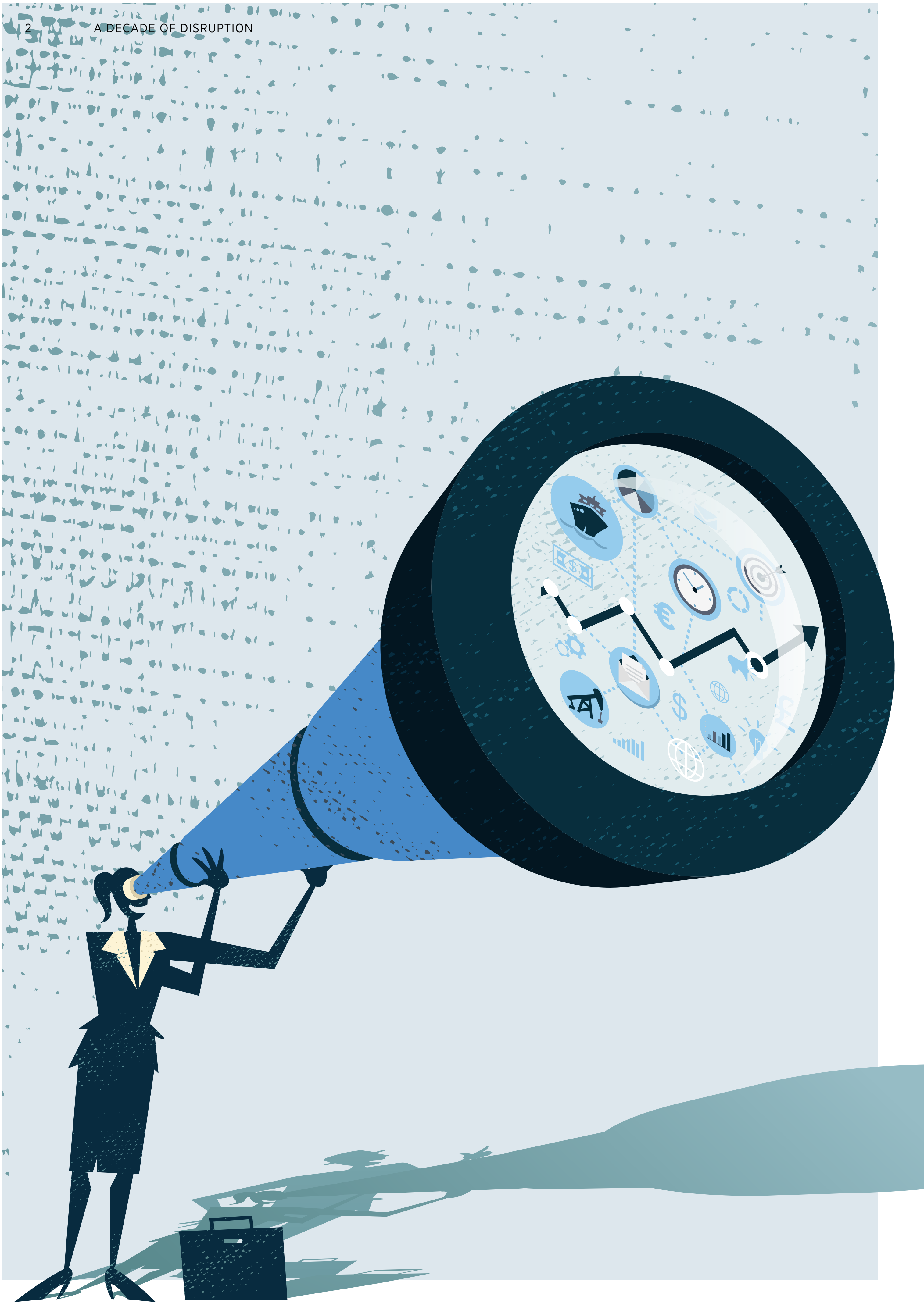
A DECADE OF DISRUPTION

Reinventing Financial Services



FOREWORD

As strategic advisors, we spend a lot of our time with leading banks and insurers to consider the future market environment and the models that will be required to win within it.

When reflecting on these conversations, it is interesting to note that many of the trends being discussed today have remained much the same over the last 100 years. Indeed, we are seeing technological, demographic and socio-economic developments that are comparable in scale to those that took place between the end of the First World War and the Wall Street Crash just over a decade later.

Looking back to the first quarter of the Twentieth Century – with the financial sector unprepared for the economic, political and social upheaval that was to come – it is tempting to assume that what takes place during our next decade will be less dramatic. If that's the case, the leaders of financial institutions can expect the economy to grow smoothly and gradually, and their businesses to face no threat from new entrants.

We think there are two main reasons why such an assumption could lead to failure. Firstly, many stakeholders feel the sector is not working. Regulators, governments and shareholders are all, to a greater or lesser degree, dissatisfied with the status quo and are questioning its ability to withstand another significant shock. Secondly, banks and other financial services firms can no longer rely on the enormous customer inertia which assured their survival in the past. On the back of these changes, we are seeing the emergence of a broad set of 'disruptive realities' that present new opportunities as well as increased uncertainty.

In this paper, we explain why we think financial services firms have only two real options left. They can carry on as they are, making minor adjustments to their strategy and operations, and hope that everything works out for the best. Or they can get on the front foot, understand the threat that a new entrant might pose to their business, and prepare to disrupt the market themselves.

Andrew Dawson
Head of FS Strategy Consulting
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A LESSON FROM HISTORY

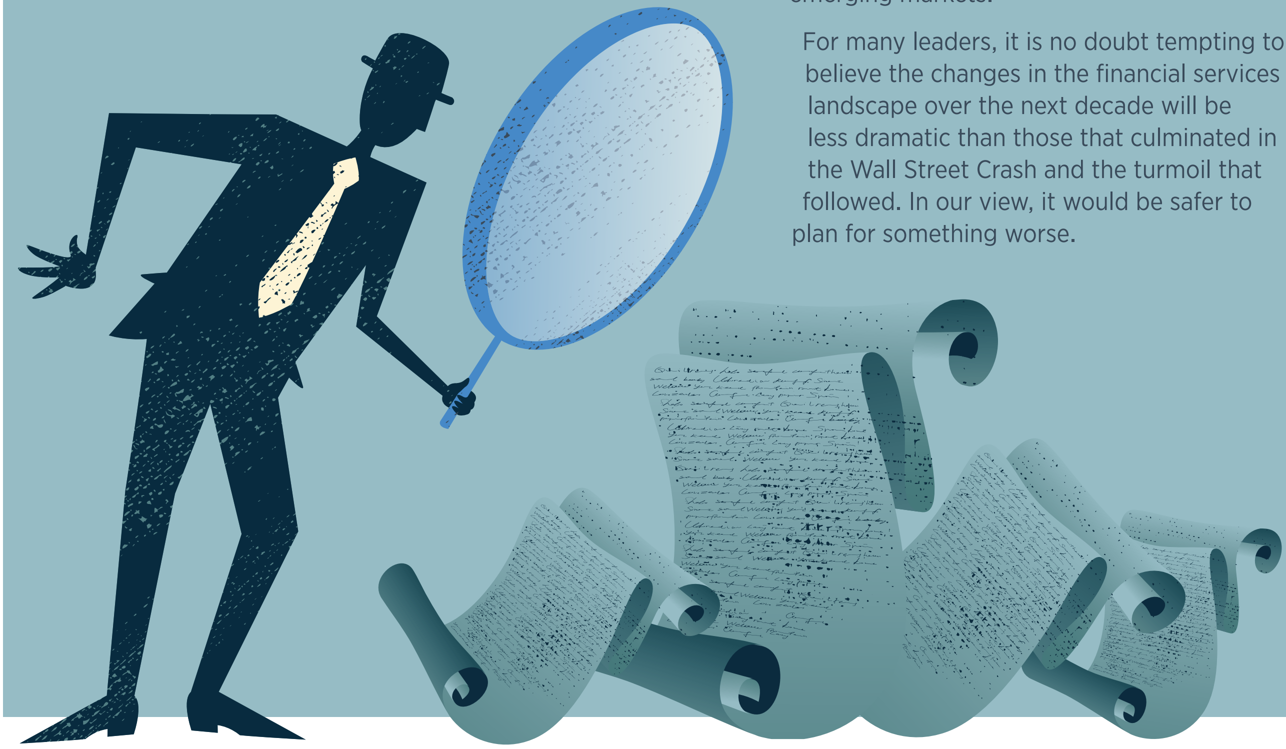
The disruptive opportunity

There is constant conjecture as to what the future might hold for financial services. And yet, if we are to pause and consider our place in history, are the challenges we face really so different from those of the past? Imagine yourself at the helm of a financial services corporation in 1920. What would you have seen? What would you have thought about your environment and your prospects?

The world had recently emerged from a terrible war that created enormous economic, social and technological disruption. The talk was of a new era, a new world – yet instability was all around. Society was on the cusp of significant behavioural and structural change, new technology was gaining traction (the telephone, electricity and the automobile were all starting to have an impact), the British Empire was faltering and the US was continuing to rise as the dominant power.

CEOs observing the market today may deduce the drivers impacting their businesses remain much the same as those in 1920. The world remains an uncertain place (despite economic recovery), new technology is coming on stream and the structure and behaviour of our society is changing. Meanwhile, natural resources are under pressure, globalisation continues and there is a gradual shift in economic power to the emerging markets.

For many leaders, it is no doubt tempting to believe the changes in the financial services landscape over the next decade will be less dramatic than those that culminated in the Wall Street Crash and the turmoil that followed. In our view, it would be safer to plan for something worse.



We see two main reasons why financial services organisations should prepare to enter a period of unprecedented disruption.

1 The financial services sector is no longer seen to be working

Across society, people are increasingly critical of the financial sector and of banking in particular. Dissatisfaction with financial services is not restricted to the general public. It is also evident among shareholders, regulators and politicians.

When several large banks were fined for currency rigging in winter 2014, the Financial Times[1] reported the loss of trust had reached the very heart of banking culture – and that it was no longer a problem shareholders could effectively deal with alone. Furthermore, in the UK, there remain reports[2] that investors in high street banks are unhappy with the bonuses paid to senior banking executives and assert too large a proportion of the profit goes to employees.

Political sentiment suggests governments today could be less likely to underwrite the mistakes of the sector than they were in the past. The idea of 'too big to fail' has been questioned in mainstream media[3] and financial institutions can no longer assume, in the event of another global financial crisis, they will be shored up as they were in 2008/9. In fact, recognising the sector's unpopularity with the electorate, it is perhaps only a matter of time until a political party seeks to gain political currency by saying it will not underwrite the sector in the future. Another financial crisis could see shareholders wiped out and at least some bond-holders forced to take significant haircuts.

Even with a raft of new regulation being deployed across the global financial services sector, regulators continue to find examples of mis-selling and scandal. As a result, many incumbents have been forced to maintain a relentless focus on compliance at the cost of broader market change – leaving room for new entrants to innovate propositions outside the mainstream sector. Regulators are actively supportive of ways to reduce the dominance of the large banks, encouraging more entrants to the market.

In the past, new entrants – even the successful ones – have never made much of a dent in the share of market leaders, but this may be about to change.

1. Financial Times, How bankers are paid is now everyone's business, 17 November 2014

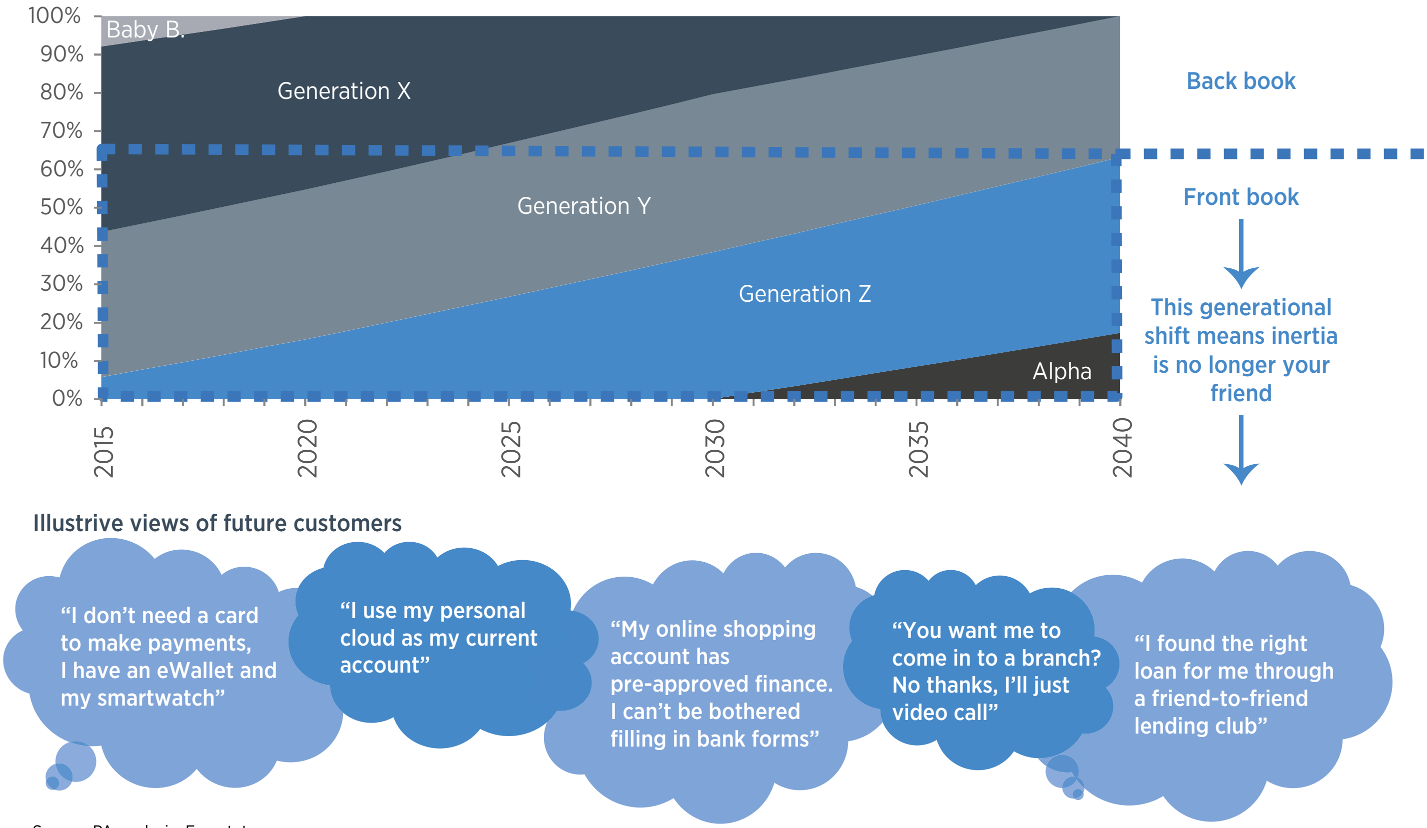
2. BBC, Barclays wins pay vote despite opposition, 24 April 2014

3. BBC, 'Too big to fail' bank rules unveiled by global regulators, 10 November 2014

2 Inertia is no longer your friend

In the past, banks and insurers have been able to rely on deep-seated customer inertia. Customers have only had a limited number of providers and services to choose from, and they have had no material reason to switch provider or veer away from what they know. Importantly, switching has always been seen as time consuming and complicated, with the costs of switching seen to outweigh the benefits. Today however, a combination of socio-demographic and technological changes mean this traditional customer 'stickiness' can no longer be relied upon. In fact, new forward business (the front book) for many financial organisations will increasingly be determined by customers who are likely to lack the inertial stickiness of their predecessors (see Figure 1).

Figure 1: Projected generational make-up of the European working population*



Source: PA analysis, Eurostat

* PA analysis of Eurostat projections, defining the working population as those aged 18 to 60 with the respective generations as follows: Baby Boomers born 1945-1964; Generation X born 1965-1979; Generation Y born 1980-1994; Generation Z born 1995-2009; Generation Alpha born after 2010

Today, customers are more empowered and informed than ever before – they are no longer content to accept the status quo. Personalised and instantly available solutions that enhance their ability to do the things they want, be it in their professional or personal lives, are increasing mobility and helping usher in new models and new competitors.

Worryingly for incumbents, many people may find it easier to carry out transactions without going through the traditional financial sector. Instead, they will be attracted to propositions developed by organisations that are more aligned to their daily lives, such as social platforms or mobile operators. If these organisations can remove the hassle for customers, allowing them to conduct their financial affairs in the online environments where they spend most of their time, the repercussions for today's incumbents will be profound.

WHAT TO EXPECT IN A DECADE OF DISRUPTION

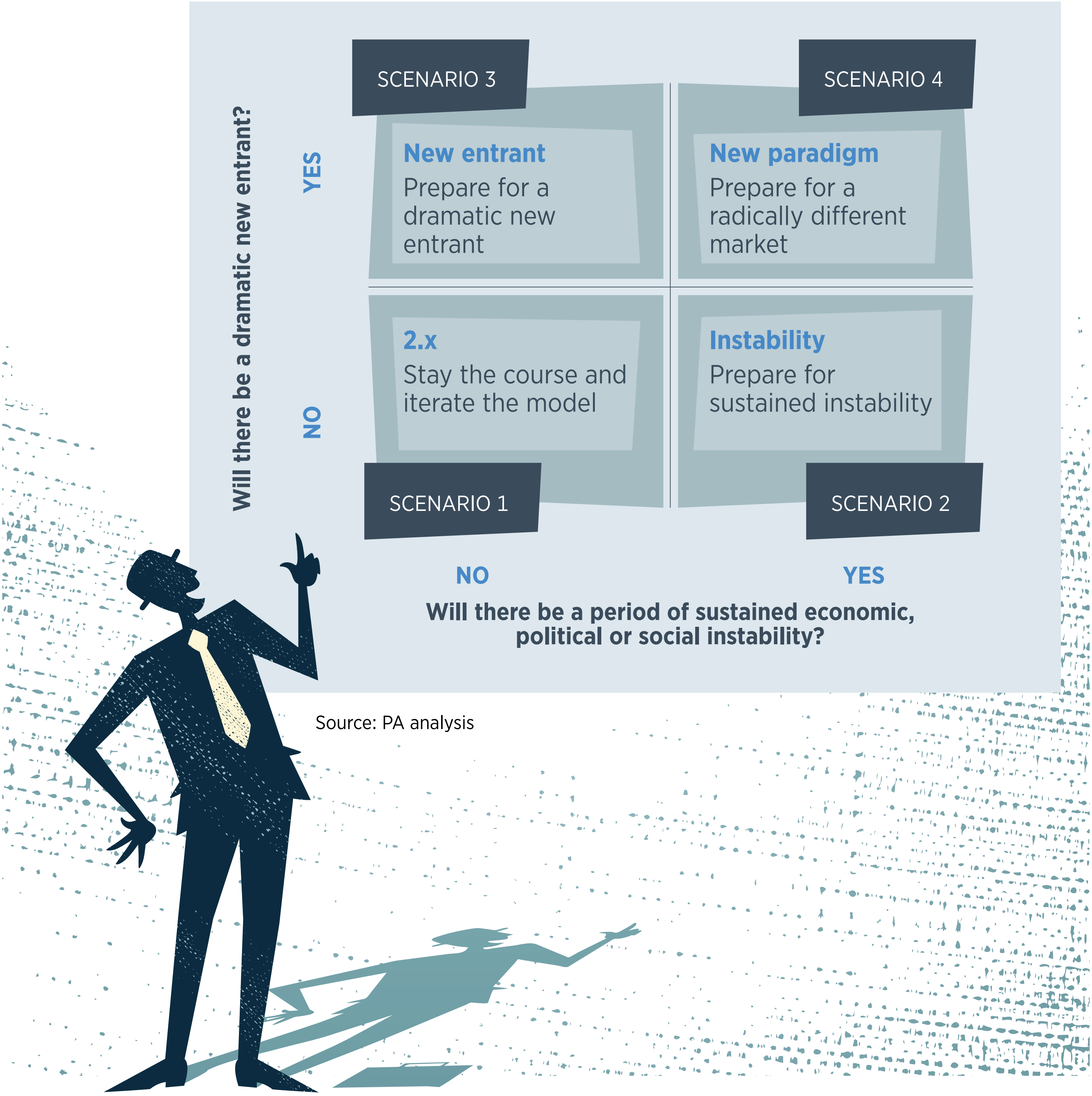
Scenario planning to ensure your relevance

As we discussed in the previous section, financial services leaders can expect disruption to emerge as a result of two profound changes. Firstly, they find themselves operating in a society that actively welcomes new entrants and which might hesitate – if not outright refuse – to bail out incumbents should there be a repeat of the events in 2008. Secondly, they can no longer count on the stickiness of their traditional customer base. With this in mind, there are two urgent questions leaders of financial services firms should be asking:

1. **Will there be a period of sustained economic, political or social instability that is so severe government support is required for survival?**
2. **Will there be a dramatic new entrant that is powerful and innovative enough to steal our most valuable customers?**

While it is possible the answer to both questions will be 'no', it is of course also plausible that one or the other possibility will become a reality. In practice, this means there are four scenarios – with very different implications – financial services firms should start planning for. Figure 2 outlines the four scenarios, which we explore further below.

Figure 2: Four possible scenarios



Source: PA analysis

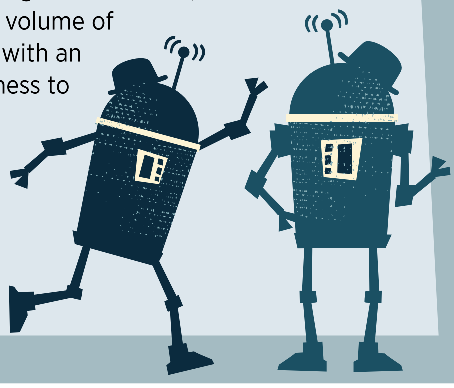
SCENARIO 3

New entrant: Prepare for a dramatic new entrant

In this scenario, a dramatic new entrant with a proposition that is powerful enough to dominate against today's incumbent firms enters the market with force. The threat is very real, with recent history demonstrating that longstanding and profitable businesses (such as HMV and Kodak) can be devastated by developments in technology or customer preferences they failed to recognise, responded inadequately to, or decided to ignore.

A company from a different sector, with ambitions to diversify its business model to fuel continued growth, might see the profit to be made in the most valuable parts of the insurance or banking value chain and try to seize them. A global software or internet business would, for example, have superior access to new forms of customer data – notably behavioural data. It would also have the best analytics, access to new technology and a brand and reach that are truly global and trusted by Generations Y and Z. As Facebook launches P2P payments, and French bank BPCE allows local payments through Twitter, there is no doubt we will see more technology-enabled business models and partnerships emerge in the years to come.

The options for incumbent firms come down to either waiting to see what happens – risking the erosion of shareholder value and loss of customers – or leading the charge by building on their knowledge of the sector, back book and sheer volume of data to partner with an innovative business to create a new offering.



SCENARIO 1

2.x: Stay the course and iterate the model

This scenario assumes no material new entrant to the sector and no sustained period of economic, political or social instability. This appears to be the central planning scenario of most banks and insurers, especially those that are currently favouring a 'wait and see' approach to the changes we are experiencing in the market.

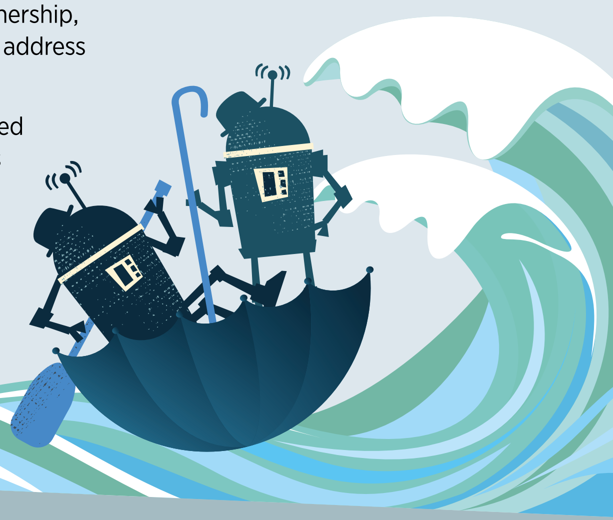
Without a material new entrant or period of large scale instability in the market, it is likely incumbent players will continue to focus on incrementally improving their models. They will probably focus on a combination of efficiency gains and new customer propositions to gain or protect their market share. There will be an incremental investment in digital and data analytics, but this scenario does not ultimately represent a wholesale change of the model – hence the nomenclature of '2.x'.

SCENARIO 4

New paradigm: Prepare for a radically different market

In this scenario, the financial sector will face sustained economic, political or social instability and dramatic new entrants, possibly including state-sponsored players, at the same time. Should this manifest, we would be looking at a whole new financial services paradigm where governments take a more direct role participating in the financial system, ie creating their own state players alone, or through partnership, and proactively encouraging new entrants that help to address the social or economic challenges they face.

In this world all bets are off, but the models that succeed will feature the ability to build meaningful partnerships in the public and private sector to meet the economic and social challenges at that time.



SCENARIO 2

Instability: Prepare for sustained instability

This scenario considers a world in which there is a period of sustained economic, political or social instability that is so severe government support is required for survival.

Even a quick glance at the news reveals significant economic, political and social tensions remain across the developed and developing world – economic tensions in the Eurozone and falling oil prices are prime examples. Should these escalate, the impact on financial institutions operating within, or connected to, affected jurisdictions would be significant. Organisations that are able to anticipate and align their model quickly to a period of instability will likely minimise the disruption they face and/or the support they require. But those that fail to do so risk significant losses or even collapse.

What can you do?

Many banks have plausible plans to survive and thrive in scenario one, but few have clear plans for scenarios two, three or four. The reason for this is that for many CEOs, it is difficult to know how to frame the challenge ahead of them, particularly in the context of the near-term imperative to reduce costs and respond to new regulation. In many cases the best response to these scenarios involves an element of cannibalisation of the existing business – a situation which few management teams respond well to.

In such a complex environment, there can be no 'silver bullet' answers and no straightforward three-step plans to guarantee success. There are, however, some deceptively simple questions that leaders should be asking themselves. Approached carefully, these questions provide a loose framework to help you plot your future course.

Are you focused on the right areas?

When planning how to transform your business, it is essential you consider the wider changes that are already affecting the economy and society at large, and determine if there are sources of revenue or risk you haven't explored yet. For many firms, the most important trends will be those they don't directly observe, and therefore thinking about the underlying drivers of change will be important. Listed below, and detailed in the appendix, we have outlined five disruptive market realities which will continue to impact the sector over the years to come. Stress testing your business model against these realities will help to define the strategic and operational areas that require the greatest attention both immediately and going forward:

- REALITY 1: **A world of ongoing uncertainty**
- REALITY 2: **Shifting trade and capital**
- REALITY 3: **Fundamental socio-demographic change**
- REALITY 4: **A new technology landscape**
- REALITY 5: **A data and analytics revolution**

Do you have the right capabilities?

To avoid disruption, financial institutions will need to think differently. This may call for fresh products, new partners and even the recruitment of a different type of employee. The customer will be central to business design, meaning the mission of the organisation may look different to today. Figure 3 outlines a range of concepts that will likely influence this new way of organisational thinking.

For many financial institutions, the scale of cultural change implied by the concepts above is daunting. But progressive CEOs are now beginning to embrace these areas – seeking ways to drive innovation, facilitate partnerships and build on the many advantages they have relative to new entrants. These benefits include regulatory clearance, deep underwriting/credit capabilities and an existing book of customers.

Figure 3: Concepts which will influence new ways of thinking

Principles	Capabilities	Behaviours
Be forward minded and alert to disruption	Use scenario planning to make speed of response a competitive strength	Think beyond tomorrow
Be personal to your customers wherever and whoever they may be	Excel at managing your brand; be loved and aspired to	Experiment and innovate
Operate at the speed of a fashion retailer	Be brilliant at managing partners and partner with the world's best	Embrace change
Recognise that you can't be expert at everything	Be expert at interrogating and interpreting data	Be social, responsive and relevant
Never be breached	Employ new talent – e.g. data scientists, anthropologists, designers and psychologists – and bring new talent into leadership positions	Operate as one

Source: PA analysis

Disrupt or be disrupted

This is a hugely challenging time for financial services. The cost pressures are significant and more costs will need to be taken out, but there is an extent to how far cost cutting within an existing business model can make things better. Companies must find more radical ways to take market share from competitors and avoid losing ground to more progressive rivals or new models that are emerging.

The risk of failing to respond quickly enough is very real. Too many companies still believe their size and former glories will protect them from disruption. In fact, it is relevance and agility – not size – that will be the critical determinant of success.

As we enter an unprecedented period of upheaval for financial services, all the above options, questions and scenarios boil down to one simple idea:

Sooner or later, someone is going to disrupt the market – why shouldn't it be you?

APPENDIX:
Five disruptive market realities

As businesses plan their course of action in a radically different sector, we believe five disruptive realities will define the executive focus over the next decade.

Senior executives must recognise how these changes will likely open their businesses to the very real threat of disruption. How well financial services respond to these changes will determine whether they have a future or whether they, too, will find themselves consigned to history.

- REALITY 1: **A world of ongoing uncertainty**
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REALITY 1: A world of ongoing uncertainty

Senior leaders in the financial services sector have spent much of the last six years dealing with the uncertainties brought about by the financial crisis and related market instability. Understandably, this work has been underpinned by a view that, eventually, the sector will get back to normal. This view is false.

Even as growth and confidence are returning to many markets, the ominous threat of all-too-familiar asset bubbles, significant private debt and diminishing central bank support grow stronger. Evermore diligent regulation continues to be a sustained legacy of the crisis, particularly as stories of misconduct continue to emerge.

Figure 4 shows a selection of the forces which are changing the way people live their lives, companies conduct business and governments set policy. In our view, disruption will come at the intersection of two or more of these forces, with this correlation being the killer.

Figure 4: The forces at play

Instability	Socio-demographic	Digital	Innovation	Economic
Fiscal pressure	Ageing	Cloud	Industrial innovation	State capitalism
Capital pressure	Generation Y/Z	Big data	Machine to machine	Rise of sovereign wealth funds
Political change	Inequality	Social media	Biotechnology	Capital and trade shifts
Social unrest	Urbanisation	Smart devices	Nanotechnology	Emerging markets
Regulatory change	Networked society	Sensor and wearable technology	3D printing	Natural resources
Cost efficiency	Global society	Artificial intelligence	Personalisation	Sustainability

Source: PA analysis

One example of uncertainty is that as the world's population continues to grow and emerging economies develop, there will be increasing pressure on the world's natural resources – from oil and gas, to food and water. As a result, it is likely any solutions found will vary as a result of political or other external interventions. This means new assets could evolve that can be openly traded. For example, we may see the emergence of bio-credits that attribute economic value to resources that are considered to be globally or nationally beneficial, such as rainforests or coral reefs. This would then reduce the economic incentive to destroy them.

Climate change, resource depletion and the frequency and magnitude of catastrophic natural events also have significant relevance to financial service providers from a risk and underwriting perspective. If predictions around climate change made by the Intergovernmental Panel on Climate Change and other leading international bodies prove accurate, extreme natural events will only become more frequent.

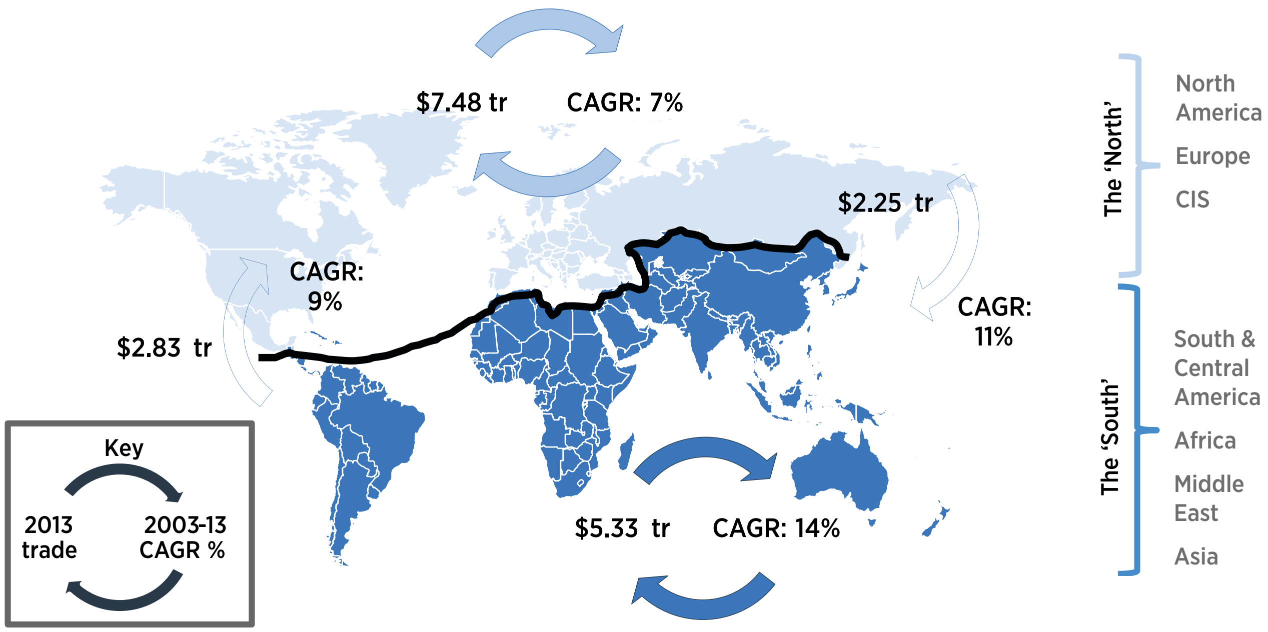
The risk for leaders is that their organisations are permanently playing catch up with uncertainty caused by previous external events or interventions. The winners will likely be those that recognise the broader external trends and move to reinvent their organisations around them.

REALITY 2: Shifting trade and capital

The recent slowing of growth in emerging markets has led to a change in sentiment towards these economies. Yet, while there are clearly risks in these markets and a debate rages about exactly where future growth will be, the fundamentals remain the same and emerging markets will continue to grow faster than established markets.

Within the emerging markets, there is huge potential demand for financial services. Some 2.5 billion people still have no access to banking services[4], there are major infrastructure funding needs and there is a rapidly rising middle class. As shown in Figure 5, merchandise trade on a south-to-south axis is growing at about 14 per cent a year, China is already Brazil's biggest individual-country trading partner and three of the world's 10 fastest-growing countries are reported as being in Sub-Saharan Africa. In physical terms, large volumes of trade are bypassing the West and where trade flows, capital follows.

Figure 5: Global trade in merchandise exports (2013; US$ trillions)



Source: World Trade Organisation Statistics Database (2014) – World Exports Trade Flow in USD @ Current Prices; PA Analysis. 1 trillion = 1,000,000,000,000

4. World Bank, Development Research Group, Policy Research Working Paper 6025, April 2012

Choosing where and how to grow is one of the more complex challenges facing leaders. The simple answer may be to follow your customers, but there are many considerations in determining the best route. These include assessing a market's long-term growth prospects, establishing the ease of doing profitable business in different jurisdictions and understanding a country's ability to hedge against external shocks to its economy. Mexico, for example, is highly dependent on the prosperity of the US, whereas Singapore's performance is influenced by a large number of economies in the region and further afield.

Recognising that cultures and ways of doing business differ dramatically between countries is critical – simply exporting an existing model to an emerging market will not necessarily work. There are several countries which do not operate according to Western capitalist models and, whilst they may offer attractive opportunities, they can require markedly different approaches for business models to be successful.

Organisations with a long history of working with these factors, such as consumer goods companies operating in Africa, have an institutional advantage in terms of managing the risks and building profitable operations.

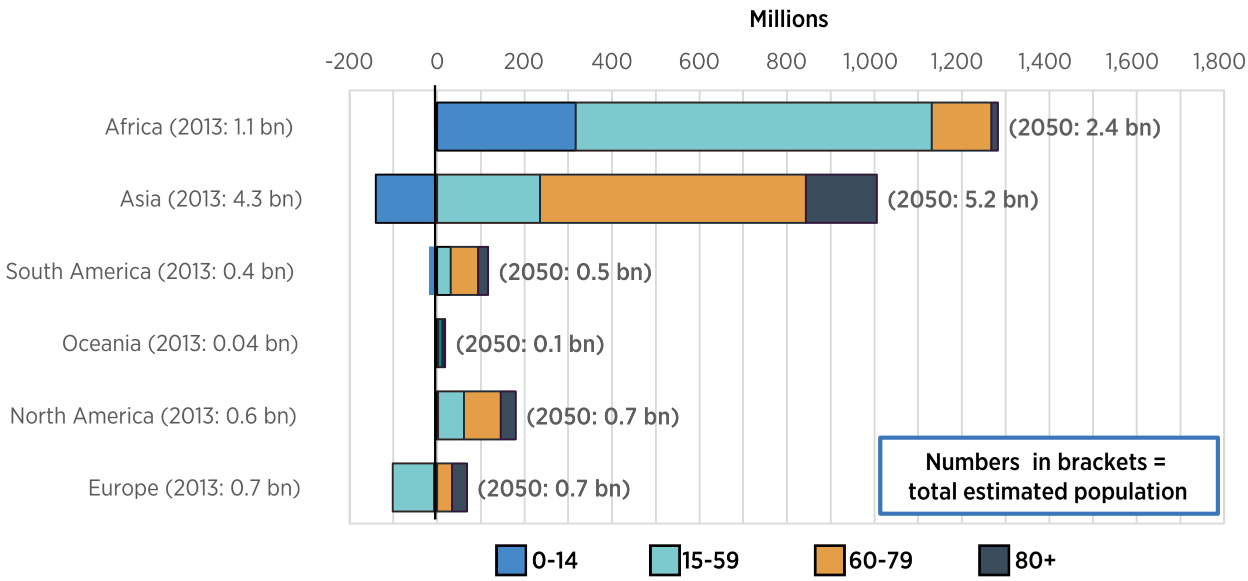
The change in trade and financial flows underlines the need to look at each individual market on several dimensions and to understand the connections between them. You need to recognise that success will depend not just on where you operate, but also on how you operate; namely, your ability to align your culture, propositions and operating model to the realities of operating on the ground.

REALITY 3: Fundamental socio-demographic change

Changes in the structure of the world's population are having a fundamental impact on customer behaviour and the size and shape of key market segments. Demographic and social factors – from an emerging middle class in many developing markets to the widespread use of social technologies – can no longer be ignored.

The world's population is forecast to grow significantly, but it is the structure and makeup of that growth that is particularly interesting. As depicted in Figure 6, the world is ageing and dependency ratios are increasing. In some countries, notably in Europe, there is forecast to be a significant reduction in the size of the population aged between 15 and 59; namely the segment which includes the majority of working people and arguably contributes the greatest demand for financial services.

Figure 6: Projected population change by age group (2013 – 2050)



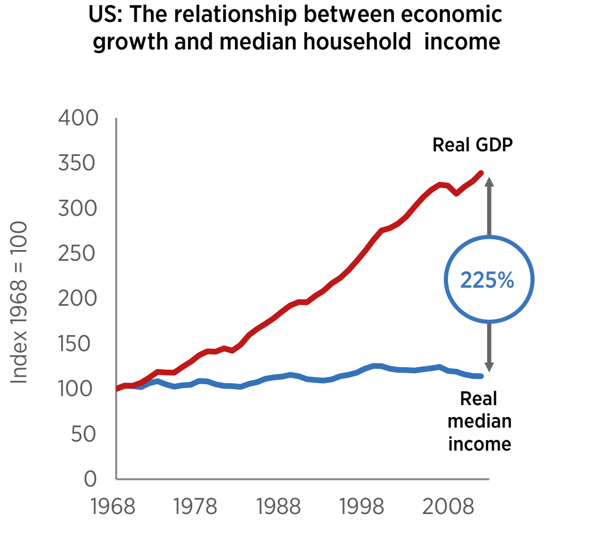
Source: United Nations, Department of Economics & Social Affairs, Ageing profiles: Accessed in June 2014

The expectations of younger people are also changing. Today's young people have grown up in the digital age, are technically literate and conduct much of their lives online. As a result, they expect financial services providers to be part of the same interactive, instant world. They will want value, personal service and greater convenience, and will simply go elsewhere if they cannot get what they want from their existing provider.

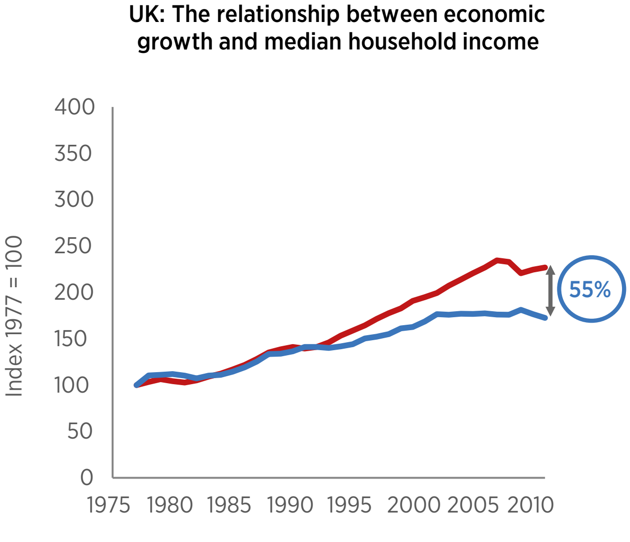
At the same time, people will increasingly live in cities. Currently, 3.9 billion people live in urban areas, and the UN predicts this number will increase by another 2.5 billion over the next 40 years.[5] City-dwellers tend to be richer than their rural counterparts and bigger purchasers of consumer goods; they also tend to want access to a wider range of financial services. Furthermore, cities will increasingly develop their own distinct economies, encouraging segmentation of customers at a more granular geographic level.

On a socio-economic level, as some countries become mathematically wealthier, the inequality gap within them actually grows, to the extent that large swathes of their populations derive zero benefit from economic growth. In the West, as whole generations are priced out of the housing market and other social norms become unattainable, it is likely that tensions will rise and sections of society will become more disenfranchised. As the downside risks include economic dislocation, and even large-scale social and economic upheaval, financial service providers and governments will likely need to collaborate to find a solution. Figure 7 shows how this situation has developed over recent years in the US and the UK.

Figure 7: Income inequality in the US and UK



Source: US Census Bureau, Current Population Survey, Annual Social and Economic Supplements, Bureau of Economic Analysis



Source: Office for National Statistics

The economic challenges created by the scale of socio-demographic changes we face may also necessitate greater collaboration between government and the financial services sector to address demand in areas such as residential care, healthcare provision and affordable housing.

To succeed in this environment, financial services organisations will need to better understand their customers and the different behaviours they exhibit, improve the way they target their propositions and increasingly look to innovative partnerships to differentiate their offerings.

5. United Nations, Department of Economic and Social Affairs Population Division, Revision of the World Urbanisation Prospects, 2014

REALITY 4: A new technology landscape

The pace of innovation is going to continue to grow. Developments in digital communications, nanotechnology and biotechnology all have the potential to change how we live our lives and how we do business. There will be more of the same, but there will also be new technological developments that no one has even thought of yet. So, there will also be more uncertainties.

In the payments sector, we are already seeing digital technologies have a profound impact on existing models. Peer-to-peer lending, mobile technologies and an increasingly connected society are all contributing to the demise of cash. Examples include Square, which provides a network to accept card payments through a smartphone, and Paym, through which people can make direct payments using their mobile number and device.

Another area where technologically-enabled change is likely to come fast is insurance. The CEO of a large insurance business recently told us he considered the insurance sector to be at “intelligence war”, but it seems far from certain that insurance firms are better placed than new entrants to win this war. The emergence of cheap and simple sensor technology can help the industry understand, pre-empt and mitigate risk, rather than responding and reacting to it when it has occurred. In life insurance, wearable sensors will give real-time information about a person’s health and their compliance with treatment. Biotechnology and advancements in genetic science will also contribute to a shift in insurance models, from reacting to illness to helping to mitigate symptoms before they arise. In car insurance, self-driving or intelligent cars will reduce, or even eliminate, accidents and provide detailed information about owner behaviour.

Digital technology is all around us and is leading to an increasingly interconnected society of people and things. The average UK household now owns four types of internet-enabled device, with 24 per cent owning six or more.[6]

Wearable computers, for example Apple’s Watch, will bring a new wave of online connectivity and allow people to conduct a wider range of activities while on the move. The use of this kind of technology is only going to grow as new devices are developed and adoption continues to increase.

The surge of innovation at the frontiers of science – such as in nanotechnology, biotechnology and robotics – will have impacts across supply chains and challenge conventions in many industries. Amazon is currently testing unmanned aerial vehicles to deliver packages to customers shortly after the time of the order. Such technology will have enormous implications on the supply chain and customer experience. It will also likely give rise to new regulations around the usage of drones.

What is certain, is that it will be commonplace for even the most well-established company to get left behind or outflanked by a new competitor as technology lowers barriers to market entry and accelerates the speed at which disruption can occur.

6. Ofcom, The Communications Market Report, 2014

REALITY 5: A data and analytics revolution

Organisations have access to unprecedented amounts of data about their operations and customers. Used intelligently, this ‘big data’ can shorten innovation cycles and enable more rapid, even real-time, decision making. Senior executives are now able to engage directly with data to make tactical decisions much faster and to explore strategic decisions more fully before committing to a particular course of action.

Within capital markets, advances in analytics have led organisations to increasingly use data-driven portfolio management techniques, which don’t require forecasting and therefore have lower management fees. As this approach foregoes the need for the predictive ‘skills’ of individual traders, analytics is, in some respects, helping to demystify the investment management industry.

Notwithstanding issues around privacy and protection, data is also unlocking new sources of insight. For example, social intelligence (data generated through social media interactions) can provide highly accurate predictions of consumer responses to trends, products and services. Yet, many organisations have been reluctant to embrace this data, instead believing the massive increase in the volume of data makes sorting a signal from the noise increasingly challenging.

The truth is that companies making the best use of this data have developed a flexible experimental approach to analysis, which based on a defined hypothesis of what they are looking for, lets the data speak for itself. We find the insights which often prove most valuable are strikingly counterintuitive and could not have been deduced from traditional data methods. In the exploratory phase of data analysis, the most exciting phrase is often, “Hmmm, that looks odd…”

Financial institutions must step up. While we are seeing significant ambition to embrace new forms of data analytics, many large financial organisations are still struggling with its adoption. Given the sheer volume of data held by financial institutions, the organisations which work out how to use it to enrich the experience they provide for their customers will derive real competitive advantage.

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