2.2 percent during 2012-2016.

Unemployment³ continues to act as a drag on the economy (Figure 3). There is a significant drop in the labor force participation rate as workers who are not looking for jobs are not counted among the unemployed: If this rate was at the same level as the beginning of the recession, the unemployment rate would be a full two percentage points higher. Typically, unemployment declines with an increase in job openings. Currently, however, it takes a much higher rate of job openings to drive down unemployment — the shift in this relationship is a reflection of an increased incidence of structural unemployment.

Outlook: Economist Intelligence Unit forecasts the 2012 unemployment rate at 8.1 percent.

Figure 3: Job openings, unemployment, and labor participation rates
The pace of new business creation rapidly declined during 2007-2009 (Figure 4) and has been acting as a serious impediment to employment and economic growth. A part of this dip could be attributed to demographics: a high proportion of an aging population is likely to be risk-averse and, thus, unlikely to start a new business. In addition, increased regulations are potentially preventing risk-taking across businesses.

Figure 4: New business creation


Outlook
Contagion of the European economic crisis and structural problems in the U.S. economy have resulted in slower hiring, weaker consumer sentiment, and reduced new business creation. The Thomson Reuters/University of Michigan index of consumer sentiment increased to 74.3 in July from 72.3 in June. In comparison, the index of consumer expectations decreased to 65.1 from 65.6 during the comparable period. Average consumer confidence in 2012 remains lowest since 1982, primarily due to concerns about fiscal policy. Further, the Conference Board noted that consumer confidence is unlikely to gain any significant momentum in the next few months. The Purchasing Managers Index (PMI) stood at 49.8 percent in July, the second contraction since July 2009 and lower than the average 52.5 percent for the last 12 months, reflecting a slowdown in business activity. A cautionary environment such as this will likely hinder CRE recovery.

Bottom Line
Increased restraint will slow CRE recovery momentum, even though key CRE parameters — fundamentals, transactions, lending — have been on the mend. CRE fundamentals are likely to witness a more modest pace of growth across several property types. However, demand for high-quality properties is expected to remain intact, as investors continue to seek stable and less volatile returns in the current economic environment.
Issue Two: CRE Fundamentals

CRE fundamentals are benefiting from favorable absorption-completion dynamics. Construction activity remains at record lows due to tight underwriting conditions and supply-side adjustments for relatively lower demand for most property types. Rent and vacancy levels are stabilizing across property types, although they lag pre-recession levels (Figures 5 and 6). While this provides a reprieve to landlords, lack of new development activity does not bode well from a long-term growth perspective. In the near-to-medium term, the Eurozone crisis is likely to act as an overhang as tenants across property types demonstrate caution. Hence, CRE stakeholders face uncertainty in sustaining recovery momentum.

Figure 5: National rent growth by property type
Figure 6: National vacancy rate by property type

* Forecasted data from 3Q12
Source: CBRE-EA, 2Q12

<table>
<thead>
<tr>
<th>Apartment</th>
<th>Rent Growth</th>
<th>Vacancy</th>
<th>Net Absorption</th>
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<tbody>
<tr>
<td>The apartment sector is demonstrating strong growth, although the pace of expansion appears to be slowing. This slowdown is reflected in net absorptions, which, despite being positive in 2Q12, declined YoY, due to the increase in development activity. Vacancy levels declined 60 bps YoY to 4.8 percent and effective rent growth increased 80 bps YoY to 5.0 percent. In fact, effective rents are now above pre-recession levels. Tight underwriting standards, high home foreclosures, and stagnant income continue to favor renting and impact home-buying decisions. Thus, apartment demand will likely continue in the medium term, although development activity will likely slow rental growth.</td>
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<table>
<thead>
<tr>
<th>Office</th>
<th>Rent Growth</th>
<th>Vacancy</th>
<th>Net Absorption</th>
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<tbody>
<tr>
<td>Office fundamentals continued to stabilize amid a flight to quality, as vacancy levels decreased 50 bps YoY to 15.7 percent in 2Q12. Rent grew 2.8 percent YoY in 2Q12 compared to flat growth in 2Q11. Given limited development activity, the result of low demand and tight development financing, the office sector posted a net absorption of 12.7 million square feet in 2Q12 compared to 9.0 million square feet in 2Q11. Among major office markets, New York and San Francisco are the strongest, with low vacancies allowing landlords to increase rental rates. In contrast, office markets such as Sacramento and Phoenix, which were significantly affected by the housing crisis, continue to remain the weakest. The sector will likely improve further as the year progresses, although the impact of European uncertainty on U.S. capital markets may act as a damper. While average rents are likely to grow, a more robust recovery is not expected to begin until 2015.</td>
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</table>
Lodging ADR Growth Occupancy RevPAR

Lodging demand continues to remain strong, driven by improved business and leisure travel. In 2Q12, higher occupancy (+3.1 percent YoY to 65.1 percent) and average daily rate (ADR: +4.7 percent YoY to $106.40) led to a 7.9 percent YoY growth in revenue per available room (RevPAR). Both full- and limited-service hotels posted better-than-expected performance. San Francisco (+15.0 percent) and Los Angeles-Long Beach (+14.4 percent YoY) were the strongest markets, with double-digit growth in RevPAR. However, higher room rates will likely impact demand, which may be offset to some extent by limited new supply.

Industrial Rent Growth Vacancy Net Absorption

The industrial space showed modest improvement, as demand for larger buildings outpaced demand for smaller ones. Also, there is an increase in warehouse demand from e-retailers. Rent growth turned positive for the first time since the recession (0.6 percent in 2Q12 versus -2.71 percent in 2Q11) and vacancy improved to 13.2 percent compared to 14.0 percent in 2Q11. However, with Europe accounting for a quarter of U.S. exports, the current recession will likely result in lower exports and impact demand for industrial space. New construction activity remains slow due to low rents and elevated supply, and net absorption was essentially flat YoY at 26.5 million square feet in 2Q12. A modest increase in demand will likely improve vacancy rate and rents.

Retail Rent Growth Vacancy Net Absorption

The improvement in retail real estate fundamentals has moderated as retailers remain wary of uncertain growth in consumer spending. In addition, retailers are cautious about expanding brick and mortar stores as they target consumers through multiple channels due to the continuing growth in online sales. However, store completion is at a record low, which will temper the effect of lower demand to some extent. In fact, net absorptions grew in 2Q12 to 4.1 million square feet compared to a negative 2.2 million in 2Q11. In 2Q12, vacancy declined 20 bps YoY to 13.0 percent. Effective rents declined 1.8 percent YoY, which is substantially better than the 3.7 percent decrease in 2Q11. However, key markets such as New York, Chicago, Boston, and Los Angeles are unlikely to return to pre-recession peak levels in the medium term.

Outlook

CRE fundamentals have improved across all sectors, with flat to positive net absorptions. Most sectors, except the multifamily segment, have low development activity. Leasing activity has improved across most property types. With the macroeconomic environment pointing towards a slow and unsteady recovery, CRE players will have to focus on cost management to survive and grow.

Bottom Line

The key positive in the past year has been an improvement in absorption levels across property types. This has helped alleviate concerns about high vacancy levels. However, rent growth remains soft except for apartments, which implies that tenants still hold bargaining power. Revenue growth for CRE players is unlikely to reach pre-recession levels over the next few years, and construction and delivery of new properties remain minimal. That said, sectors such as apartment and lodging continue to grow strongly. The comparatively slower recovery in the office, industrial, and retail sectors indicates a coming era of reduced expectations and slower growth.
Issue Three: CRE Lending

Increased investor demand, improved fundamentals, and enhanced CRE loan performance continue to drive lending, especially for class-A properties. In 1H12, banks continued to ease underwriting standards and increase commercial mortgage originations, while life insurance companies and government-sponsored entities (GSEs) led overall originations. However, weak CMBS performance, high debt maturities, and concerns over stricter provisions under the Dodd-Frank Act and Basel III continue to pose risks for CRE debt markets.

CRE loan originations rise; moderate growth expected through 2013

Commercial mortgage originations grew 64.0 percent YoY to $195.0 billion in 2011 and continue to rise in 2012 (the MBA origination index grew 25.0 percent YoY in 2Q12), as life insurance companies, government agencies, and banks compete for CRE loans, especially for core properties. Among property types, the retail sector reported the highest growth in mortgage originations — 56.0 percent YoY in 2Q12 (index value of 253.0 in 2Q12 versus 162.0 in 2Q11) — followed by hotel properties. In contrast, CMBS recovery has continued to slow since 2H11, driven by the sovereign debt crisis and increased economic uncertainty: Issuance grew just 6.8 percent YoY in 1H12 compared to 605.7 percent in 1H11. There continues to be significant bifurcation in the market, as well-located and leased properties have strong access to debt capital, while other properties find it difficult to source financing. The Mortgage Bankers Association (MBA) expects commercial mortgage originations to increase by 6.6 percent YoY to $244.0 billion through 2013.

Credit standards ease slightly; lenders focus on permanent resolutions

According to the Federal Reserve’s 3Q12 Senior Loan Officer Opinion Survey, there was a net 10.9 percent decline in “Domestic Respondents Tightening Standards for CRE Loans,” which illustrates continued easing of banks’ credit standards. In addition, lenders are focusing on permanent resolutions of distressed loans versus modifications/extensions, driven by higher commercial property prices, and increased refinancing options. For instance, between 2Q11 and 2Q12, nearly 78.5 percent of the total distress workouts (or $47.7 billion) were resolutions; the remaining were restructurings (Figure 7). That said, credit conditions remain strict for the broader CRE market (including construction loans), despite easing in the last five quarters for prime properties.

Figure 7: Loan resolution vs. restructuring

Note: Data pertains to a trailing 12-month total
Source: Real Capital Analytics (RCA), August 2012
Bank loan delinquencies decline; CMBS performance and looming maturities remain a concern

The increase in loan workouts and improved property fundamentals has decreased CRE loan delinquencies at commercial banks — 5.0 percent in 2Q12 compared to 7.1 percent in 2Q11. However, slower recovery in non-prime markets provides significant challenges for the $1.7 trillion in CRE debt maturities due between 2012 and 2016. Of the debt maturing through 2016, 29.0 percent is estimated to be “underwater.” In addition, high CMBS delinquencies (9.0 percent as of 2Q12) remain a concern.

Figure 8: CRE debt maturities by lender type

Outlook

Prospects for a broad CRE market recovery are being delayed due to tepid CMBS issuance and increased caution towards loan originations and refinancing for “non-trophy” assets in secondary and tertiary markets. In addition, Dodd-Frank Act and Basel III provisions on enhanced risk-retention requirements for CMBS and higher capital charges on bank CRE loans will lead to increased origination and securitization costs and stricter eligibility criteria — factors that may limit lending, increase debt cost, and result in a financing gap in the U.S. CRE markets.

Bottom Line

While increasing bank leniency and improved fundamentals have helped revive the CRE market, the high level of maturing debt remains a significant barrier to recovery. However, lenders’ focus on permanent loan resolutions through pre-foreclosure sales will likely provide opportunities for investors to acquire overleveraged properties at attractive prices.

1 Trepp, LLC changed the underlying index used for calculation of underwater loans. Consequently, since August, the number has reduced significantly compared to 65.0 percent reported until July.
**Issue Four: REITs and PERE**

REITs have been strong performers in the CRE recovery, given their easier access to capital, high acquisition activity, and superior investment returns compared to traditional asset classes. However, PERE has had a comparatively slower recovery as investors remained on the sidelines during an uncertain macroeconomic scenario and delayed private equity (PE) exits.

**Robust fundraising and investments by REITs; relatively modest by PERE**

REITs continue to take advantage of easier access to capital as leverage (reduced to 35.6 percent as of June 2012 from 39.8 percent at the start of 2011\(^2\)) and fundraising return to customary levels (Figure 9). In addition, REITs have utilized the surplus capital for acquisitions (net acquisitions of $7.0 billion in 1H12 vs. $5.3 billion in 1H11).\(^2\) PERE fundraising, though slow (Figure 10), is refocusing on traditional areas such as core and opportunistic strategies, with 46.0 percent and 35.0 percent of investors planning to invest in these funds, respectively, over the next 12 months.\(^2\) While there is ample dry powder — $78.5 billion\(^2\) — to target U.S. CRE investments, PERE capital deployment continues to be slow due to uncertainty about current economic conditions.\(^2\)

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**Figure 9: U.S. REIT fundraising**

* YTD represents data through August 2012
Source: NAREIT, September 2012

**Figure 10: U.S. PERE fundraising**

Source: Preqin, September 2012
REITs outperform most competing asset classes; PERE continue to underperform

Public REITs continue to outperform other asset classes (Figure 11) with returns of 20.4 percent\(^{ii}\) in 2012 YTD,\(^{i}\) as investors seek portfolio diversification and superior inflation-hedged returns. In 2011, PERE funds posted an average internal rate of return\(^{iii}\) (IRR) of 12.1 percent, in comparison to 15.5 percent in 2010.\(^{iv}\) During the pre-recession period, PERE funds reported an average IRR of 21.7 percent during the period 2003 to 2007.\(^{v}\)

**Figure 11: Comparative performance by asset class**

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
<th>FY10</th>
<th>FY11</th>
<th>FY12 YTD*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public REIT (All REIT Index)</td>
<td>-17.8</td>
<td>-37.3</td>
<td>27.5</td>
<td>27.6</td>
<td>7.3</td>
<td>20.4</td>
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<tr>
<td>NASDAQ</td>
<td>9.8</td>
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<td>43.9</td>
<td>16.9</td>
<td>-1.8</td>
<td>19.5</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>5.5</td>
<td>-37.0</td>
<td>26.5</td>
<td>15.1</td>
<td>2.1</td>
<td>16.0</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>-1.6</td>
<td>-33.8</td>
<td>27.2</td>
<td>26.9</td>
<td>-4.2</td>
<td>15.2</td>
</tr>
<tr>
<td>DJIA</td>
<td>6.4</td>
<td>-33.8</td>
<td>18.8</td>
<td>11.0</td>
<td>5.5</td>
<td>9.1</td>
</tr>
<tr>
<td>Private Real Estate (NCREIF Property Index)**</td>
<td>15.9</td>
<td>-6.5</td>
<td>-16.9</td>
<td>12.6</td>
<td>14.3</td>
<td>5.3</td>
</tr>
</tbody>
</table>

* YTD is as of September 12, 2012
** NCREIF 2012 data is as of June 30, 2012
Source: NAREIT, September 2012

**Outlook**

REITs’ access to equity and debt capital continues to favorably position them to acquire properties (including distressed) and makes it a compelling asset class from an investment perspective.\(^{vi}\) In addition, PERE investments in secondary and tertiary markets can potentially help to revive the broader CRE market. However, given the minimal development activity and the expected slowdown in operating fundamentals, sustained outperformance may be challenged. REITs and PERE may be increasingly drawn to invest in Asia, selected European and other emerging markets in search of growth and higher returns.

**Bottom Line**

REITs have been one of the drivers of prime property transactions over the past few years, given their relatively easier access to capital. However, given rising business complexity, REIT growth prospects depend on higher rental income and operational optimization. Investments in technology and business initiatives (see Issues 8-10) such as sustainability, enterprise mobility, and analytics will be important for REITs’ long-term growth prospects.
**Issue Five: CRE Deal Flow**

Transaction activity has been a bright spot in the CRE recovery process, driven by REITs and distressed deals. However, CRE deal flow appears to be decelerating due to overall slowed economic growth.

**Transaction activity grows, albeit at a measured pace**

Transaction growth appears to be flattening in the first half of 2012 (Figure 12) due to global economic uncertainty: 3.7 percent YoY growth in 1H12 followed a strong 130.7 percent YoY growth in 1H11. However, an encouraging trend is increased investor interest in secondary and tertiary markets, even as there is high competition for trophy assets in gateway markets. In terms of investor class, REITs and institutional funds continue to drive investment recovery, with net positive acquisitions of $7.0 billion and $0.4 billion, respectively, in 1H12 (Figure 13).

Figure 12: U.S. CRE deal volume by property type

* YTD represents data through July 2012
Source: RCA, September 2012

Figure 13: Net CRE acquisitions by investor type

*FY12 is through 2Q12
Source: RCA, July 2012
CRE prices stabilize
Commercial property prices have increased modestly over the past 12 months, with a 5.2 percent YoY increase in the Green Street Advisors Commercial Property Price Index (CPPI) in August 2012 (Figure 14), as investors’ improved access to capital and the relatively low cost of debt financing got tempered by economic concerns.32 Nonetheless, compared to other investment options, property yields remain attractive in an extended period of low interest rates.

Figure 14: Green Street Advisors Commercial Property Price Index (CPPI)

Distressed property sales decline
Distressed-driven sales declined 18.9 percent YoY to $14.9 billion through July 2012 and comprised 11.2 percent of total U.S. CRE sales, down from 12.5 percent during the same period last year (Figure 15). Distressed assets have likely peaked, as troubled assets stood at their lowest level since 3Q09 and net new additions to distressed inventory, after adjusting for loan workouts, fell for the fifth consecutive quarter in 2Q12. However, distressed property sales will continue to be a key transaction driver, as nearly $169.9 billion of distressed assets remain.33

Figure 15: Distressed-driven CRE sales volume

* YTD represents data through July 2012
Source: RCA, September 2012
**Outlook**
CRE transaction activity is likely to grow at a slower pace due to continued economic uncertainty. With easier access to capital, REITs will likely dominate transaction activity in the medium term, albeit with increased competition from investors such as institutions and equity funds. In addition, distressed assets will continue to be an important transaction catalyst in the next 12 months, as lenders seek to permanently resolve troubled mortgages.

**Bottom Line**
A broad-based transaction market recovery may be protracted as conduit lending, which investors depend on to finance non-trophy assets in tertiary markets, is yet to see a meaningful recovery. In addition, macroeconomic and regulatory concerns will influence near-to-medium term deal flow.
Issue Six: Single-family Homes
The single-family homes market continues to slowly improve, with low but relatively stable prices and home equity value, choppy sales, moderate supply, foreclosures, and limited mortgage financing options. Most of the government’s efforts to stimulate the residential sector have failed to deliver the intended results. However, the recent initiative aimed at encouraging private investor participation to clear the glut of foreclosed homes has generated investor interest.

Residential real estate sector is on the mend
The residential real estate market is demonstrating mixed trends, but appears to be on the mend. The S&P/Case-Shiller Index (national composite) rose 1.1 percent YoY and 2.2 percent QoQ (seasonally adjusted) in 2Q12, due to low inventory and seasonality. As of June, home prices for cities that constitute the 10-city and 20-city indices are back to summer 2003 levels, which is a positive indicator for the housing market. According to Pulsenomics LLC, home prices will likely show an average cumulative appreciation of 3.5 percent by the end of 2014 and 10.2 percent by the end of 2016.34 (Figure 16). Sales of new single-family houses grew 3.6 percent MoM in July to a seasonally adjusted annual rate of 372,000.35 Existing-home sales increased 2.3 percent MoM and 10.4 percent YoY to a seasonally adjusted rate of 4.5 million in July.36 Distressed homes accounted for 24.0 percent of July sales, one percentage point lower on a MoM basis.37 That said, total housing inventory increased 1.3 percent MoM to 2.4 million homes in July and represents a 6.4 months supply compared to 6.5 months in the prior month.38

Figure 16: Home prices

According to Pulsenomics, signals of a bottom and an upturn are imminent, with 3.5 percent cumulative appreciation in U.S. home prices predicted for FY12 – FY14, and 10.2 percent for FY12 – FY16.

Figure 17: Existing home sales

Source: Standard & Poor, August 2012; Pulsenomics, June 2012

Home Price Expectations Survey

Note: Home Sales are at Seasonally Adjusted Annual Rate (SAAR)
Source: National Association of Realtors (NAR), August 2012
Foreclosed homes emerging as the new asset class
As of June 2012, the foreclosed pipeline included about 1.5 million homes, although new foreclosures declined approximately 4.0 percent MoM. While the pace of new foreclosures has slowed, there remains a large inventory of distressed homes. Since the beginning of the housing crisis, the results of most government efforts, such as the Home Affordable Refinance Program (HARP), which allows refinancing options to borrowers, were below expectations. In its most recent initiative, the government (FHFA/Fannie Mae) has invited bids from private players to acquire singlefamily foreclosed homes classified as real estate-owned or REO (about 180,000 total as of 1Q12), with the intent to eventually rent these homes to renters. The current effort, which is in its pilot stage (bids for approximately 2,500 REO homes) has generated significant interest and is being compared to the Resolution Trust Corporation of the 1980s. In fact, participants are considering the option of buy-to-rent or buy-to-securitize-and-rent. Banks are open to the sale of distressed homes, and are trying to ascertain an efficient execution mechanism. This aside, private equity players and homebuilders, individually or as a consortium, are buying foreclosed homes with the intent to rent. In summary, several efforts are being made to "institutionalize" foreclosed homes and cash in on the new "asset" class. However, price discovery of distressed homes may act as an impediment to the success of this program. Further, efficient management of single-family home portfolios is a challenge that must be addressed by investors.

Residential mortgage issuance low amid stringent regulatory and underwriting standards
The residential mortgage market has stabilized into a "new normal" and is yet to demonstrate growth, despite measures such as reorganization of the GSes (Fannie Mae and Freddie Mac) and introduction of alternate finance mechanisms (covered bonds). While mortgage debt levels continue to drop, new non-agency issuances remain at record lows amid low interest rates and stringent underwriting standards. According to the Office of the Comptroller of Currency’s 18th annual underwriting survey, residential real estate loans, including construction, experienced the most tightening in underwriting standards during the 2011-12 survey period. Of the 84 banks surveyed, 29.8 percent continue to tighten underwriting standards; it remains unchanged for 77.3 percent (tightened for several years). Delinquencies (seasonally adjusted) rose sequentially in 1Q12 for residential real estate loans at commercial banks to 10.2 percent from 9.9 percent in 4Q11 but improved YoY from 10.3 percent in 1Q11. Delinquency rate on one-to-four unit residential properties improved to 7.4 percent in 1Q12, down 18 basis points and 92 basis points, sequentially and YoY, respectively. Hence, high residential real estate loan delinquencies at commercial banks continue to pose a risk.

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HARP is designed to help homeowners with underwater mortgages, through reduction of monthly payments or replacement of a riskier loan structure, such as an interest-only mortgage with a cheaper and more stable fixed-rate mortgage.

REO is a class of property owned by a lender—typically a bank, government agency, or government loan insurer—after an unsuccessful sale at a foreclosure auction.
Outlook

Despite several housing-related parameters that show lackluster improvement, home ownership is still a priority, as demonstrated in a 2011 National Association of Realtors (NAR) survey in which 72.0 percent of respondents (renters) favored it over renting compared to 63.0 percent in 2010. Additionally, some markets are beginning to show improvements in transaction activity and modest improvements in pricing, driven by low interest rates and exceptional housing affordability. Apart from government measures, growth in demand for single-family homes will likely be driven by first-time home buyers. Typically, entry-level buyers account for four of 10 purchases; they accounted for 34.0 percent of purchasers in July.\(^43\) Also, there is a shortage of homes in the lower price range, which is stemming opportunities for first-time buyers.\(^44\) Any rise in interest rates may accelerate home buying in the short-term as buyers try to lock-in a low rate. However, banks’ stricter underwriting standards may act as an impediment as financing continues to be an issue, and existing homeowners have been reluctant to purchase larger and more expensive homes due to significant equity losses in their existing homes.

Bottom Line

Distressed single-family homes are a key obstacle to economic growth. The situation is further compounded by stringent underwriting norms for residential real estate loans, resulting in a continued decline in new issuance, despite low interest rates. There appears to be no single solution to address the problem. The market timing and asset selection, the alpha strategies for dealing with distress, have to be crafted state-by-state and city-by-city across the country.
**Issue Seven: Globalization of CRE**

The European economic slowdown continues to cause real estate investors to be cautious and favor Class A properties across the globe. From a regional perspective, relatively high-growth emerging markets such as Brazil and Asia Pacific (APAC) continue to develop and interest foreign investors looking for higher growth and returns.

**Global CRE sales volumes decline**

Global transaction volume declined 23.4 percent YoY to $306.3 billion in 1H12 from $399.7 billion in 1H11, a fall-out of the general economic uncertainty. Asia Pacific continues to lead regions in absolute volume terms in 1H12 at $128.6 billion, although it declined by 34.9 percent YoY. Americas sales volume was $102.3 billion in 1H12 compared to $105.6 billion during the same period last year, a modest decline of 3.2 percent. In fact, Americas region sales as a percentage of global sales have improved consistently and were at 33.4 percent in 1H12 compared to 26.4 percent in 1H11, primarily due to strong performance in Brazil and Canada, and improved U.S. markets (Figure 20).

Among the developed markets, European transaction activity is dominated by the UK, France, and Germany as the recession has led to a substantial flight to quality. Canada continues to generate significant investor interest due to attractive yields and the strength of the Canadian economy. Among the developed APAC markets, Australia continues to rebound thanks to increased investor focus on core properties and Japan is witnessing a modest recovery in transactions after last year’s natural disasters.

Investment activity in key emerging markets remains strong, despite the economies appearing to lose steam due to favorable local supply-demand dynamics. China, considered to be a preferred global CRE investment destination, continues to demonstrate strong growth in rents and capital values, with Shanghai and Beijing leading this marketplace. However, India’s investment activity has slowed due to a deceleration in domestic growth and policy-making. The Middle East and North Africa (MENA) markets continue to be affected by political and social turmoil.

![Figure 20: CRE transaction volume by region](image)

*YTD represents data through 2Q12
Source: RCA, August 2012*
U.S. remains an attractive cross-border CRE investment destination

New capital for investment in CRE globally dropped 9.4 percent YoY to $298.0 billion,\(^4\) attributed to the economic slowdown. The U.S. continues to be the preferred investment destination, with 43.0 percent of capital\(^4\) likely to funnel into the region. Interest in U.S. CRE is validated by a recent Association of Foreign Investors in Real Estate (AFIRE) survey, wherein about 60.0 percent of respondents identified the U.S. as offering the best potential for capital appreciation. Further, over the past decade, cross-border investment in U.S. real estate was approximately 7.8 percent of total U.S. transactions annually, while other investments were made through REITs and co-mingled funds.\(^4\) Canada, Australia, Germany, the UK, and Switzerland have been the largest cross-border investors cumulatively since 2001.\(^4\) Despite economic concerns, the global investor interest in U.S. CRE continues to support the recovery in CRE transaction activity and pricing. In addition, modifications to loosen the Foreign Investment in Real Properties Tax Act (FIRPTA) regulations will likely attract more capital to the U.S. CRE market.

Outlook

Foreign investor interest in the U.S. CRE market may help players partially offset the impact of a domestic slowdown, especially as development activity remains minimal. In addition, cash-rich U.S. CRE players can opportunistically tap international prospects. For instance, the European economies present favorable opportunities (e.g., a high level of activity in France and the UK) to invest in high-quality as well as distressed properties, given that select properties appear attractively priced considering existing market conditions.

Bottom Line

Foreign investment has contributed to the transaction market recovery. While much of this foreign investment has been focused on high-quality properties in major cities and financial districts within the U.S., opportunities exist in secondary and tertiary markets where investments have been traditionally slow. In addition, U.S. real estate investors will increasingly invest overseas as they seek growth and market diversification.
Environmental sustainability performance in real estate is of significant interest to many, as buildings in the U.S. account for nearly 41.0 percent of energy usage, 73.0 percent of electricity consumption, 13.6 percent of potable water usage, and 38.0 percent of greenhouse gas (GHG) emissions. Investors’ and tenants’ property decisions are increasingly influenced by CRE players’ adoption of sustainability initiatives. In addition, local government planning and zoning institutions today expect sustainability considerations to be built into development plans before granting entitlements. It is imperative, therefore, that CRE players understand the business value of sustainability, driven by stakeholder expectations, and follow established frameworks for sustainability reporting and disclosure.

Sustainability initiatives can be a powerful driver for developing innovative processes and operating models if all the risks and opportunities are appropriately considered. It may enable CRE players to reduce operating costs, boost revenues, mitigate enterprise risk, and build brand value. A recent study on the effect of sustainability initiatives on REITs’ performance established that an increase in portfolio greenness (proportion of green properties to total portfolio) enhances a REIT’s return on assets (ROA), return on equity (ROE), and ratio of funds from operations (FFO) to revenue. In addition, the study established that listed REITs with a higher proportion of green buildings exhibit significantly lower betas, implying superior risk-adjusted returns.

Currently, many CRE players adopt sustainability initiatives on an ad-hoc, project-wise basis; however, to be truly effective, a sustainability strategy should be implemented at the enterprise level, where it can impact social, economic, and environmental issues (Figure 21). In addition, players should increase collaboration among different business units to effectively manage sustainability-related goals at the enterprise level. To successfully implement sustainability initiatives, CRE players should identify strategic opportunities with regards to resource use (energy, water and material use), goals, and key performance indicators. Further, CRE players should adopt appropriate tools and processes that track and monitor the performance, enable comparison against benchmarks, and assist in timely reporting and disclosure to internal and external stakeholders.

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vi According to the US Green Building Council (USGBC), LEED-certified buildings have lower operating costs and provide healthier and safer working environments for occupants. Further, the Energy Star program claims that buildings with the Energy Star label generally consume 35.0 percent less energy and emit 35.0 percent less carbon dioxide than average uncertified buildings.
vii According to research done by Eichholtz et al. (2010) and Fuerst and McAllister (2011), commercial buildings with energy efficiency ratings command significantly higher rents, more stable occupancy rates, and higher prices than otherwise comparable conventional buildings.
viii As per a study by Kok and Jennen (2012), lower levels of energy efficiency and sustainability have been associated with an increased risk of obsolescence.
ix Refers to a building that is environmentally responsible and resource-efficient throughout its life cycle: from siting to design, construction, operation, maintenance, renovation, and demolition.
Outlook
By 2015, an estimated 40.0 to 48.0 percent of new non-residential construction by value will embed sustainable building practices (e.g., USGBC LEED). In addition, the sustainable construction portion of the largest non-residential retrofit and renovation activity will more than triple, growing to 25.0 to 33.0 percent of the activity by value. Embedding sustainable building practices into CRE strategies, in addition to measuring and communicating performance, can enhance brand value. Also, quantifying and verifying sustainability performance will become increasingly important as external reporting standards continue to be developed.

Bottom Line
Energy price volatility, increased water scarcity, concerns over GHG emissions, higher adoption of "green" building materials (low toxicity materials) and the costs associated with solid waste pose a high risk and need to be effectively managed by CRE players. Since many players are still in nascent stages of implementing sustainability initiatives, opportunities exist to enhance operating returns by investing in sustainable building and property management practices. Players that take a leadership role and build a long-term sustainability strategy will likely gain a competitive advantage by creating tangible and intangible (brand) value.
Historically, CRE players have lagged other industries in technology adoption and innovation, focusing instead on core operations such as leasing and development. However, since the recession, the industry has had a protracted recovery in line with the broader economy, with fundamentals yet to bounce back to pre-recession levels and minimal development activity. In addition, CRE players are challenged by changing tenant demands corresponding to the latter’s adoption of technologies such as cloud computing, social media, analytics, and mobile applications (apps). The use of commercial real estate has also changed significantly due to new technologies, and CRE has been impacted by online commerce, alternative work place strategies, virtual meetings and advancements in logistics. CRE players need to adapt to changing business conditions by leveraging these and other information technologies (IT) to increase functional integration across the enterprise.

Cloud Computing

Cloud computing is a term for delivering hosted services (infrastructure, platform, software) over the Internet. A cloud service is sold on demand, typically by the minute or the hour: it is elastic — a user can have as much or as little of a service as they want at any given time; and the service is fully managed by the provider. Cloud computing is a disruptive force comparable to the emergence of client/server architectures 25 years ago. It can support CRE stakeholders’ key business objectives and functions because it offers:

- Better operational efficiency, thus lowering overall IT, personnel, and resource costs
- Better control and increased ROI on IT investments
- Improved business agility, e.g., more efficient deployment, greater flexibility and scalability than traditional IT models.

Figure 22: Cloud adoption opportunities across key CRE functions

Source: Deloitte Analysis
Data sensitivity is a key issue when adopting cloud technology. Players in an early stage of adoption may decide to use public cloud systems’ Software as a Service (SaaS) for tertiary functions such as human resources, payroll, sales, and marketing. Subsequently, they could adopt a public-private (hybrid) model and include “core” functions such as finance and accounting, construction and design, asset management, and leasing (Figure 22). Given the investments required for cloud computing, the adoption strategy may differ based on a company’s size. Small and mid-sized CRE players (market cap of less than $5.0 billion) are likely to opt for public clouds, whereas larger players may prefer a hybrid model (Figure 23). The CRE cloud market is anticipated to grow at a CAGR of 25.0 percent through FY15. That said, CRE players will need to overcome security, compliance, and data integration challenges to effectively use cloud computing.

Figure 23: Type of cloud adoption by firm size

Source: Deloitte Analysis

Enterprise Mobility
Mobility is emerging as a game-changer in the CRE industry, with various stakeholders (e.g., consumers, tenants, renters, investors) expecting to interact with each other directly from their mobile devices. This trend comes as no surprise, as consumer interest in smartphones, tablets, video games, and embedded apps is growing by the day. Companies big and small, across virtually every industry, are clamoring to unlock the potential of mobility in their business. The trend is validated by estimates such as the apps market’s expected growth to more than $2.0 billion by 2012. Further, about two-thirds of all U.S. consumers will likely own a smartphone and half intend to own a tablet by 2013.

Mobility in CRE can help to enhance the customer experience via convenience, flexibility, better information availability, and speed to market (Figure 24). Sales and marketing, and tenant servicing are the primary drivers of mobility adoption, with increased brand value the inherent goal. Industry players could start with vendor-purchased apps and eventually develop an enterprise mobility network. However, overall success will be driven by back-end automation and players’ ability to navigate challenges around scalability, security, reliability, maintainability, flexibility, and integration.
Social Media

According to a recent study, more than 84.0 percent of all real estate professionals use social media, with Facebook being their preferred website. Combining the use of social computing tools such as Yammer, Chatter and Jive with established communication channels such as face-to-face interactions, email, phone calls, intranets, and mass media advertising can greatly expand a CRE company’s touch points while also helping to develop insights based on people’s behavior and relationships and supplementing the enterprise’s traditional view of markets and employees.

Typically, CRE players use social media to improve tenant engagement, lead generation, sales (new and repeat), and brand-building. Internally, effective use of social media improves collaboration across departments and mitigates information silos (Figure 24). Applicability and adoption of social media within CRE is likely to differ based on property type. For instance, retail real estate players should immediately embrace social media, given that their tenants deal with wired consumers. In the residential segment, a recent study revealed that 73.0 percent of homeowners prefer realtors who promote their offerings through video, but only 12.0 percent of the RE industry currently uses YouTube. It appears as though there is both a need and opportunity for real estate players to use video to promote their services. However, success of a social media strategy will require CRE companies to address security, privacy, and integration issues.

Outlook

CRE players can use information technologies as strategic tools to drive improvements across the enterprise. Cloud computing increases operational efficiency, mobility improves the customer experience, and social media helps CRE firms gather pertinent data around consumer behaviors, which can be further studied through sentiment analysis to derive meaningful insights. However, concerns about security, privacy, and data integration persist across the new wave of technologies.
Bottom Line

As enterprise IT functions become increasingly available via cloud computing services, traditional IT solutions will likely become less competitive. Further, the advent of smartphones and tablets increased consumer demands to be "connected," and the convergence of traditional and new media is likely to spawn a new era in technology-driven communication. CRE players already are playing catch-up to consumers: they should aggressively adopt technological innovations to spur growth and maintain their competitive edge.
Issue Ten: Analytics

Because they will be operating in an uncertain economic environment for the foreseeable future, CRE players will need to concurrently address business challenges, improve operational performance, and effectively manage enterprise risk. This requires:

- Better understanding of tenant business and value drivers
- Effectively managing pricing, operational costs, and capital deployment
- Achieving better visibility into enterprise-level performance metrics
- Increasing access to actionable information and insights to business users across the organization
- Acquiring and retaining the right talent
- Managing large amount of unstructured data flowing through the enterprise and unearthing patterns and insights.

Analytics can help CRE players address these needs by integrating capabilities in data management, statistics, technology, automation, and governance into a potent catalyst for making better and faster decision-making.

Figure 25: Analytics architecture for CRE players

Many CRE players are in the initial stages of implementing analytics (Figure 25) across key operational areas such as leasing, property management, budgeting, and tenant servicing. By property type, we believe that retail and multifamily are likely to lead analytics adoption, due to their need to analyze complex consumer data. Analytics can positively impact performance across a number of focus areas, with risk and finance the top analytics domains (Figure 26). Analytics can facilitate finance transformation by providing accurate and timely reporting on key performance indicators, in-depth analysis of business performance, and robust, forward-looking insights.
However, CRE players need to invest in improving data quality and data governance to reap the benefits of analytics.

Figure 26: Analytics utility across key focus areas for CRE players

**Outlook**

Given the advent of “big data's” increase in sophisticated capabilities to unearth valuable insights, the analytics value proposition is expected to continue to rise. In the medium-to-long term, CRE players will likely move higher in the analytics maturity continuum and adopt predictive and prescriptive analytics in addition to descriptive analytics. Further, the level of analytics implemented will likely be a key differentiator in assessing tenant mix and retention strategies across sub-sectors.

**Bottom Line**

Analytics solutions can process the unstructured data captured from non-traditional sources such as geographical information systems (GIS), social media, mobile communications, emails, and videos. In addition, the analytics delivery model is changing from desktop-based software solutions that operate in silos to more integrated and accessible solutions that use cloud and mobile technologies. CRE players may benefit from leveraging analytics to drive bottom-line growth in the long term, especially as the slow, post-recession recovery lends limited support to topline growth.

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*Big Data refers to enterprise data that is unstructured, generated from non-traditional sources, and/or real-time — in addition to being large in volume.*
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2013 financial services industry outlooks
2013 Property and casualty insurance industry outlook
Poised for sustained growth, but challenges remain
Introduction: Macro- and micro-concerns likely to impact the property and casualty insurance industry in 2013

The economic recovery has been erratic over the past two years, but there have been gains in private sector hiring as well as auto sales, creating millions of new insurable exposures for property and casualty carriers.

Exhibit 1. Economic rebound uncertain, but growth pockets emerging

As the economy goes, so goes the property-casualty insurance industry. And while an economic recovery has been underway in the United States for quite some time, thus expanding the available pool of insurable exposures, we still have a ways to go to recover the jobs and regenerate the business activity that was lost following the 2008 financial contraction.

Over the past year, economic growth has been slow and unsteady. At the same time, low interest rates have undercut investment income and pressured carriers to raise rates to compensate, but not so high as to forfeit market share. Catastrophe losses, most recently courtesy of “Superstorm” Sandy, continue to depress the balance sheets of a number of carriers.

The industry’s growth prospects are further hindered by events outside the country, which threaten to undermine or perhaps even derail the fragile U.S. recovery. In the Eurozone, the possibility of a full-fledged financial crisis remains. Although European policymakers have taken steps to curtail the risk of a sovereign debt default, lingering concern over the fate of the Greek and Spanish economies is keeping the region and the world on edge.

In addition, growth rates are slowing down for the world’s biggest trading partner, China, as well as other developing markets, which could further exacerbate sluggishness in the U.S. and global economies.
Still, there are significant signs of improvement in the U.S. economy. Private sector rehiring, gains in the automobile and housing markets, and expansion of domestic energy production and manufacturing are among the macro-trends likely to instill more confidence in the economy and spur stronger growth in insurance sales.

However, insurers need to be prepared to deal with a “two-steps forward, one-step back” type of economic recovery. To adapt to this “new normal,” there are actions carriers can take not only to leverage new opportunities emerging in the short term, but to set the stage for longer-range gains, in part by improving their technology and talent base as well as their marketing and distribution capabilities.

In the face of some of the macroeconomic challenges mentioned above, U.S. insurers will have their work cut out for them securing new business while bolstering their bottom lines. Their task might be further complicated by stricter regulations concerning financial disclosure, risk assessment and capital management.

But insurers have options to bolster their ability to overcome many of these obstacles, as outlined below. While there may be much going on in the economy that is outside of the industry’s control, there are proactive steps insurers can take in terms of how they do business so they can better position themselves to adapt to life in a slowly recovering economy.
The list of 10 challenges

As we contemplate the competitive landscape in 2013, senior-level insurance executives are likely to confront a series of interdependent challenges that should be addressed for carriers to thrive in the year ahead and beyond. While many of the issues raised here are not appearing on a list of this sort for the first time, they are likely to play a much larger role in insurer growth over the next 12 months.

We’ve broken the 10 leading challenges for 2013 into four broad categories of concern—financial (how insurers can improve their top- and bottom lines), marketing (how they can more effectively reach and serve clients), management (how they might do a better job running their companies), and regulatory (how they can navigate the changing rules of the game).

There are undoubtedly additional threats and opportunities on the radar of individual carriers, and each year brings its own unforeseen problems to address. But few carriers will be able to avoid this list of 10 challenges, while those that can overcome at least a few of them will be far better positioned to take on whatever other crises emerge in 2013 and through the rest of what could be a turbulent decade indeed.
Financial concerns: How can insurers improve their top- and bottom lines?

P&C insurers can piggyback on growth sectors

Even though the economic recovery is slow and sporadic, property and casualty insurers are poised for top-line growth this year. Unable to depend on investment income due to low interest rates and a volatile securities market, carriers have been paying closer attention to underwriting, often with the support of new and improved predictive analytics, and raising prices for coverage accordingly.

As a result, premiums on average have been rising in the middle-single-digits in both personal and commercial lines, with accommodations made up or down depending on the individual risk. This trend is likely to continue and perhaps gain momentum in 2013, particularly in catastrophe-prone areas of the country, and especially on the East Coast given the impact of massive losses from “Superstorm” Sandy in late October.

At the same time, insurers have benefitted from growth in insurable exposures over the past two years as private employers continue to add workers and as housing and auto sales rebound. The combination of stricter underwriting, higher prices and an expanding exposure base should generate steady premium volume growth for many carriers in 2013.

What’s new for 2013?
The soft market for insurance may be over, but the hardening of the market is likely to remain modest. While premium rates and overall volume are both on track to rise this year, organic growth will not necessarily be quick—or high enough—to satisfy shareholders looking for a greater return on equity in a competitive capital market.

To take growth to the next level and rise above the competition, insurers might have to do more than merely wait for a rising premium tide to lift all boats. Many will test new product lines, explore additional target markets, and consider expanding their distribution channels to reach a wider base of prospects, while also contemplating opportunities for mergers and acquisitions.

Bottom line

Not all states are created equal in terms of economic recovery. With domestic energy production on the rise, those states with oil, gas and coal to exploit are experiencing faster growth and lower unemployment rates than in the rest of the United States.

Meanwhile, certain sectors of the national economy are growing faster than others—such as healthcare, which could see an additional insurable exposure boom as the Patient Protection and Affordable Care Act is fully implemented, bringing tens of millions of new patients into the system.

Outside the country, developing markets such as China, India and Brazil, while losing a bit of steam last year, are still growing at much faster rates than in the U.S. and Europe, while continuing to build a much bigger middle class of insurance prospects.

Carriers that can switch gears to expand in or enter faster-growing states, countries and industry niches will likely have an easier time improving both their top-lines and their profitability.
New combinations likely to emerge with the urge to merge

Organic growth prospects for P&C carriers appear to be improving going into 2013. However, a confluence of challenges, including excess capital in the industry, reduced ability to release reserves, steady but modest organic growth rates, and investor demand for greater returns, point towards a revived insurance merger and acquisition environment as carriers look to more quickly expand market share, distribution capabilities and economies of scale.

A buzz of activity from insurers beginning to shore up internal M&A capabilities indicates potential for a near-term upsurge in deal-making, as insurers may now be tempted to merge or acquire players or lines of business to drive growth in new markets both here and abroad.

What’s new for 2013?
Major transformational deals in the U.S. are less likely than bolt-on acquisitions of additional distribution channels, business lines and geographic outlets, both here and outside the country. However, a rising stock market, improved pricing conditions and pent up demand could prompt P&C insurers looking to broaden their scope to intensify M&A efforts, potentially driving up the volume and value of deals.

 Meanwhile, carriers may see the distribution landscape changing as well, as brokers and agents will remain a hot M&A segment. But there may be fewer potential targets available in the regional and mid-size space, as many have been gobbled up during the flurry of consolidation activity over the past several years.

Bottom line
Difficulties in agreeing to deal terms may continue to be an impediment, although it appears that spreads in valuations have stabilized and are beginning to narrow. While it’s tricky to predict where the capital markets—a noteworthy predictor of M&A activity—will go over the next six-to-12 months, it seems the overall environment is ripe for an acceleration of insurer deals.

It’s time for insurers to proactively rebuild strategic internal M&A capabilities abandoned since the financial crisis. Insurers should create enriched M&A playbooks, rigorous targeting and screening strategies, and readiness studies to position themselves for when deal activity accelerates and targets are identified.

They then should be prepared to effectively integrate acquisitions once they are executed, which can often be a bigger challenge than finding or completing a deal in the first place.
Show me the money: Low interest rates prompt search for alternative investments

There is no respite in the near future for insurance carriers suffering the effects of falling investment yields, as the Federal Reserve has indicated plans to try to hold interest rates at low levels through mid-2015. The resulting diminished investment income impedes the industry’s ability to generate a return on equity that satisfies stakeholders while still providing competitive product rates. In some areas, premium rate increases over the last few quarters have taken up part of the slack, but carriers will likely require new strategies to bolster income from investments and improve their bottom line.

The implication is that carriers will continue to focus on assets that generate higher absolute returns. The drawbacks to this strategy include questions as to whether incrementally improved spreads justify incremental increases in portfolio risks and the potential for higher capital requirements.

At the same time that insurers are struggling to maintain or grow investment income, outside sources of non-traditional capital are boosting investments in the property-casualty insurance business, including hedge funds that are launching new reinsurance firms and the expanding securitization of risk via insurance-linked instruments such as catastrophe bonds.

What’s new for 2013?

Insurers will likely become more aggressive in their quest for higher yields by exploring or increasing investments in various alternative asset classes such as real estate, private equity, developing-country stocks and bonds, hedge funds, commodities, and oil and gas assets. In addition to higher yields, some alternative investments can provide an additional hedge to insurers against low interest rates, due to their negative correlation with traditional investments.

Also on the horizon, particularly for smaller insurers, is the outsourcing of alternative investment management to third-party asset managers, who are more familiar with such asset classes and might offer cost advantages.

Insurers may also further leverage catastrophe bonds and the new reinsurance capacity coming into the market via hedge funds to shed some of their extreme underwriting risks and maintain capital at comfortable levels.

Bottom line

Carriers are likely to look to boost investment yields so they have a better chance of generating their targeted return on equity. Insurers may therefore revisit their strategic asset allocation, including consideration of potential increases in alternative assets to generate higher returns and diversify their investment portfolios.

To determine optimal asset allocation and manage their portfolio risk, carriers are likely to embrace more sophisticated portfolio and risk management strategies. An alternative investment portfolio that optimizes the return within external constraints is critical to boost the bottom line.

To achieve this goal, insurers are expected to seek an acceptable balance between maximizing returns versus assuming additional risk and capital requirements.
Marketing concerns: How can insurers more effectively reach and serve their customers?

Special delivery: The more distribution options, the better
In personal lines, younger auto and homeowners consumers are the most likely to buy direct from carriers, while those in the youngest age segments who bought through agents and brokers are the most skeptical about the value of their intermediaries, according to a survey by Deloitte Research in the summer of 2011. The use of agents, as well as loyalty to intermediaries, rose with the age of respondents.

But given the growing proclivity of younger consumers to do business over the Web, it is no certainty that intermediaries can count on them to behave more like their parents as they mature. This means demand for intermediary services could fall over time, especially if their value is limited to price-shopping and policy-peddling.

Meanwhile, focus groups convened in the summer of 2012 on behalf of Deloitte’s Center for Financial Services found that small-business consumers might be open to buying even standard commercial coverages directly from carriers under certain circumstances—including a reasonably discounted price, more clearly-written policies, and an option for higher-grade “concierge” service. These focus groups made clear that agents and brokers can no longer take it for granted that small-businesses will continue to buy commercial insurance through an intermediary unless they can demonstrate the value they bring beyond marketing a risk and handling minor service issues.

What’s new for 2013?
Even for those carriers committed to selling in whole or in part through an agency distribution force, a reassessment of relationships remains likely, as insurers are increasingly eager to align with the most productive and profitable distribution partners—not only among established distributors, but up-and-coming intermediaries as well given the growing need to replenish an aging agency force.

Thus, more carriers are expected to turn to advanced analytics not just to underwrite policies and settle claims, but to identify performance drivers and industry best practice benchmarks so they partner with agents and brokers showing substantial growth potential.

Meanwhile, additional carriers may look to establish direct-channel options to more effectively reach those currently underserved by the traditional agency distribution system, as well as consumers who prefer to do-it-themselves and deal on their own with a carrier, often online.

Bottom line
No one can afford to take their distribution systems for granted. More insurers are likely to grow bolder in exploring alternative channels to capture greater market share, catering to the needs and preferences of different segments while cutting frictional costs.

More carriers may be challenged to effectively manage multiple platforms and resolve channel conflict while maintaining the customer experience. This trend is likely to grow beyond personal lines, as more commercial insurers consider direct-to-consumer sales initiatives targeting small-business consumers.

However, agents are likely to remain a major source of business for the foreseeable future, especially among those consumers requiring advice and service to navigate more complex personal and commercial exposures. That means those carriers doing business through independent agents should take steps to fortify their distribution team, while some of those selling direct might consider adding an independent agency component to their sales force to reach customers with a different set of needs and service expectations.

1 The Voice of the Personal Lines Consumer: Buyers in the Driver’s Seat, Deloitte Research, 2012
Innovation becomes part of a winning insurer’s DNA

An increasingly commoditized P&C market and intense competition should energize the quest for differentiation, and the conduit to distinction in 2013 is innovation. Insurers looking to pursue organic growth should start thinking more broadly about how to remain relevant with consumers, with the true winners recognizing the coming tidal wave of changing customer expectations and needs.

Insurers should take a deliberate and disciplined approach to nurture ideas that add value to customers. At the same time, they should focus on a portfolio of sustaining and disruptive innovations that challenge the status-quo.

What’s new for 2013?

Insurers are likely to experiment with product design, led by the pioneers in pay-as-you-go telematics. Some will invest in predictive modeling capabilities to conceive new lines of business and products that cover emerging risks. Services can be enriched with mobile and online capabilities that take a customer across the insurance cycle for real-time sales, monitoring and service.

Carriers should begin to benefit from ever more advanced analytics, as they transform existing processes and technology to achieve a 360-degree view of each customer. Those that accomplish this innovative strategy are more likely to realize competitive advantages from cross-selling and subsequently attain the ‘stickiness’ that carriers strive for in customer retention.

Advanced analytics can help micro-targeting of segments and facilitate cross-selling opportunities. It will also significantly improve the accuracy of fraud detection through real-time analysis of structured and unstructured data.

Bottom line

Insurers should focus on becoming more adroit with advanced technology and increasingly sophisticated analytics to vie for competitive advantages in product and service offerings.

Innovation can help insurers target growth opportunities from emerging risks, such as the uncertainties of a globalized supply chain, cyber exposures, political unrest, and in emerging markets where insurance penetration is poised to increase multifold.

In addition, as science fiction begins to morph into reality (and cars literally begin to drive themselves), insurers will have to become more nimble in product design and underwriting. But, keep in mind, innovation often whips up headwinds, from consumer acceptance to new regulations and limits.
Operational concerns: How can insurers do a better job running their companies?

As carriers continue to rely more on mobile technology to improve their productivity in the field, they should make data security a priority as a breach could leave them open to legal liabilities and reputational damage.

Tech to the rescue!
Burdened with legacy systems and business practices, many insurers are struggling to adapt to the accelerating momentum of technology advancements and subsequent shift in consumer behavior and preferences. Consumer expectations are being set by other industries, and as a result the use of smartphones, tablets and computers is now virtually ingrained in society.

Real-time service and convenience is the standard to meet, with speed-to-market a critical concern. Social media and prospects of the next game-changing technology schemes are challenging industry players to consider how to use these vehicles to harvest the growing amount of real-time structured and unstructured data to the long-term benefit of their business.

Predictive modeling and advanced analytics are also becoming more prominent on insurers’ radar, as a prolonged period of low interest rates and subsequent anemic returns highlight a critical mandate for increased underwriting excellence. Predictive modeling capabilities and advanced analytics could be instrumental in a carrier’s quest to differentiate themselves through enhanced customer experience with better policy administration, targeted marketing, pricing, claims servicing, and fraud control.
At the same time, privacy, liability, regulatory, and reputational risk concerns make data security a renewed priority as the increased use of technology opens insurers to a wider range of potential cyber-exposures should a breach occur.

Finally, regulators are demanding greater transparency and oversight through increased reporting and self-disclosures, which will require technology system modernization.

**What’s new for 2013?**

The use of advanced analytics for core underwriting, policy administration, and claims management functions might require significant IT system consolidation. Insurers will likely expand their footprint in the digital world with the use of new technologies such as content analysis, sentiment analysis and digital identity to benefit from changing customer preferences. Others may leverage social media more productively than as a billboard for the company’s brand.

Many carriers are also likely to look to bolster the value proposition offered by their policy administration systems in terms of product innovation, underwriting excellence, business intelligence and analytics, as well as delivery technology.

Cloud computing provides a breakout opportunity to insurers to migrate off legacy core systems, improve operational efficiency, and reassess the validity and relevance of existing business rules. Cloud use may also provide advanced fraud detection capabilities through real-time analysis of structured and unstructured data.

The use of “Big Data,” particularly via telematics, is expected to continue to attract attention, as both personal and commercial line auto insurers expand capabilities in the usage-based insurance model. The critical challenge will be to separate the hype of “Big Data” from its real-world, practical application.

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**Bottom line**

Advances in consumer technology will continue to push the tech demands faced by carriers while shaping customer expectations. Increasingly, a carrier’s technological capabilities create competitive advantages, prompting more insurers to consider disruptive technologies as one way to gain an edge.

Legacy systems will need to be modernized to meet stakeholder expectations. How effectively an insurer integrates technology within each function, and creates business process improvements as a result to enhance the customer experience, is likely to determine the industry’s long-term winners.

Carriers should also look to leverage new technology not just to connect better with consumers on sales, but in service as well, particularly with the demand for 24/7 access and “do it yourself” capabilities becoming table stakes across industries.

However, with each new tech initiative, insurers should carefully reexamine and consider how to fortify their data security systems and put in place rapid response risk management plans in case a breach should occur.
Insurers can improve their recruitment efforts by developing in-depth proficiency profiles that go well beyond basic job descriptions, and then using advanced analytics and predictive models to spot prime candidates for positions requiring specialized skill sets, even from other industries.

**Exhibit 5. Help wanted**


7 **Solving the talent paradox: Switching gears on recruitment and retention**

How is it that while millions of workers are unemployed and eager for a job, many insurers are finding it very difficult to fill critical roles requiring more specialized skills, such as actuaries, underwriters and claims investigators? That paradox can be explained in part by the fact that unemployment among highly-educated individuals is far lower than it is with the population at large, creating stiff competition for the most able job candidates.

This challenge is exacerbated by the fact that a growing number of carriers are losing experienced personnel to retirement because of an aging workforce. At the same time, insurers find themselves in need of more highly-skilled individuals to handle the advanced data analytics and predictive models being deployed throughout their operation, as well as comply with new regulatory and financial reporting requirements, among other emerging personnel needs.

In addition, reputational challenges and a lack of awareness about opportunities in the industry continue to hinder insurer efforts to recruit the best and the brightest out of college and graduate schools.
What’s new for 2013?
Many insurers will likely not be able to fill their personnel needs by placing an online “Help Wanted” ad or recruiting talent from competitors. Instead, they will have to more precisely identify what it takes to get the job done in each critical function so they can proactively and creatively seek out non-traditional candidates through alternative sources.

To fill the personnel gap, insurers should consider refocusing their talent initiatives. To accomplish this, they have to take steps to better understand the background and skill sets required of those in specialized positions, facilitated by the development of in-depth proficiency profiles that go well beyond basic job descriptions.

They also should recognize that employees of various generations, ethnicities and levels of development often have very different outlooks on what they expect and value from their employers, and customize how they approach and motivate each segment.

Bottom line
While insurers need to do a better job recruiting talent both from within the industry and among the most promising graduates, due to the talent paradox they are not going to be able to fill all of their critical roles with external candidates despite the large pool of unemployed workers available. They therefore would be wise to build from within as an equally important priority, focusing their talent retention investment dollars on retraining and moving existing staff into critical, hard-to-fill roles requiring specialized knowledge and skills.

Insurers should also expand their available talent pool by diving deeper into the knowledge base, behaviors and personal attributes required to make their skilled players successful. Such data can be incorporated into predictive models that spot personnel already working at the company as well as at competitors who can assume more valuable roles. In addition, such models can help identify candidates from other industries altogether who could most easily and productively transition to a new career in the insurance industry.

Meanwhile, to attract and retain top talent, carriers should recognize that different segments of employees do not have the same expectations and preferences when it comes to the workplace experience, and respond accordingly.
With catastrophe losses taking big chunks out of the insurance industry’s bottom line, insurers should tap wider data sources to get a better handle on potential exposures, especially in new areas hit more frequently or severely thanks to changing climate patterns.

Herding cats: Global warming puts insurers on the hot seat

The worst draught in years and the widespread devastation caused by “Superstorm” Sandy once again flashed the spotlight on the difficulties in anticipating catastrophe exposures, as well as the wide coverage gap in place due to the unwillingness or inability of many to buy the proper insurance for such contingencies.

Even though claims hitting private crop insurers are heavily reinsured by the federal government, draught-related losses for carriers were likely to total in the billions for 2012. Meanwhile, Sandy ran head on into the New York/New Jersey coastline, causing massive flooding, severe wind damage and widespread power outages that left many areas in the dark for weeks. Tens of billions in claims for auto, homeowners and commercial policyholders for lost property and business interruption could make Sandy the second-highest insured loss, topped only by Hurricane Katrina.
Insured losses from Sandy were expected to be exacerbated because government officials determined the storm not to be of hurricane force when it hit the region, meaning that carriers will not be able to trigger hurricane deductibles to mitigate their exposure.

Unfortunately, this point is moot for many of those who suffered water-related losses during Sandy and its aftermath if they do not have personal or commercial flood insurance. Such uninsured individuals will have to cover much if not all of their repair and replacement costs with their own personal funds, perhaps putting the spotlight on shortcomings in the private insurance sector as well as in federal programs designed to fill the catastrophe gap.

What’s new for 2013?
At a minimum, expect insurers to raise prices for personal and commercial property accounts by a few additional points in disaster-prone areas, particularly if carriers are concerned about their ability to enforce hurricane deductible clauses in their policies. In addition, insurers may choose to mitigate their exposure by limiting the number of policies they write in such regions, putting further pressure on rates by reducing supply.

However, with property-catastrophe prices on the rise and standard carriers perhaps moving to lower their exposure, more non-traditional sources of capital are likely to flood the market, backed by investors willing to take on disaster exposures in return for risk diversification and higher yields during this low interest rate period. Look for the launch of additional permanent capital facilities such as reinsurers backed by hedge funds, as well as the expansion of insurance-linked securities, through the issuance of new cat bonds.

Bottom line
Insurers should tap wider data sources to get a better handle on the potential exposures they face not only in known disaster areas, but in regions where such catastrophes have rarely been seen but where storms may be experienced more frequently or severely due to a changing climate. More advanced data analytics can allow carriers to make sounder judgments when it comes to pricing, risk concentration and ultimately in determining where (and where not) to write business.

The influx of nontraditional capital in the form of hedge funds and cat bonds is expected to bolster capacity and might help take the edge off potentially severe rate hikes. But such sources could turn out to be fickle in the long-term if too many “anomaly”-type disaster losses strike in the United States and globally.

Increased emphasis on improving building codes, revising coastal zoning requirements and delivering a harder sell on the need for flood insurance among a wider group of policyholders would also likely be wise.

But at some point, U.S. insurers might choose to follow the example set by their European counterparts in terms of working to more proactively address the potential impact of climate change by mitigating the causes of global warming, rather than retroactively getting stuck with much of the cleanup and recovery bills.
Regulatory concerns: What should carriers do to keep up with new rules?

“Superstorm” Sandy revealed the quandary facing the property-casualty insurance industry. On one hand, the well-capitalized sector was properly positioned to absorb the losses, and may even benefit in the long run from a hardening market. However, quick intervention on the question of hurricane deductibles embodied a new aggressiveness by state regulators that may hamper insurers’ ability to properly manage risk.

Take New York, for example. That state had allowed hurricane deductibles to encourage insurers to provide coverage in exposed, expensive coastal areas, but promptly invoked what some might have considered a technicality—were insurers to have used it to avoid coverage—to say these deductibles did not apply to Sandy damage. Insurers were also instructed to accept homeowners’ documentation of losses instead of requiring an on-site inspection first before processing claims. New York also imposed a 30-day moratorium on cancelling or terminating homeowners’ and small-business owners’ insurance policies in storm-stricken areas for any reason, including non-payment of premiums.

These actions may raise concerns as to what to expect from regulators if insurers seek to rebalance their risk portfolios by reducing some geographic concentration. The last time this happened in New York, insurers were subject to hearings and media coverage, meaning the price of prudent risk management in 2013 may be some reputational risk.

What’s new for 2013?
Homeowners insurance may not be the sole area of increased reputational risk due to regulatory actions. The Federal Insurance Office is mandated to study the effects of auto insurance availability and affordability on low-income and underserved communities. The National Association of Insurance Commissioners set up a task force and scheduled hearings at its last 2012 meeting to discuss the matter.

Consumer groups have complained about the use of legitimate predictors that may seem unrelated to driving behavior in setting auto rates, and with states like California banning many of these predictors, the door is open for other state regulators to do the same as a consumer protection issue.

Bottom line
“P&C insurers should prepare for continued aggressive consumer protection measures,” said Howard Mills, Director and Chief Advisor of Deloitte LLP’s Insurance Industry Group. “But there are win-wins on the horizon for innovative companies. New collision avoidance technologies in cars, for example, may reduce accidents and leave consumers and regulators calling for rate reductions. Innovative insurers thinking about how to deal with new or improved product sets can open the way for increased customer satisfaction and market growth.”
ERM becomes a differentiator

The basic elements of enterprise risk management (ERM) are solidly in place within many P&C insurance companies. However, with new requirements on the horizon for ORSA (Own Risk and Solvency Assessment), being developed by the National Association of Insurance Commissioners, many carriers may have to scramble to fill gaps to demonstrate an acceptable framework.

The end game is for insurers to more effectively identify, measure, monitor, manage, and report the risks inherent across their operations, while facilitating full integration of ERM into decision-making throughout the organization.

However, apart from regulator pressure, insurers have also begun to recognize the importance of ERM as a tool to differentiate their companies in terms of how proactively they deal with emerging risks in an increasingly complex global exposure environment.

What’s new for 2013?

ERM is likely to see its profile raised at insurance carriers in 2013. As insurers gear up to meet new regulatory requirements, ERM efforts will require a significant investment of time, talent, and resources. Following extensive gap analysis, insurers are expected to make improvements in their data and information management capabilities.

Also on the horizon is a convergence between risk management and strategic decision-making to facilitate the most efficient use of capital. This will likely elevate ERM to top levels of insurance organizations and begin to permeate the DNA of the P&C business. Consequently, the role of Chief Risk Officer will continue to become more prominent and deeply entrenched in strategic planning.

Bottom line

An effective ERM function is an imperative for insurers beyond regulatory mandates coming down the road. It provides top management with a broader view of potential threats and prepares insurers to deal with worst-case scenarios that might arise.

To reach the next level of ERM maturity and fully realize the potential of an integrated risk management function, insurers should upgrade technology and skill sets across the enterprise. Carriers should also recognize this holistic risk management approach as a strategic priority and embrace its principles to more effectively avoid catastrophic exposures, contain costs, and establish competitive advantages.

Moreover, carriers are likely to begin to embed predictive analytics within risk management to get a prospective view of the implications arising from various exposures, and prepare in advance against potential adversity.
It’s relatively easy to identify the challenges facing insurance carriers and their distributors, but it’s a lot harder to determine how an individual insurer should respond. Each course of action has its own risks and rewards, but perhaps the one certainty is that doing nothing is rarely an option. Even carriers that consider themselves successful under their own version of the status quo should evaluate the potential vulnerabilities of their business models in a rapidly evolving economy and insurance marketplace.

For now, senior executives at least should begin assessing how the challenges raised in this report are likely to affect their ability to generate growth and profitability. Each issue is both a threat as well as a potential opportunity, depending on how a particular carrier chooses to address the challenge.

As noted earlier, there is a lot in the world beyond the control of insurers. But risk is their business, and by taking both small and bold risks now to get a better grip on their larger exposures down the line, their stakeholders and customers will likely be better for it.
2013 Life insurance and annuity industry outlook
Considering new directions in a recovering economy
Introduction: Macro issues expected to affect the life insurance and annuities industry in 2013

Perhaps the biggest headwind facing life insurers and annuities providers is the sluggish U.S. economy. While a recovery has been underway for quite some time, it's been slow and unsteady. Meanwhile, low interest rates and an uncertain stock market are making it very difficult for carriers to reliably offer guaranteed rates of return in their policies.

And with millions still out of work or underemployed, and many more focused on repaying mortgage, credit card and student debts, a lot of consumers have shorter-term financial priorities to worry about other than life or annuity protection.

The industry’s growth prospects are further hindered by events outside the country, which threaten to undermine or perhaps even derail the fragile U.S. recovery. In the Eurozone, the possibility of a full-fledged financial crisis remains. Although European policymakers have taken steps to curtail the risk of a sovereign debt default, lingering concern over the fate of the Greek and Spanish economies is keeping the region and the world on edge.

In addition, growth rates are slowing down for the world’s biggest trading partner, China, as well as other developing markets, which could further exacerbate sluggishness in the U.S. and global economies.

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In addition, growth rates are slowing down for the world’s biggest trading partner, China, as well as other developing markets, which could further exacerbate sluggishness in the U.S. and global economies.
Still, there are significant signs of improvement in the U.S. economy. Private sector rehiring, gains in the automobile and housing markets, and expansion of domestic energy production and manufacturing are among the macro-trends likely to instill more confidence in the economy and spur stronger growth in insurance sales.

However, insurers should be prepared to deal with a long period of low interest rates and what might turn out to be a “two-steps forward, one-step back” type of economic recovery. To adapt to this “new normal,” there are actions carriers can take not only to leverage opportunities emerging in the short term but to set the stage for longer-range gains, in part by improving their technology and talent base as well as their marketing and distribution capabilities.

In the face of some of the macroeconomic challenges mentioned above, U.S. insurers will have their work cut out for them in attempting to secure new business while bolstering their bottom lines. Their task might be further complicated by stricter regulations concerning financial disclosure, risk assessment and capital management.

But insurers have options to bolster their ability to overcome many of these obstacles, as outlined below. While there may be much going on in the economy that is outside of the industry’s control, there are proactive steps insurers can take in terms of how they do business so they can better position themselves to change directions and adapt to life in a slowly recovering economy.
The list of 10 challenges

As we contemplate the competitive landscape in 2013, senior-level insurance executives are likely to confront a series of interdependent challenges that should be addressed for carriers to thrive in the year ahead and beyond. While many of the issues raised here are not appearing on a list of this sort for the first time, they are likely to play a much larger role in insurer growth over the next 12 months.

We’ve broken the 10 leading challenges for 2013 into four categories of concern—financial (how insurers can improve their top- and bottom lines), marketing (how they can more effectively reach and serve their clients), management (how they can do a better job running their companies), and regulatory (how they can deal with the changing rules of the game).

There are undoubtedly additional threats and opportunities on the radar of individual carriers, and each year brings its own unforeseen problems to address. But few carriers will be able to avoid this list of 10 challenges, while those that can overcome them and even capitalize on the opportunities that emerge will be far better prepared to take on whatever other crises emerge in 2013 and through the rest of what could be a turbulent decade indeed.
Financial concerns: How can insurers improve their top- and bottom lines?

1. Picking your spots: Making hard decisions about where to compete
With the economy still very much in flux, life insurers and annuity providers will have to run a veritable obstacle course to keep growing while remaining profitable in the year ahead. One of the biggest hurdles is the low interest rate environment, which is forcing carriers to rethink their long-term commitments to policyholders with guaranteed income products. The slow economic recovery is another major challenge, given that many consumers are focused on more immediate concerns such as getting a job, selling their home, or paying off other debts.

These conditions will leave many consumers wary about discretionary spending, making life insurance and annuity growth somewhat problematic as prospects address other, more pressing financial priorities. Carriers must be more focused and creative to grow organically, while some will look to boost their reach and bolster economies of scale via mergers and acquisitions.

What’s new for 2013?
Insurers are expected to put more emphasis into reconfiguring their product mix, policy features and distribution options. The sale of higher-risk, guarantee products will likely be deemphasized by some carriers, while others may exit the market. A number of insurers will look to divest non-core operations to focus capital on more productive lines, while others make strategic acquisitions to provide access to new markets, products or sales channels.

Group life could provide growth opportunities as private employers continue to add new hires to their benefit rolls. In addition, there may be more deals transferring private pension plan obligations to an insurer as part of a massive group annuity contract.

As noted later in this report, health care reform and the expanding retirement savings market could also create new opportunities for life and annuity providers to leverage. The underserved middle-market could be a prime target as well.

And while the U.S. economy struggles to regain its momentum, developing markets in Asia and Latin America might offer attractive complements or substitutes, as these regions are generating above-average levels of economic growth as well as a burgeoning middle class. However, regulatory hurdles and competition with foreign and domestic incumbents present their own sets of challenges that new entrants will have to face.

Bottom line
Some of the biggest gains could be made by those who target “emerging markets” in their own backyard. Indeed, not all U.S. states are created equal when it comes to the pace of economic recovery.

With domestic energy production on the rise, those states with oil, gas and coal to exploit are experiencing faster growth and lower unemployment rates than in the rest of the United States. Carriers that refocus their efforts to capitalize on such geographic differences could ride the wave of more rapidly rebounding markets.
Mergers and acquisitions could change the insurance landscape

With a confluence of challenges likely to inhibit organic growth prospects for life and annuity insurers, it begs the question whether 2013 will be the year that insurance mergers and acquisitions take off to achieve both growth and economies of scale.

Low interest rates and new capital requirements will compel some life insurers to shed unprofitable assets. Moreover, as post-election uncertainty on regulatory reform is now largely past, life insurers may be tempted to invest closely held capital to acquire players or lines of business to drive growth in new markets both here and abroad.

What’s new for 2013?
It is anticipated that life insurer restructuring will move into high gear in the U.S. and globally. With low interest rates and unreliable equity markets undermining investment income and making it difficult to fulfill product guarantees to policyholders, and with higher reserve requirements potentially on the horizon, many carriers may reevaluate which businesses to remain in, and begin to sell non-core or underperforming pieces.

While some insurers will consider buying out potentially unprofitable legacy annuity contracts, others may spin-off annuity businesses. Several large domestic and foreign companies may divest life insurance assets in the U.S. to concentrate on core businesses and regions. Merger or acquisition deals may spring from carrier interest in entering or growing within emerging markets to pursue growth potential that seems more elusive in mature regions.

Bottom line
Difficulties in agreeing on deal terms may continue to be an impediment in the near-term as many life insurers are trading below book value. However, it appears spreads in valuations have stabilized and are beginning to narrow.

While it’s tricky to predict where the capital markets—a noteworthy predictor of M&A activity—will go over the next six-to-12 months, the overall environment appears ripe for an acceleration of deals. Life insurers should reevaluate the profitability of their lines and products, and position to concentrate on strategic, core businesses.
Low yields prompt search for more lucrative investment options

There is no respite in the near future for insurance carriers suffering the effects of falling investment yields, as the Federal Reserve has indicated plans to try to hold interest rates at low levels through mid-2015. The resulting diminished investment income impedes the industry’s ability to generate a return on equity that satisfies stakeholders while still supporting previous rate guarantees to policyholders and providing competitive product rates. While carriers are trying to mitigate the impact of these trends by scaling back on interest-sensitive products as well as reducing guaranteed benefits, such adaptations will likely provide only partial relief, with a corresponding downside risk to earnings. Carriers will also likely require new strategies to bolster income from investments as well as their bottom line.

The implication is that carriers will continue to focus on assets that generate higher absolute returns. The drawbacks to this strategy include questions as to whether incrementally improved spreads justify incremental increases in portfolio risks and the potential for higher capital requirements.

What’s new for 2013?

Insurers will likely become more aggressive in their quest for higher yields by exploring various alternative asset classes such as real estate, private equity, developing-country stocks and bonds, hedge funds, commodities, and oil and gas assets. In addition to higher yields, some alternative investments can provide an additional hedge to insurers against low interest rates, due to their negative correlation with traditional investments.

Also on the horizon, particularly for smaller insurers, is the outsourcing of alternative investment management to third-party asset managers, who are more familiar with such asset classes and might offer cost advantages. At the same time, carriers are expected to continue their efforts to de-risk, by scaling back on guaranteed products, providing offers to surrender annuities with rich living-benefit guarantees, or completely exiting certain life and annuity product lines.

Bottom line

Carriers are likely to look to boost investment yields so they have a better chance of generating their targeted return on equity. Insurers may therefore revisit their strategic asset allocation, including consideration of potential increases in alternative assets to generate higher returns and diversify their investment portfolios.

To achieve this goal, insurers are expected to seek an acceptable balance between maximizing returns versus assuming additional risk and capital requirements. To determine optimal asset allocation and manage their portfolio risk, carriers are likely to embrace more sophisticated portfolio and risk management strategies.
Marketing concerns: How can insurers more effectively reach and serve their customers?

Special delivery: Expanding distribution options

Life insurance and annuity companies face a number of hurdles hindering their ability to reach the uninsured and underinsured markets, with gaps in their distribution models being one of the most challenging.

For example, millions in the middle market either need life insurance (or additional coverage if they already have a basic term policy), yet agents and brokers often find it difficult to economically reach and service such consumers given the lower commissions generated in this segment.

What’s new for 2013?
Carriers looking to overcome challenges reaching the middle market might consider developing or bolstering direct-to-consumer options to supplement their agency distribution system. At the same time, to gain additional market share in the upscale customer segments, carriers selling through independent agents and wholesalers should reassess their intermediary relationships to promote greater productivity and economies of scale going forward.

While exploring new distribution options, carriers will also depend more on advanced analytics not just to underwrite their products, but to identify performance drivers, better value indicators and industry benchmarks for best practices to make certain they are aligned with those agents and brokers with the highest growth potential, both among established as well as up-and-coming intermediaries.

Expanding the net: Bringing new segments into the fold
Business as usual is no longer a prudent or profitable philosophy in the life and annuity sector. Persistently low interest rates and the uncertainty of tax reform’s impact combine with a still struggling economy to create a “perfect storm” for life insurance and annuity (L&A) players.

Insurers looking to pursue organic growth in this environment should start thinking more broadly about how to innovate with products and distribution channels to remain relevant with consumers and penetrate more of the under-served market segments.

What’s new for 2013?
Overcrowding in the mass affluent space will likely prompt many carriers to cast their net down-market, seeking to inexpensively distribute simplified products to previously under-targeted and subsequently underpenetrated low-to-middle market segments.

This will require design of simpler, more flexible, lower-priced products and lower-cost distribution vehicles. Expect insurers to align with retail centers and even health exchanges for ease and convenience that appeal to the low-to-middle market.

Other strategies are likely to include more targeted marketing, expanding use of predictive analytics, sales force diversification, and a greater push to educate the low-middle market on the need for protection products. Some may enhance capabilities to inexpensively tap into this opportunity via the Web through simplified issue.

Bottom Line
Innovation is now an imperative, as insurers are less likely to thrive unless they quickly adapt to the new low-interest rate environment. Penetrating underserved markets may require product remodeling and more cost-effective distribution strategies.

Profitable growth opportunities might also be available for those who employ predictive analytics to customize product design, micro-targeting and marketing efforts. The winners in the “new normal” environment will have to look out of the box and delve into new arenas with innovative strategies that will make the efforts worthwhile.
3

Cracking the code on the retirement income market

Only three out of 10 U.S. consumers feel very secure about having enough savings and income to maintain a comfortable lifestyle when they retire, according to a recent survey conducted on behalf of Deloitte’s Center for Financial Services.

The survey queried nearly 4,500 Americans representing a wide range of income and age groups. It found that the lack of security could be in part because 60% of respondents do not have a formal retirement plan, while many (particularly younger consumers) don’t understand some of the basic products designed to address retirement needs—including life insurance and annuities.

At the same time, the survey found a failure to connect between financial services providers and consumers when it comes to retirement. Only about one-third of the respondents turned to a professional to help advise them on planning their retirement, while six out of 10 said they have not been contacted by any financial institution or intermediary about their retirement savings and income needs.

There are also trust issues to overcome, with three out of 10 respondents saying they don’t trust financial institutions offering guaranteed income to be able to fill their commitment when they retire. One in five don’t trust insurance agents and financial planners to provide objective advice to address their retirement savings and income concerns.

What’s new for 2013?

Financial services institutions in general, and those writing life insurance and annuities in particular, should rethink their approach to gain more trust and generate growth in the retirement savings market.

Educational marketing should be a major component to better explain how the industry’s long-established life insurance and annuity products can serve a multitude of purposes, including retirement income. Affordability concerns also have to be alleviated, as nearly half of those surveyed believe they don’t have enough disposable income to commit to retirement savings.

Bottom line

Life and annuities carriers and their intermediaries should consider taking a more holistic approach to crack the code on the retirement income market. The survey found that while consumers often have a multitude of conflicting financial priorities to address, including retirement, fewer than half tend to think of their retirement savings and income needs as part of an interconnected financial plan.

Therefore, those pitching retirement products and services will likely have to broaden their approach to help clients brace for additional concerns—especially healthcare, given that six out of 10 surveyed said they feared no matter how well they prepare, health and long-term care costs could overwhelm their retirement savings and income goals.
Healthcare reform may shake up life distribution

With implementation of the Patient Protection and Affordable Care Act now assured following the reelection of President Obama, life insurers will need to carefully assess the challenges and opportunities posed by the possibility of life and other protection products being marketed along with health insurance via the new distribution ecosystem of health exchanges and direct-to-consumer outlets.

Such outlets may help life insurers lower distribution costs and better connect with historically underpenetrated low-to-middle income and small-business segments. However, it will require deft maneuvering with new and traditional distribution partners for life carriers to reap those benefits.

What’s new for 2013?

Public health exchanges will come online in preparation for individual and employer mandates going into effect in 2014. Taking advantage of the prohibition preventing public exchanges from selling ancillary products, private exchanges are expected to enhance their value proposition for businesses and individuals seeking one-stop shopping for health and ancillary coverage.

Health plans are poised to gain access to millions of new consumers through these exchanges, along with direct sales and via their agency partners. This potentially puts them at an advantage if they choose to leverage this access to cross-sell life, disability, and accident products.

Life insurers can take advantage of the new opportunities by focusing their core marketing and underwriting strengths on these growth segments. Products might have to be simplified, operating platforms might need to be enhanced to plug and play with new channels, and brand-building may be required to compete effectively for this segment’s business.

Another option for L&A players would be to explore partnering with health insurers to offer their life, disability and accident products. Several carriers are already testing out this strategy, and the trend is anticipated to accelerate.

Developing new hybrid products or revising underwriting and pricing guidelines based on combined analytics and data management capabilities are further avenues for potential partnerships with health plans.

Bottom line

With the uncertainty around health care reform resolved, life insurers should begin now to position themselves to take advantage of emerging cross-selling opportunities as well as ward off potential threats from new competitors.

Simplified, lower-premium products sold through new low-cost channels are likely to have the biggest impact in reaching this emerging market of mostly low-to-middle income consumers. This could be a win-win for life carriers and consumer segments with inadequate health and life coverage.

With millions of consumers prompted to buy health insurance or pay a penalty next year under a new federal mandate, there might be an opportunity to cross-sell life insurance and annuity products via the same channels.
Operational concerns: How can insurers do a better job running their companies?

Solving the talent paradox: Switching focus to internal development

How is it that while millions of workers are unemployed and eager for a job, many insurers are finding it very difficult to fill critical positions requiring more specialized skills, such as underwriters and actuaries? That paradox can be explained in part by the fact that unemployment among highly-educated individuals is far lower than it is with the population at large, creating stiff competition for able job candidates.

This challenge is exacerbated by the fact that a growing number of carriers are losing experienced personnel to retirement because of an aging workforce. At the same time, insurers find themselves in need of more highly-skilled individuals to handle the advanced data analytics and predictive models being deployed throughout their operation, as well as comply with new regulatory and financial reporting requirements, among other emerging personnel needs.

In addition, reputational challenges and a lack of awareness about opportunities in the industry continue to hinder insurer efforts to recruit the best and the brightest out of college and graduate schools.

What’s new for 2013?

Many insurers will likely not be able to fill their personnel needs by placing a “Help Wanted” ad or recruiting talent from competitors. Instead, they will have to more precisely identify what it takes to get the job done in each critical function so they can proactively and creatively seek out non-traditional candidates through alternative sources.

To fill the personnel gap, insurers should refocus their human capital initiatives. To accomplish this, they should take steps to better understand the background and skill sets required of those in specialized positions, facilitated by the development of in-depth proficiency profiles that go well beyond basic job descriptions.

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Insurers may find it tough to fill their most skilled personnel openings with a “Help Wanted” ad, and would be wise to upgrade their internal development programs to better leverage those already on board.

Exhibit 4. Help wanted

U.S. insurance industry critical workforce requirements projection 2008-2018

Tech infrastructure requires regular upgrades
Burdened with legacy systems and business practices, insurers are struggling to adapt to the accelerating momentum of technology advancements and subsequent shift in consumer behavior and preferences. Consumer expectations are being set by other industries, and as a result the use of smartphones, tablets and computers is now virtually ingrained in society, and demand for real-time service and convenience is the standard to meet.

New technology, including the widening use of predictive modeling and advanced analytics, are instrumental in the industry’s quest to enhance the customer experience and speed up the business process to allow placement of new policies in a matter of days or hours rather than weeks.

Meanwhile, industry players are being challenged to consider how to harvest and leverage the boundless supply of real-time structured and unstructured data to the long-term benefit of their business.

At the same time, privacy, liability, regulatory and reputational risk concerns make data security a renewed priority, as the increased use of social media, mobile computing and other technologies opens insurers to a wider range of potential cyber-exposures should their systems be compromised.

Finally, regulators are demanding greater transparency and oversight through increased reporting and self-disclosure, which will require technology system modernization.

What’s new for 2013?
L&D insurers will likely expand their footprint in the digital world with the use of new technologies such as content analysis, social computing, sentiment analysis and digital identity.

Carriers may move to take their customer cycle mobile, from sales through claims, while leveraging social media more productively than merely as a billboard for the company’s brand. Investments in digital technology will meet a need for enhanced customer service, product and service education, and connection with younger generations.
A critical need for advanced analytics is expected to drive more targeted investments around related technology. Insurers will enhance their capabilities for core underwriting and policy administration functions.

Finally, life insurers pursuing product and process simplification strategies will actively evaluate the option of cloud computing. This strategy provides a breakout opportunity for insurers to migrate off their legacy core systems, rationalize products and processes, and reassess the validity and relevance of existing business rules.

**Bottom line**

The insurance industry is fast becoming a technology business, so carriers should deal with business and technology issues under one unified strategy.

Legacy systems should be modernized to support enterprise-wide risk management and shifts in consumer behavior. However, with each new tech initiative, insurers should reexamine and consider how to fortify their data security systems and put in place rapid response risk management plans in case of a breach.
Regulatory concerns: What should insurers do to keep up with new rules?

Regulatory reform: Time to look ahead again

While the reelection of President Obama provided some regulatory certainty in that Dodd-Frank will remain the law of the land, life insurers are still faced with concerns as 2013 dawns, including increased scrutiny by regulators over risk management practices just as continued low interest rates make it even harder to meet desired investment return goals without increasing risk.

Among the top regulatory issues facing life insurers is preparing for full implementation of the Risk Management and Own Risk and Solvency Assessment (RM-ORSA) Model Act, put together by the National Association of Insurance Commissioners. First reports are due in 2015, and getting ready for that first filing may involve changes to a company’s operating model, enterprise risk management system, information technology systems, and its human capital. The positive side for life insurers is that ORSA may help them prepare for and reduce the impact of future economic incidents.

For large and multinational insurers, concerns over the development of the various solvency regimes and their capital impact may still continue, and the impact of the long overdue Federal Insurance Office report on state regulation remains to be seen. But federal legislative concerns, most notably any changes in the tax treatment of life insurers, may assume more importance as Washington searches for ways to reduce the budget deficit.

What’s new for 2013?

Expect to see insurance regulators continuing to look closely at existing practices for possible consumer harm or economic concerns. Chief among these may be the use of captives by life insurers. Some regulators have privately expressed concerns that such captives may not have been used for what they consider legitimate risk transfers, but as a means of moving risk off balance sheets.

Insurers have a number of regulatory challenges ahead, including scrutiny of the use of captives by life carriers.

Exhibit 5. Putting the regulatory puzzle together

Insurers should be prepared to defend these practices as legitimate accounting and risk-transfer measures, and consider how much transparency they may be able to tolerate as the price for regulatory approval.

Bottom line

“Some of the regulatory overhang since the financial crisis is slowly receding,” said Howard Mills, Director and Chief Advisor of Deloitte LLP’s Insurance Industry Group. “Those who will be designated as Systemically Important Financial Institutions should know that in 2013. We know the new normal for risk management requirements. We can expect some continued difficulty in the investing and growth environments, and more regulatory scrutiny of existing practices, as well as the possibility of an active Federal Insurance Office.”
In the Final Analysis...

It’s relatively easy to identify the challenges facing insurance carriers and their distributors, but it’s a lot harder to determine how an individual insurer should respond. Each course of action has its own risks and rewards, but perhaps the one certainty is that doing nothing is rarely an option. Even carriers that consider themselves successful under their own version of the status quo should evaluate the potential vulnerabilities of their business models in a rapidly evolving economy and insurance marketplace.

For now, senior executives at least should begin assessing how the challenges raised in this report might affect their ability to generate growth and profitability. Each issue is both a threat as well as a potential opportunity, depending on how a particular carrier chooses to address the challenge.

As noted earlier, there is a lot going on in the world that is beyond the control of insurers. But risk is their business, and by taking both small and bold risks now to get a better grip on their larger exposures and biggest challenges down the line, their stakeholders and customers will likely be better for it.
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