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A report from the Deloitte Center for Financial Services

2020 banking and capital markets outlook

Fortifying the core for the next wave of disruption

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KEY MESSAGES

- A new wave of disruption more forceful and more pervasive than what we have seen in recent years will likely unfold in the next decade. With this disruption, though, comes endless opportunity.
- The combined effects of technological disruption, sweeping changes to the nature of work, demographic shifts, climate change, and possible Japanification could have serious implications for the banking industry.
- These forces may also change how banking is done. Banking will be more *open, transparent, real-time, intelligent, tailored, secure, seamless*, and *deeply integrated* into consumers' lives and institutional clients' operations.
- But while the way banking is done might change, banks' role will likely not. Despite what happens, banks should remain true to their core identity as financial intermediaries: matching demand with supply of capital.
- As we enter a new decade, banks should also fortify their core foundation on multiple dimensions, including technology infrastructure, data management, talent, and risk management.

Riding the next wave of disruption

A NEW WAVE OF disruption more forceful and more pervasive than what we have seen in recent years will likely unfold in the next decade. While the roots of this disruption—technological, economic, geopolitical, demographic or environmental—may remain the same, the unique convergence of these factors should unleash unprecedented change in the broader society and economy, and, consequently, in the banking industry as well.

Foremost among the drivers of disruption should still be technology. The fusion of current technologies, such as machine learning and blockchain, and emerging ones such as quantum computing, could not only create new opportunities, perhaps greater in scale than ever before, but also engender new risks. Additionally, technology will also radically change work as we know it, as well as who is doing the work, and where it gets done.

Meanwhile, on the economic front, "Japanification"—persistent low growth, low inflation/deflation, and near-zero/negative interest rates—is a real possibility for many advanced economies, particularly in Europe.[1] Whether full-scale Japanification or Japanification-lite happens, it could have material consequences for growth and profitability in the banking industry globally.

Furthermore, fundamental demographic changes across the globe will likely alter growth dynamics significantly. Aging populations in advanced economies as well as emerging countries such as China could stress social, political, and business systems in ways we have not seen before.

And, last but not least, concerns about climate change and social impact will force banks to reprioritize their role in society and sacrifice short-term gains for long-term sustainability.

The combined effects of technological disruption, sweeping changes to the nature of work, demographic shifts, climate change, and possible Japanification could have serious implications for the banking industry. The low-growth scenario, in particular, could result in a drastic reduction in banking capacity, with fewer banks than we have today able to recover their cost of equity. Institutions that lack scale or differentiated capabilities, in most cases, will likely be challenged.

These forces can also change how banking is done. Banking should become more *open, transparent, real-time, intelligent, tailored, secure, seamless*, and *deeply integrated* into consumers' lives and institutional clients' operations.

But while the way banking is done changes, banks' role will likely not. Despite what happens, banks should remain true to their core identity as financial intermediaries: matching demand with supply of capital. Banks' competitive advantages should continue to be their ability to manage risk and complex financial matters, conducting business in a highly regulated market, driving innovation to serve client needs, protecting clients' privacy, and maintaining trust, all at scale. No matter what, banks will remain trusted custodians of customers' assets. This role could include protecting things such as digital identity, heralding a new frontier for banking in the digital age.

And while banking is changing, so, too, could the purpose of banks. Banks will likely increasingly cater to a greater good, placing themselves at the forefront of tackling large socioeconomic issues, such as climate change or social equity.

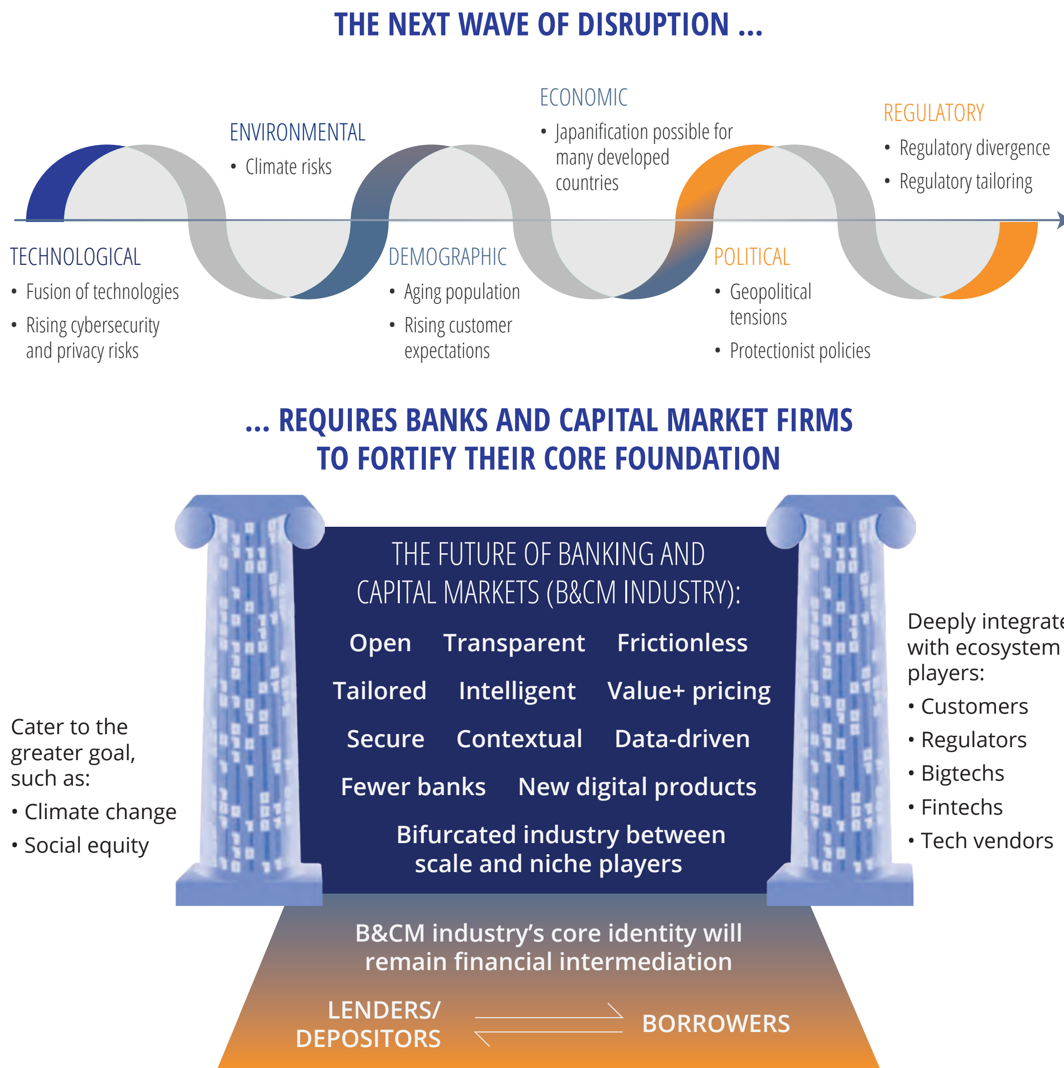
With this disruption, though, comes endless opportunity. As the cusp of the next decade nears, bank leaders should reexamine their aspirations in light of this new reality and fortify their banks' core foundation. Don't let short-termism distract from developing a larger, bolder vision. Instead of shying away from change, leaders should imagine the possibilities for how best to ride this wave of disruption.

What is the current state of the banking industry?

The global banking system continues its positive streak, with profitability increasing to new

FIGURE 1

Fortifying the core for the next wave of disruption



Source: Deloitte Center for Financial Services.

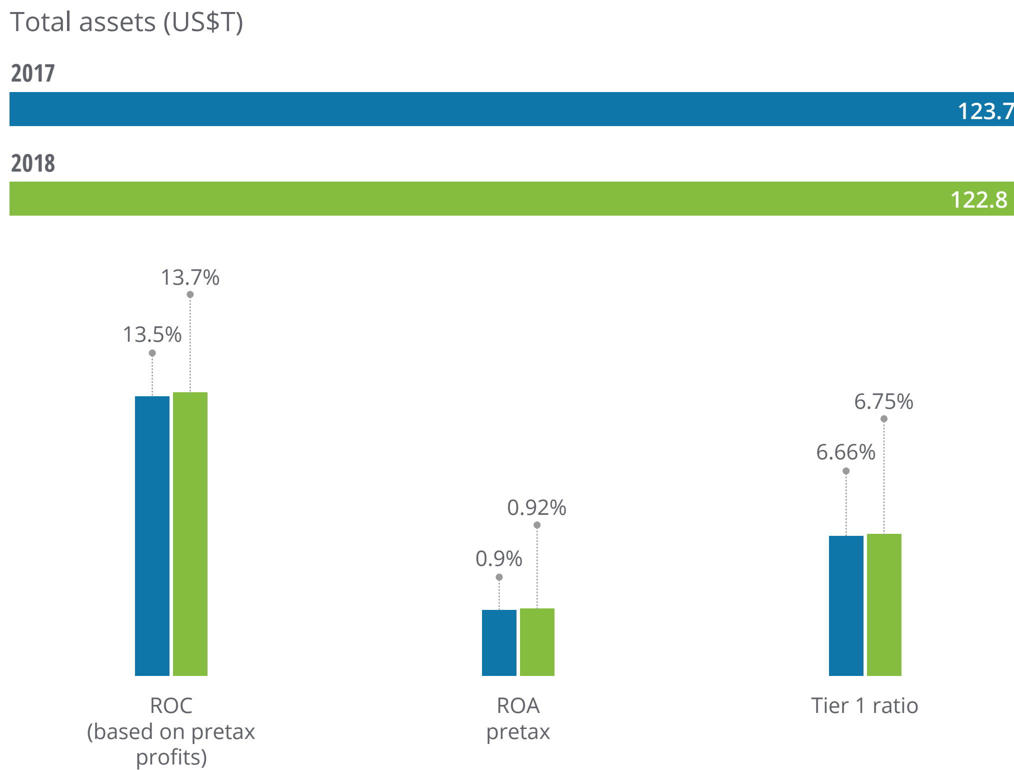
postcrisis levels. According to the *Banker*,[2] return on capital (ROC)[3] as of 2018 was 13.7 percent, higher than 13.5 percent at the end of 2017.[4] However, the industry still has not found its way back to sustainable profitability levels, with return on equity (ROE) of 9.6 percent being below the 12 percent mark often associated with banks' cost of capital.[5] Global assets declined to US$122.8 trillion, mainly due to the disposal of noncore assets by European banks (figure 2). On the positive side, the state of banks globally has again become more resilient, with the tier 1 ratio edging to 6.75 percent, up from 6.66 percent in 2017.

The US banking industry has shown modest improvement in most areas and remains strong. ROC stood at 18 percent, supported by a strong return of assets (ROA) of 1.5 percent. Total assets were US$16.5 trillion, up by 3 percent from the previous year.[6] Tax cuts and higher federal funds rates (until mid-2019) were significant contributors to increased profits. Consumer borrowing has surpassed levels last seen before the financial crisis.[7]

Similarly, Canadian banks grew total assets by an impressive 11.2 percent year over year to US$4.7 trillion, mainly driven by mortgages, and loans to both individuals and businesses.[8] However, profit margins have declined, and loan loss provisioning rates have crept up due to fading macroeconomic conditions.[9]

FIGURE 2

State of the global banking system: Top 1,000 banks



Source: "Top 1000 Banks 2019," *Banker*.

In contrast, many European banks are still preoccupied with rationalizing their businesses and are working toward achieving the profitability levels of other regions. ROC stood at a meager 10.2 percent in 2018,[10] unchanged year on year, despite an improvement in nonperforming loans and higher profits by southern European banks. Pervasive challenges included a structurally lower net interest margin (NIM) due to the continually fragmented European market and oversaturation of banks in key markets, such as Germany. Near-zero and negative central bank interest rates also did not help the cause. Total assets have remained steady at around US$25.8 trillion.[11]

The story in Asia is mixed, with Chinese banks generally continuing to get bigger. The top four largest banks globally this year were again Chinese.[12] Meanwhile, Japanese banks have been unable to escape systemic growth concerns stemming from low growth and its aging population. ROC was 5.8 percent, while ROA was 0.31 percent, which was predominantly due to the low rates/low-growth environment.[13] Assets decreased by 3 percent to US$13.1 trillion. However, ROC for China was strong at 14.4 percent,[14] though below last year's 15.6 percent.[15] The US-China tariff dispute appears to have weighed on asset growth, which, among other factors, has dampened the global economic outlook.

Meanwhile, Australian banks increased lending by 4.7 percent to $US1.8 trillion by the end of 2018, driven by growth in the owner-occupied housing market.[16] Going forward, the picture looks less gloomy; margins will likely come under pressure as competition in the oligopolistic retail banking sector increases, as the banking market is encouraged to be more competitive by the Australian Competition and Consumer Commission (ACCC).[17]

What to expect in 2020?

In the United States, unemployment has hit a record low and inflation is under check, but signs of a potential downturn are looming: The yield curve[18] inverted for the first time since 2007. Deloitte economists forecast the probability of a US recession in the coming year at 25 percent,[19] similar to last year. Most other G-7 countries, such as Japan, Germany, Italy, and the United Kingdom, are in a similar situation or worse. Globally, the IMF has forecasted slower worldwide GDP growth of 3 percent in 2019, with no region unaffected (figure 3).

Equally concerning is central banks' limited repertoire of monetary tools; rates are either at historically low levels or bordering on/in negative territory in key regions around the world.[20] The recent move by the European Central Bank (ECB) to cut rates and reinstate quantitative easing could stir growth, but if it doesn't, it could result in more pain.

On the regulatory front, global regulatory fragmentation continues to be a reality. Institutions now must contend with numerous requirements that are often unfinalized or under revision.

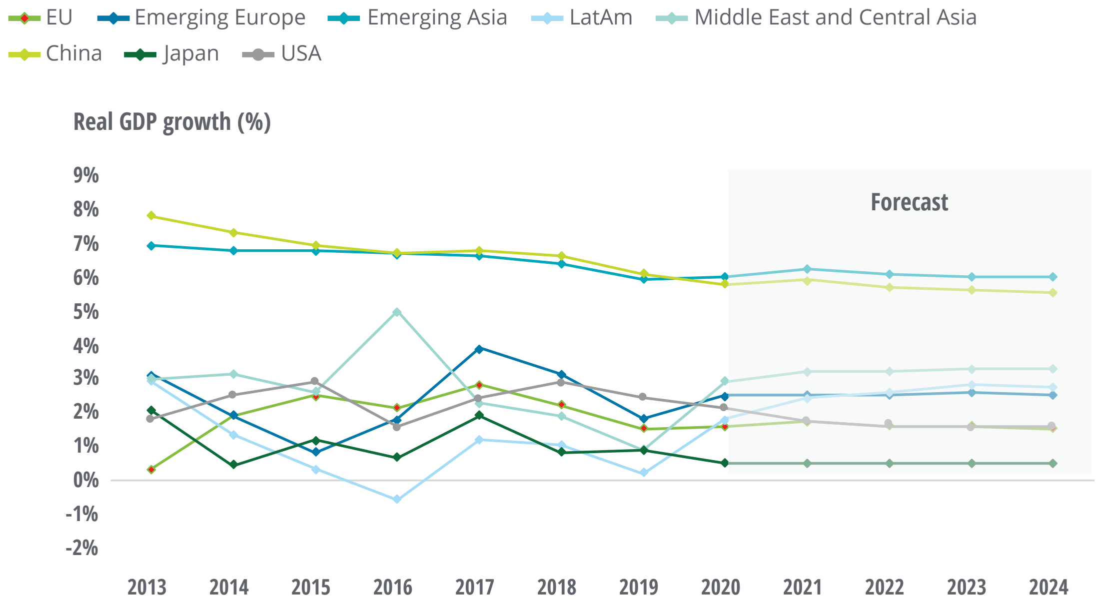
And, of course, potential risks from geopolitical tensions, such as Brexit or the ongoing trade wars, warrant constant attention.

How should banks prepare for the next decade?

Anticipating the wave of disruptions over the next decade, bank leaders should reimagine the possibilities for how banking is done with big, bold ideas. By hyperscaling their transformation and

FIGURE 3

Real GDP growth forecasts in different regions



Source: International Monetary Fund (IMF).[21]

actively engaging with the ecosystem, new partnerships and alliances can become imperatives for change. But in this drive for change, leaders should also focus on the important mission of social responsibility.

Last year, we urged banks to reimagine transformation as a multiyear process and "change how they change." This message, of course, is still relevant, but as we enter a new decade, banks should also fortify their core foundation on multiple dimensions, including technology infrastructure, data management, talent, and risk management.

On the technology side, banks continue to face pervasive challenges. One is *technical debt*, or the lack of legacy system modernization, which is a huge impediment to transformation. Another is the sorry state of data, which can prevent banks from realizing the full potential of investments in new technologies. High-quality, easily accessible data, the necessary fuel for any technology solution, is still not widespread. Many banks are still struggling with how best to tackle these challenges. We urge the banking industry to go *back to basics*: Fix the data problem before undertaking radical technology transformation and slowly chip away at technical debt via core modernization.

In this report, we offer perspectives on what to expect in 2020 and beyond across seven primary business segments: *retail banking*, *payments*, *wealth management*, *investment banking*, *transaction banking*, *corporate banking*, and *market infrastructure*. We also lay out our expectations across a few domains—*regulatory*, *technology*, *risk*, and *talent* (figure 4).

FIGURE 4

An overview of the 2020 banking and capital markets outlook

Source: Deloitte Center for Financial Services.

Regulations

Complex as ever

LAST YEAR, WE noted a divergence in global regulatory standards, as many countries looking for ways to spur economic growth bucked the previous trend of postcrisis synchronization. In 2019, global regulatory fragmentation continues to be a reality, and financial institutions are now contending with numerous—often unfinalized—requirements with implications that have yet to be fully realized.

In the United States, there are multiple "tailoring" efforts underway to evaluate, streamline, and modify regulations based on the size and complexity of operations.[22] Notably, regulatory agencies are pushing for a focused, tailored approach to new rule-making, issuing "supervisory guidance" and tailoring past regulatory requirements. At the same time, they are looking ahead to new risks—such as LIBOR (London Interbank Offered Rate) transition, business resiliency, and technological change and innovation.

The US Federal Reserve Board ("the Fed") is tailoring a proposal to implement the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), which would ensure that stringent requirements for the largest financial institutions are in place but are scaled back for those that fall below the legislative threshold.[23] Additionally, tailoring the EGRRCPA would provide some relief to foreign banking organizations below certain thresholds.[24] These proposals together are expected by year-end 2019.

The EGRRCPA also includes an amendment to the Volcker Rule. Its planned relaxation (Volcker 2.0), in January 2020, would lift trading restrictions for midsize banks and ease compliance for larger banks.[25] While the change should not greatly impact bank trading volumes, it will likely reduce banks' compliance challenges.[26]

Numerous changes to the capital and stress testing framework are also underway. The Fed issued

amendments to its capital planning framework Comprehensive Capital Analysis and Review (CCAR) and the Dodd-Frank Annual Stress Testing (DFAST), which should improve the design framework and boost the transparency of both.[27]

Additionally, attempts to reform Fannie Mae and Freddie Mac are likely to gather speed.[28] The US Treasury Department's initial proposal seeks to privatize the entities, loosening the government's influence on residential mortgage lending over time.

Nonfinancial risks are also top of mind for regulators, as their consequences become more apparent across cybersecurity, business resiliency, compliance, operational risk, data governance, and data quality. To address fiduciary responsibility, the US Securities and Exchange Commission (SEC) approved Regulation Best Interest (Reg BI) in 2019,[29] which enhances conduct standards for broker-dealers and investment advisers when dealing with retail clients. More fiduciary standards could be in the pipeline at the state level—New Jersey and Massachusetts are contemplating their own rules, which could complicate compliance challenges for broker-dealers.[30]

Regulating privacy is another growing concern. Because the United States doesn't have a comprehensive federal privacy standard that protects all types of US consumer information (including financial data), some states such as California, New York, and Vermont have begun to craft their own mandates.[31]

As fintechs become mainstream, the issue of how best to regulate them has become more urgent. On one hand, incumbents and fintechs want the latitude to experiment and innovate without the weight of stifling regulation. On the other, innovators also want a degree of regulatory certainty to ensure that their investments will pay off over the long run and not be shut down or create unexpected legal, compliance, or regulatory costs.

In the United States, some of the uncertainty related to bank charters is likely to continue. The Office of the Comptroller of the Currency (OCC) announced in 2018 that it would begin accepting fintech bank charter applications, but a federal court recently ruled that it lacked the authority to issue a bank charter to any entity that does not have federal deposit insurance.[32]

Meanwhile, although cannabis has been legalized in numerous states, it remains illegal under federal law. This leaves banks that provide cannabis-related banking services in a precarious position. Two pending federal bills—the Secure and Fair Enforcement Banking Act of 2019 (SAFE Banking Act) and Strengthening the Tenth Amendment Act Through Entrusting States Act (STATES Act)—could clear up uncertainty and permit banks to provide services to cannabis businesses that comply with state laws.[33]

While the question of a eurozone-wide deposit protection plan remains mired in controversy, the European Union (EU) has made substantial progress in other aspects of its banking union project.

The European Parliament's recent revisions to the Capital Requirements Directive and Regulation (commonly known as CRD5 and CRR2) are considered to be a win for the banking union. CRD5 and CRR2 will revise capital requirements and could, therefore, strengthen the capital and liquidity positions of EU banks.[34] While these revisions implement some parts of Basel III, rules in Basel IV are excluded.[35]

Many financial institutions, however, have made compliance progress after the EU implementation of the General Data Protection Regulation (GDPR) in 2018. GDPR has brought sweeping protections to the personal data of EU citizens and standardized data rules across the European Union.[36]

With the growth in cross-border transactions, Know-Your-Client (KYC) and anti-money laundering (AML) regulations are getting more attention. The United States recently introduced the Illicit Cash Act to streamline the requirements and transparency for reporting suspicious activity, which is expected to increase banks' regulatory challenges.[37] Similarly, in the aftermath of various money-laundering scandals in 2018, EU regulators are also overhauling their rules.[38]

Finally, in Asia Pacific (APAC), there are few prospects for major new regulations for the finance industry on the horizon. Instead, APAC regulators continue to focus on operating a reformed supervisory system. They are engaging directly with financial firms (for example, conducting on-site supervisory visits) to better understand their practices.[39] APAC regulators are also paying more than just lip service to conduct and culture. They are increasingly taking a harder stance on misconduct and have set stringent expectations for professionalism and conduct.[40]

Amid global regulatory fragmentation, financial institutions—especially those with large global operations—are under significant pressure to reconcile local jurisdiction demands and their home country regulations. Smaller institutions are also not immune to these regulatory ebbs and flows. With divergence expected to continue, coupled with some geopolitical instability and the possibility of an economic downturn, banks can best prepare by continuing their compliance modernization journey using the latest governance, risk, and compliance technologies.

Technology

Fixing the basics

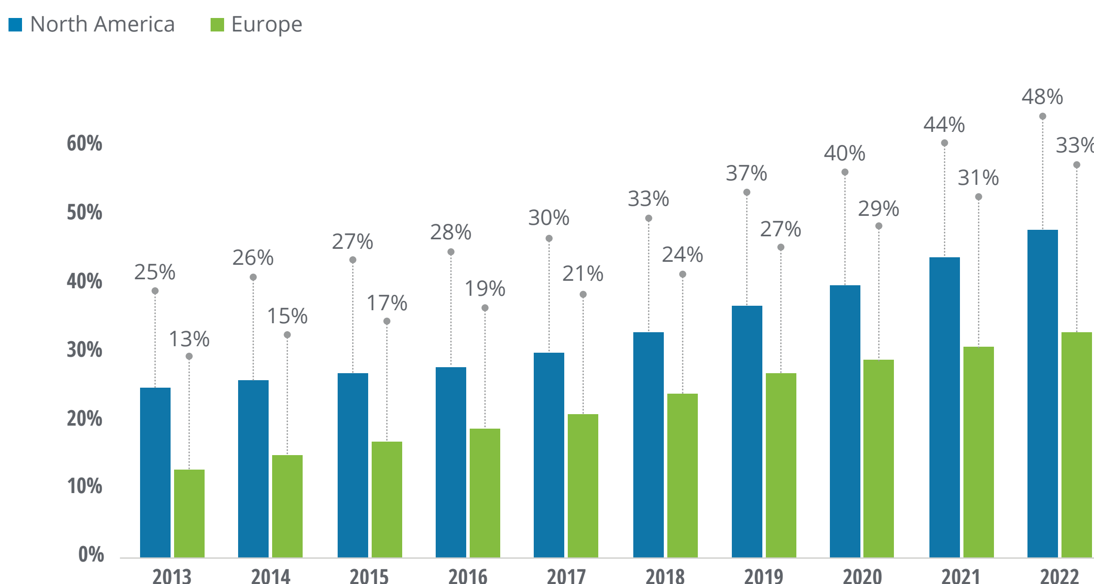
LAST YEAR, WE highlighted the need for banks to excel at data management, modernize core infrastructure, embrace artificial intelligence (AI), and migrate to the cloud. However, most banks are far from where they'd like to be in their digital transformation,[41] despite an increase in new technology investment in recent years. This trend is expected to continue in the foreseeable future. For instance, in 2022, North American banks are expected to spend nearly one-half of their total information technology (IT) budget on new technology, while European banks would spend about one-third, a figure higher than the current level (27 percent) (figure 5).

Challenged with legacy technology and data quality issues, most banks are unable to achieve the desired returns on their modernization initiatives.[42] As a result, there might be a need to shift attention and adopt a back-to-basics approach in 2020 before banks can fully reap the rewards from advanced technologies.

As a first step, institutions should tackle their technical debt, which is typically caused by past underspending and layering newer technologies on top of aging infrastructure. Legacy systems are among the biggest barriers to bank growth.[43]

FIGURE 5

New technology investment as a percentage of banks' IT spending



Source: Based on Celent research; Rochelle Toplensky, *Wall Street Journal*, "Technology Is banks' new battleground," September 10, 2019.[44]

2020 could be the year of "build and migrate," as banks continue to test approaches to core system modernization. Establishing a new, parallel, cloud-native core banking platform is gaining traction as a strategy. This is because it is less risky, reduces time-to-market, brings results, and allows core banking functions to be migrated over time.

Meanwhile, AI applications' deployment results remain modest. Although individual, siloed uses have been successful, Deloitte research has shown that holistically adopting AI across the enterprise and making it part of enterprisewide strategy reaped the highest return on companies' AI investments in financial services.[45] Therefore, to achieve scale, banks should build tight governance structures and bring the workforce along on the journey. They should also consider the risks (for example, potential bias in AI-powered algorithms) and fortify their own cybersecurity defenses.

To unlock AI's promise for growth and for banks to evolve from a product-centric to a customer-first organization, harnessing the potential of data will be a key focus in 2020 and beyond. However, data that resides in banks' siloed systems is just one piece of the puzzle. As consumers' digital footprints rapidly grow, new kinds of data are added into the mix. And while increasing the prevalence of ecosystems and data-sharing between institutions expands customer data, it also complicates data management and raises privacy concerns. Banks should rethink their data architecture and get their houses in order to maximize returns from analytics initiatives. Additionally, privacy-enhancing techniques can help banks derive value from data-sharing without compromising privacy.[46]

Lastly, digital transformation is not limited to technology and data. To realize long-term success, the human side should also be addressed. As technology gets cheaper and is readily adopted by the industry, the initial advantages may decrease in the long term. This is why it's important for banks to learn how to use technology to develop new customer insights and deliver contextual offerings. Another equally important aspect to consider will be culture. More often than not, the success or failure of a digital transformation effort may depend on cultural issues rather than technical ones.[47] To make transformation happen, leaders may need to focus on developing a new mindset for how best to use technology, people, and processes. Only those financial institutions that build a collaborative and innovative culture to drive change can achieve real returns on their technology investments in the next decade.