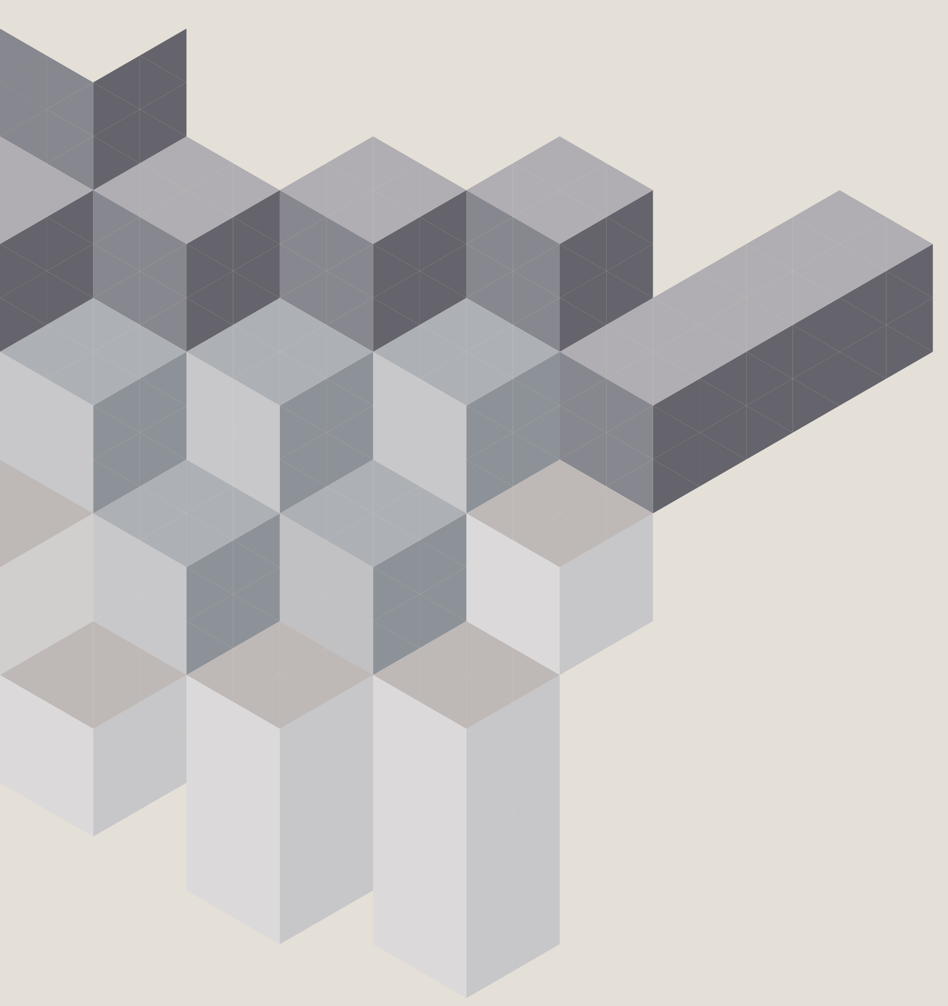
The State of the Financial Services Industry 2017

TRANSFORMING FOR FUTURE VALUE

MARSH GUY CARPENTER MERCER OLIVER WYMAN



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A NOTE FROM OUR MANAGING PARTNER

Despite the enormous changes in the financial services industry in recent years, the large incumbent banks, insurers, and asset managers still dominate the provision of financial services. A plethora of significant new players are emerging – including fintech startups, established payment, technology, and information firms, telecoms, and other providers – and are eyeing attractive parts of the broader financial services industry. However, few of these firms appear willing or able yet to take on the incumbents on the core provision of highly regulated financial services, at significant scale. So the question for us is not really whether the financial services incumbents will exist in five to ten years, but whether they will thrive.

This question of how financial services incumbents will fare is far from settled. For several years after the crisis, the agenda of the incumbents was dominated by restructuring and regulatory reform. In recent years, though, large financial services firms have increasingly focused on digital change: embracing mobile channels, redesigning customer experiences, partnering with innovators, using cloud computing, exploring new datasets and analytic tools, and digitizing stubbornly inefficient processes.

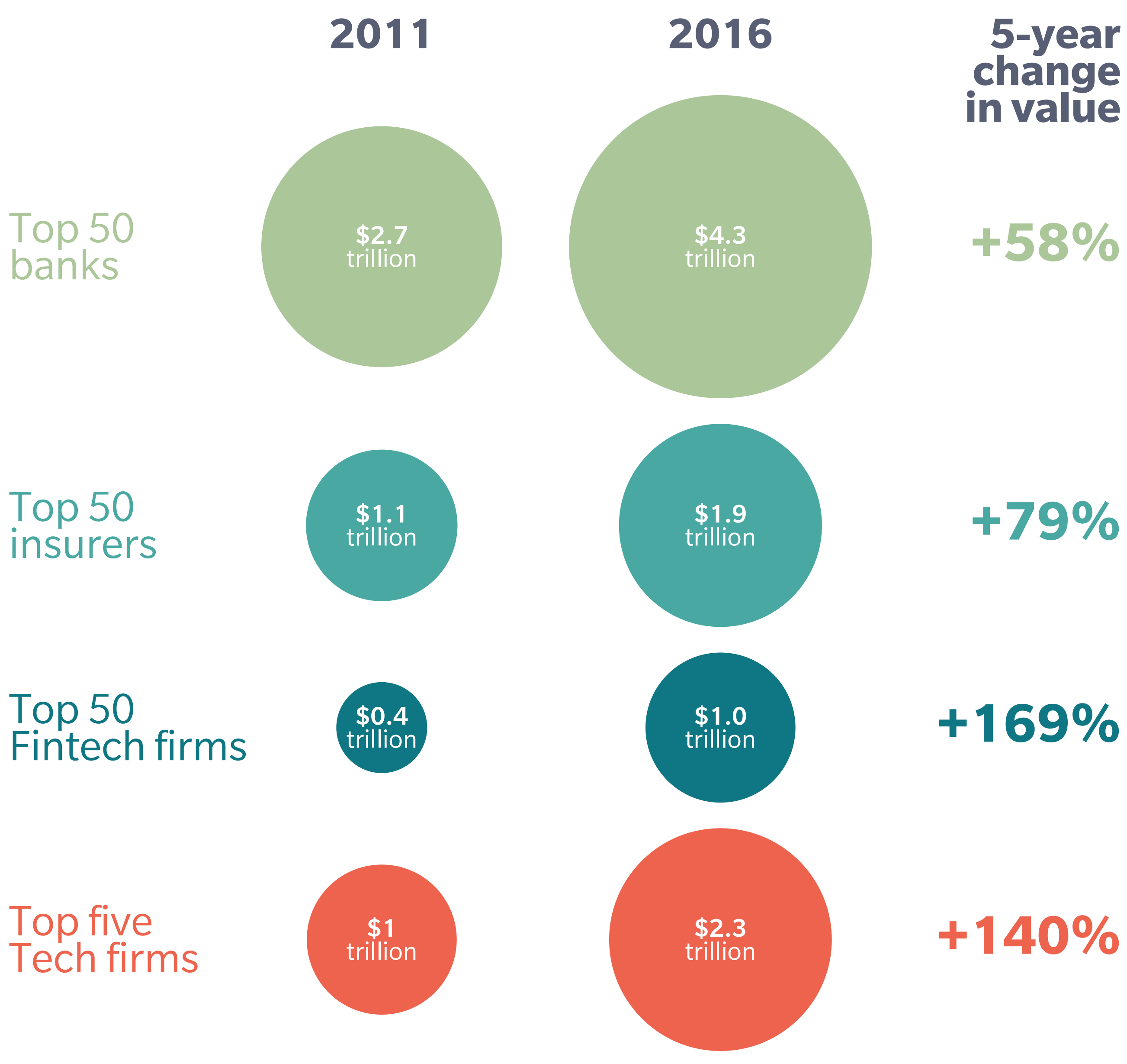
While many financial services firms are eager to explain these digital initiatives to their customers, employees, and shareholders, very few firms have articulated a "digital equity" plan: a clear view of how their investments are going to generate future shareholder value in a digital, modular world. This lack of digital equity plans is consistent with the shifts in valuation we have observed over the last five years. The largest global banks and insurers saw shareholder value grow by an average of 10% per year. In contrast, major Fintech firms (new and old) delivered value growth at more than twice that rate – above the spectacular returns of the leading tech industry giants (see Exhibit 1).

We believe it is time for financial services incumbents to articulate their own digital equity plans. In our report this year, we contrast three examples of such plans, and then use these examples to highlight what we believe will be the key drivers of shareholder value in the coming years. We offer perspectives on how financial services incumbents can identify new sources of value, and how they can transform to realize that future value.

Sincerely,

Ted Moynihan
Managing Partner and Global Head of Financial Services, Oliver Wyman

EXHIBIT 1. COMBINED VALUATION OF TOP GLOBAL FIRMS IN EACH CATEGORY



Three CEOs are having a late dinner together, the night before they each will present at an industry conference.

Jason has led a large retail bank for four years

Emma is just beginning her second stint as CEO of a big insurer

Toshiro became CEO of a global investment bank last year

Their conversation turns to the topic of their presentations tomorrow, their respective strategic plans.

JASON: My story for tomorrow? Well, it's pretty simple: stay the course.

Our strategy has worked the last few years – we just need to keep executing. Our core business is retail banking in North America, and it is fundamentally a good market to be in. We delivered an 11% return on equity this year, and you know what the interest rate environment was like.

Of course, we also have one eye on the longer term, so our chief digital officer has taken the rest of the management team to do the rounds in Silicon Valley, and we have made a few investments in Fintech startups, and set up our own innovation lab – all on top of doing a big update to our mobile app this year.

We want to keep our customers happy, make good credit decisions, and maintain our cost discipline. If we do that – and if we get a little help from higher interest rates – we can make 13% RoE in the next few years.

JASON:
'STAY THE COURSE'

EXHIBIT 2. JASON'S STRATEGY

$billions	2016	2020 plan	CAGR
Total assets	300	328	+2%
Net revenues	11.3	12.5	+3%
Net interest income	6.0	7.2	+5%
Non interest revenue	5.3	5.3	0%
Operating expense	6.7	6.8	0%
Loan loss provisions	0.6	0.6	0%
Pre-tax profits	4.0	5.1	+6%
ROE	11%	13%	
Cost-to-income ratio	62%	57%	

Maintain market share

2% rate rise allows expansion of NIM

+2% uplift in ROE

10–15 bps in lost margins flattens noninterest revenue... Leverage scale to combat new entrants on pricing??

Continue branch reduction & process optimization initiatives

TOSHIRO: How I envy you! We investment banks are going to struggle the next few years to deliver double-digit ROEs – and I'm not sure many of my competitors will make it.

EMMA: I'm hoping you can, though?

TOSHIRO: My team can, I believe. It will be painful though. I think one-third of our current employees will be working for someone else by 2020.

JASON: So many?

TOSHIRO: Perhaps more. Our trading businesses still aren't making the returns they need to, and the annual push to find 5-10% in spend reductions has stalled. So, we've decided to take a much more radical approach. We're calling it "deep digital," and the idea is to really shift the operating model for a bunch of our businesses. Our goal is to lower our cost-to-income ratio by 15 percentage points over the next four years.

JASON: Not afraid of an aggressive target, are you?

TOSHIRO: I don't see that we have a choice. We've got to get some huge cost reductions, to defend against disruption, and to improve low-return business lines to hurdle rates. The journey will be difficult for the company and its employees, and challenging too for our shareholders, given the investments required. But we will see it through.

TOSHIRO:
'DIGITIZE AND DEFEND'

EXHIBIT 3. TOSHIRO'S STRATEGY

$billions	2016	2020 plan	CAGR
Total assets	800	774	-1%
Net revenues	34.5	36.8	+2%
Non interest revenue	31.0	32.6	+2%
Net interest income	3.5	4.2	+5%
Operating expense	25.2	22.0	-4%
Pre-tax profits	9.3	14.8	+14%
ROE	8%	14%	
Cost-to-income ratio	73%	58%	

Defend Wealth AuM with launch of our own roboadvisory platform

Digitization of wealth and trading platforms

+6% increase in ROE

Our BIG goal: Reduce cost-to-income ratio by 15 points

EMMA: I worry you are being optimistic, Toshiro. In practice, you will find you have to give the cost reductions back to the customer, so you end up only standing still in profit terms. For example, we'll get efficiencies in our underwriting by investing in robotic automation and machine learning, but so will our competitors. It's good defensive play, but we won't get any real benefit in terms of increased shareholder value.

TOSHIRO: So what are you planning to do?

Emma: We decided to go on offense instead. Today's value chain won't be tomorrow's because of digital: every one of our businesses is facing different disruption threats. We want to position ourselves in the emerging ecosystems in a way that lets us build and sustain new competitive advantages.

TOSHIRO: But don't you need to be able to predict what the future is going to look like for that to work?

EMMA: We have a structured way of doing that: we study the digital trends that are shaping the way our customers interact with the world through "day in the life scenarios." These help us focus on what matters most to our customers while also revealing inefficiencies in our service delivery and in the insurance ecosystem in general. We're keeping a close eye on competitors – not just the ones we know, but "dark horse" new disruptors – to make sure we are taking positions that will be sustainable. We're constantly scanning the market for fresh new capabilities that we can plug into our offerings.

TOSHIRO: And what have you come up with?

EMMA: 'GO ON OFFENSE TO GROW'

EXHIBIT 4. EMMA'S STRATEGY

$billions	2016	2020 plan	CAGR
Total assets	400	411	+1%
Revenues	44.3	50.3	+3%
Net premiums earned	32.3	36.7	+3%
Investment return	9.9	11.3	+3%
Fees & commissions	2.1	2.3	+2%
Claims & benefits payout	32.7	35.4	+2%
Operating expenses	8.7	8.7	0%
Pre-tax profits	2.9	6.3	+21%
ROE increase of more than 10%!			
ROE	8%	19%	
Expense ratio	27%	22%	

New digital partnerships & services driving growth

Machine learning initiative lowered loss ratio by 5%

Supplying products through low-cost digital channels gives huge uplift

Digitization keeping underwriting and claims admin costs under control

EMMA: It depends on the business. For some of our specialty lines, it's all about the customer and reengineering to give them more of what they want and less of what they don't. We may be able to build a strong relationship with them directly, or build a broader distribution platform – and we don't need to only sell our own products or stick only to insurance. In some markets we may even move away from manufacturing our own insurance products or owning the underlying balance sheet.

JASON: Sounds like you're moving far from your tried and tested businesses. Are you going to be able to take your customers with you?

EMMA: It's not always easy to build really strong customer relationships in insurance – it's hardly a product that customers love to think about. In some categories, we're going to become an extremely efficient supplier in a larger ecosystem instead. So we're developing partnerships with banks, retailers and third-party brands to provide insurance to their customers. In these areas we are focusing on product excellence and reducing friction in how we plug in to their customer offerings.

JASON: And you think that's going to drive growth for you?

EMMA: We believe so. These moves took a lot of time to figure out, and building the underlying capabilities has not been simple either. For example, we've had to really invest time and money to figure out how to set up our distribution partnerships and make them operate smoothly. Hopefully, the ease of partnering with us – and our ability to help our partners' customers – is going to make it hard for others to catch up with us.

JASON: Have your employees embraced all this change?

EMMA: Yes…the transformation was not simple, but once we had a clear view on where to position ourselves for future value we were able to get our whole organization behind it and really mobilize. And it's working.

WHAT’S TO COME

The examples of Jason, Toshiro and Emma illustrate the range of approaches we see firms taking to digitization. In this report we describe what will make firms successful in both defending their existing business and building new competitive advantages.

Section 1 discusses how incumbents can adopt Toshiro’s strategy of “deep digitization” in order to radically reduce costs and defend profits.

Section 2 dives into Emma’s ambitious strategy, examining how incumbents can develop new sustainable competitive advantages within ecosystems that are being reshaped by digital forces.

Section 3 discusses why we believe incumbents must choose an archetype and how to move to the future.

SECTION 1

DIGITIZE TO DEFEND

Toshiro sets an aggressive goal –15% cost-to-income reduction – out of necessity. He expects to achieve this goal through “deep digitization.” Why does he set such an aggressive goal? And what must he do to achieve it?

We believe his ambitious goal is a device for mobilizing the organization with a mission for wholesale change. We see many incumbents applying digital, with a wide array of initiatives and experiments, but with little payback in shareholder value from these investments. In fact, many have actually added cost and complexity by investing heavily in digital experiences on mobile devices and websites.

The real benefits accrue from internal restructuring, first rethinking the process from the customer’s experience and then driving efficiencies “front to back” through supporting operations and infrastructure. The resulting operating model and organization should look very different as a result: leaner, faster, digitized.

Toshiro anchors an ambitious goal in competitive necessity, anticipating future waves of margin compression. The challenge ahead is no longer one of applying digital technologies for modest efficiency gains, but embracing digitization as a means to transform his operating model to fend off margin erosion from efficient competitors. We believe he needs an arsenal of tools and should apply three rules of thumb:

- **Adopt a “greenfield” mindset.** Attackers will have the full benefit of modern methods across the board – shorter business cycle times, compelling digital customer experiences, efficient and flexible digital capabilities that “plug and play” with ecosystem partners. Toshiro needs to keep these digitally advantaged players in mind as he sets the bar for his own business.
- **Engage all functions and leaders to achieve outcomes.** In our story, Jason has assigned digital responsibility to a Chief Digital Officer; he has not yet come to terms with the need to digitize holistically with coordinated change capabilities, business architecture, governance and human capital. Toshiro has all his functions working together to realize fully the benefits from digitization (as depicted in Exhibit 5).
- **Lead from the top with deep conviction.** Toshiro sets a high bar and

then must play the role of "Digitizer in Chief", to ensure that the all four gears (in Exhibit 5) turn in lockstep. He must set clear, regular milestones for a gritty 3-5 year journey that will require commitment from his entire team, and result in a very different organization. And he must ensure Board commitment to the investments and restructuring required to achieve his goal.

EXHIBIT 5. A SYSTEMATIC APPROACH TO MODERNIZING YOUR BUSINESS

TRANSFORM CAPABILITIES WITH CUSTOMER SELF-SERVICE, 'BOTS' AND ANALYTIC ENGINES

Reprioritize and streamline activities with data-driven insights and customer self-service preferences

Reengineer with the objective of eliminating unnecessary activities and interactions that are no longer relevant to digitally-savvy customers

Substitute software for activities where computerized efficiency and consistency can drive step-level improvements

Reinvent activities with machine learning algorithms and artificial intelligence applied to rich data sets

REDESIGN BUSINESS ARCHITECTURE FOR SIMPLICITY AND LEVERAGE

Converge business, technology and operations into integrated definition of capabilities

Create taxonomy with protocols for flexible assembly and recombinations of key capabilities

"Utilitize" common capabilities across activity sets for efficiency and effectiveness

Externalize non-core capabilities to refocus internal resources on most value-adding activities

TECHNOLOGY AND DATA

CAPABILITY

ARCHITECTURE

PEOPLE

GOVERNANCE

TECHNOLOGY AND DATA

RESET HUMAN CAPITAL MODEL TO EMPHASIZE AGILITY AND RAPID LEARNING

Integrate different disciplines and functions to work in nimble, mission-focused teams

Shift culture to focus on rapid learning

Align incentives to promote collaboration and risk-taking

Reskill to build leadership talent and acquire critical skills

RETHINK GOVERNANCE FOR SPEED AND SYSTEMATIC INNOVATION

Compartmentalize management attention and resources with distinct models for innovation, growth and optimization

Clarify decision rights for managing and sharing key capabilities – whether internal or externally-sourced

Accelerate business cycle times and release frequency

"Deep digitization" should result in a step-level improvement in business economics – we see Toshiro's 15% cost-to-income reduction as a realistic goal.

DIGITIZATION AS A HOLISTIC EFFORT

The primary gears of business digitization are capability and architecture (illustrated in Exhibit 5); as these gears turn, the others must move in lockstep.

For instance, some of the emerging techniques for transforming capabilities will require changes to the human capital model, such as new skills and jobs. Business architecture is a critical mechanism for defining capabilities and sourcing strategies and ensuring future flexibility. Consider these situations:

Substituting bots for existing capabilities (Robotic Process Automation) will require changes to the human capital model, such as reskilling to focus on more complex tasks that require judgment, or reallocating people to entirely new activities and jobs.

Re-engineering customer engagement requires inter-discipline teams operating in agile cycles, often with digitally-savvy customers as co-creators of the modernized process. New skills – human-centered designers, for instance – may be required, working shoulder-to-shoulder with software artisans and data scientists.

Externalizing with third-party capabilities should trigger a conversation about business architecture, the pros and cons of shifting a capability to a third party and the risks that must be offset by negotiating decision rights and service-level agreements to protect data assets and preserve future flexibility. The third-party offering should "plug and play" with the business architecture set by the business, not the other way around.

Sharing capabilities within business and across a portfolio can only occur when business leaders agree on capability definitions with an engagement model that identifies "stewards" and protocols (or APIs) for how capabilities will plug-and-play across the organization.

Toshiro can devise a staged approach by applying different tools and methods, depending on objectives. He has more options at his disposal, de-risked by the fast-growing ecosystem of suppliers and reliability of modern standards. Some of these options come at dramatically reduced cost and cycle time. "Robotic process automation" can be applied relatively quickly and with little risk to mission critical activities. In other cases, more test-and-learn cycles may be

required – for instance, applying artificial intelligence to personalized customer interactions, or machine learning to risk assessment.

Jason is still formulating the case for digitization. He needs to move from early "learning journeys" – trips to the west coast to observe startups and tech giants – to coherent action. For instance, he might start by introducing standards and governance for valuable customer-linked data, while using data-driven insights for some quick wins. These table stakes efforts can be stepping stones to build confidence and conviction for a more holistic and interdependent approach that can drive outsize impact.

IMPLICATIONS FOR LEADERS AND LEADERSHIP

All CEOs face the organizational inertia that resists change, particularly dramatic change. Jason hires a Chief Digital Officer with the mandate to apply digital methods and tools to improve the business. Toshiro sees digitization as his responsibility and sets the bar high – 15% cost-to-income reduction over 3-5 years.

What can we learn from these different approaches?

HOW DIGITIZATION COMPARES TO PAST WAVES OF TECHNOLOGY

Digitization is having deep economic, behavioral and societal impact as it is absorbed into the broader economy. An array of low-cost technologies allow people to engage with each other and businesses in new ways, which then causes ongoing adaptation of technologies to behavioral changes, and at progressively lower cost and increasing speed. As a result, digitization expands possibilities for business reinvention, faster and at dramatically reduced cost.

For instance, distinctions between people and their devices at work, at home, and on the go have eroded, triggered by the adoption of smartphones along with rich services delivered via "the cloud." As people adopt these services, the data about their usage and intent further refines the service and the capabilities of the device, and so on. As a result, companies can let more services to shift from internal processes to customer self-service – lowering total costs with increased customer satisfaction.

Similarly, advances in algorithms, abundant data, and unlimited computing power changes our understanding of what can be automated, and how. Learning algorithms will automate some activities with radical improvements in precision, quality, and cost.

Equally important, digitization is ushering in the kind of plug-and-play standards of interconnecting services that has become standard practice within and between software companies. These "open APIs" can be a means to redeploy and recombine capabilities for flexibility and speed, or to source third-party capabilities without creating future "legacy systems."

As a result many of the techniques that have been restricted to tech juggernauts such as Facebook, Microsoft or Google – for cost or skill reasons – are now widely available for financial services incumbents. That's the good news. The sobering reality in Toshiro's story is that greenfield competitors can engineer with these digital advantages more rapidly than he can reengineer. He must rely on historic market position and industry regulation to buy time to adapt.

Toshiro sets a high ambition, justified by ongoing margin pressure from competitors. This move has several advantages: it mobilizes the organization with a mission, one that is focused on the outside market and future competitiveness. He adopts a milestone-driven approach that builds organizational confidence and stimulates risk-taking. As the organization rallies behind wins driven by outsize efficiency and cycle time improvements, the culture gradually shifts to favor more efficiency and agility. He drives coordinated change across all dimensions of his business, by ensuring each of the four gears moves with the others.

And he leads with conviction and tenacity. He has taken on a gritty, difficult journey to modernize his operating model, "front to back." There is no question that he will face many roadblocks and painful decisions along the way, and the organization that results will look dramatically different. We fully expect a stronger, well-fortified competitive position as a result.

Emma also embraces this "deep digital" formula while taking on a further challenge, which is essential to driving new and sustainable value: she looks across the portfolio of businesses and makes critical choices, business-by-business, for where and how to compete, by following emerging archetypes.

We turn our attention to the ideas in her playbook next.

SECTION 2

IDENTIFYING NEW SOURCES OF VALUE

Like Toshiro, Emma sees margin compression across her businesses – so aggressive digitization and a vigorous defense is an important step. But she sees the effects of digitization as deeper and more disruptive, over an uncertain time horizon: she is fairly certain that today's millennials won't adopt current products, and will likely not want to acquire them through established distribution models. She believes she needs to push harder not merely to battle margin pressures but to create new and sustainable sources of value. Her journey is more ambitious and more difficult.

How can incumbents discover and develop these new sources of competitive advantage? As discussed in Oliver Wyman's 2016 State of Financial Services report, Modular Financial Services*, the shape of both supply and demand are shifting across the industry, creating new ways to serve changing customer needs and expectations.

Financial services have historically been delivered by firms with an integrated, in-house stack of capabilities – from distribution through manufacturing and infrastructure. Digitization makes it dramatically easier to plug-and-play services from multiple companies into a seamless customer experience. The integrated model will become less defensible and the value chain will evolve into what we see as emerging ecosystems of a diverse set of providers.

Incumbents will need to make clear choices, business-by-business, about their future position in the ecosystem. They will then need to align capabilities, investments and their entire operating model with that choice. In some cases, this will mean offering competitors' products and services on a firm's distribution platform. In other cases, it may mean exiting business lines or certain operations to liberate attention for other priorities.

*http://www.oliverwyman.com/our-expertise/insights/2016/jan/modular-financial-services.html

Firms will compete to create power positions in their chosen ecosystems. This section describes three "archetypes" of these power positions – ways that firms can build and sustain new competitive advantages.

This is the essence of Emma's thinking, and how she intends to move from vigorous defense to mounting a good offense.

ARCHETYPES TO CREATE FUTURE VALUE

The tech industry has long seen fierce competition in modular ecosystems. Each firm (or sometimes business unit within a firm) succeeds by focusing on a particular role in an ecosystem and building up specialized advantages. Consider Apple: we think of Apple as the standard-setter for engaging experiences on edge devices – iPhone, iPad, AppleTV. In a different part of their business, though, their growth derives from mass adoption of their platform (the AppStore and iOS). Financial services incumbents can take a page from the tech playbook to reshape how they compete to generate real and sustainable growth.

The path starts with making choices about where the firm wants to compete – which archetype and ecosystem. This choice can be liberating: in Emma's case, she may not see the potential for a power position by pursuing an archetype in one of her businesses; which may guide her to digitize for competitive parity – applying robotic process automation to claims processing, for example. For this business she may stick with vigorous defense and manage it to maintain current value. However, she may see the opportunity to develop an entirely new risk solution business, by finding an emerging crown jewel in her existing business, and doubling-down on it as a springboard for launching her new business. For the new business, she would apply different metrics that reflect her ambition to grow and establish leadership in an ecosystem.

So choice of archetype and ecosystem can focus digitization efforts, and help address the impracticality of digitizing all parts of the business.

And it allows incumbents to be clear and focused about developing new sources of competitive advantage since it is unlikely that incumbents will be able to excel across the entire value chain, and sustain the level of investments that each business will require to outcompete the field (Exhibit 6).

Each ecosystem archetype describes a differentiated role a firm or business unit can play in a modular ecosystem, as well as the capabilities it needs to focus on:

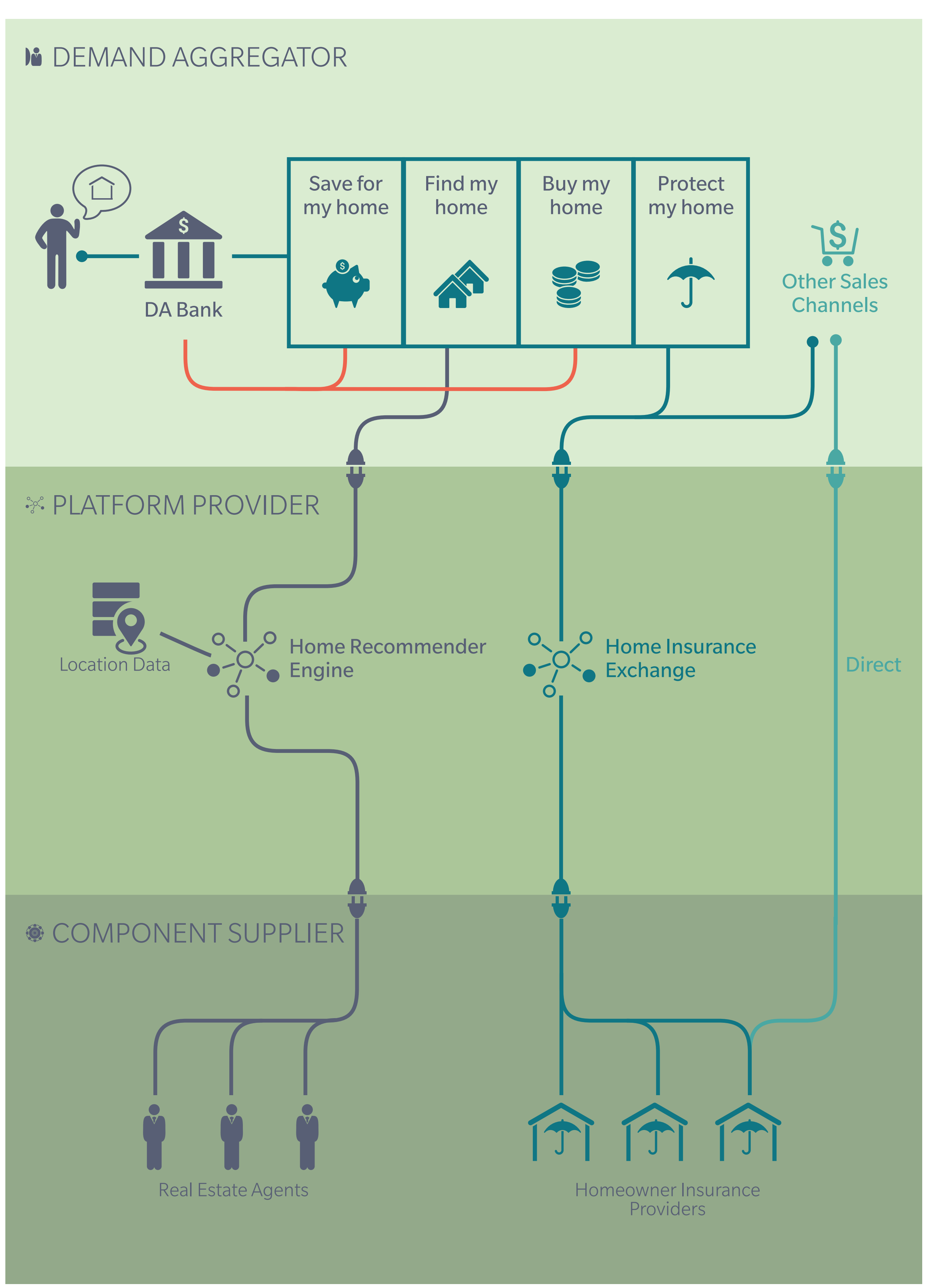
- Demand aggregators: differentiate by providing all-encompassing experiences that remove friction for customers, centered on their needs and goals

- Component suppliers: differentiate by crafting products that plug in to a range of customer experiences, inside and beyond current industry boundaries
- Platform providers: differentiate with platforms that underpin and over time broker services between many players across digital ecosystems

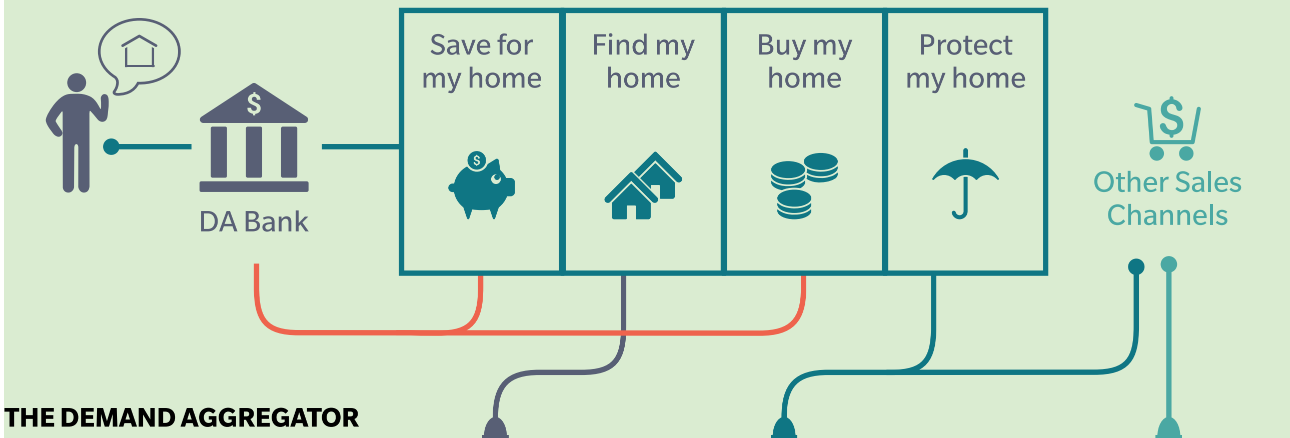
The following pages provide an example of how different archetypes interact in an ecosystem to serve an ultimate customer's needs (Exhibit 6).

VALUE CHAIN POSITION	TYPICAL ACTIVITIES	TO BUILD SUSTAINABLE COMPETITIVE ADVANTAGES, ADOPT THIS ECOSYSTEM ARCHETYPE
CUSTOMER PLATFORM providing all edge customer interactions	• Maintain consolidated view of the customer • Provide key channels of interaction and communication with customer • Examples include insurance brokers, investment advisors, and customer-facing elements of banks	DEMAND AGGREGATOR
DATA AND INFRASTRUCTURE to how data is defined, stored, used, and shared	• Provide standards for efficient data exchange and evaluation among ecosystem members (e.g. US GSEs standardization of mortgage application information) • Provide specialized data or analytics (e.g. FICO) • Encourage trust for users by creating standards for payments, data exchange, transaction confirmation, issue resolution, etc. (e.g. VISA, NYSE)	PLATFORM PROVIDER
FINANCIAL PRODUCTS AND SERVICES linked to a regulated balance sheet	• Provide stable source of credit without creating undue systemic risk (e.g. banks backed by deposits and stable funding) • Provide durable and trustworthy long-term risk protection (e.g. insurers)	COMPONENT SUPPLIER

EXHIBIT 6. THE THREE ARCHETYPES



	SOURCE OF SUSTAINABLE ADVANTAGE	KEY CAPABILITIES
DEMAND AGGREGATOR	Unique **edge experience** designed around customer needs empathy moments. *In the example ecosystem shown to the left, DA Bank is acting as a demand aggregator, serving a home-buyer with a seamless combination of its own products with externally sourced home insurance.*	• Behavioral science & customer research • Highly refined customer segmentation & profitability model based on "personas" • Data-driven marketing and experience metrics • Human-centered design discipline for unpacking customer edge experiences and end-to-end journeys • Solution design and assembly
PLATFORM PROVIDERS	Partner **ecosystem orchestration** to address broadest range of needs or specific needs, by removing friction and setting standard(s). *In the example ecosystem shown to the left, the Home Insurance Exchange is a platform provider, connecting insurers to home owners in need of insurance (indirectly in this case).*	• Partner ecosystem development and management • Web-scale transaction processing • Integrated sales and marketing • Open API architecture/streamlined process for inbound integration • Data and transaction processing efficiency • Real-time partner reporting and data/analytics services
COMPONENT SUPPLIERS	"Plug and play" **product manufacturing**, easily "pluggable" to multiple demand aggregators, often powered by balance sheet. *In the example ecosystem shown to the left, the Home Insurance Providers are component suppliers, providing best-in-class products to multiple demand outlets.*	• Compliance with stringent regulatory and supervisory requirements • Business development for orchestrating and assembling complementary components, modeled on hi-tech model (e.g. Salesforce.com) • Product feature & pricing optimization • Plug and play product API architecture for outbound integration • Balance sheet forecasting and asset/liability optimization

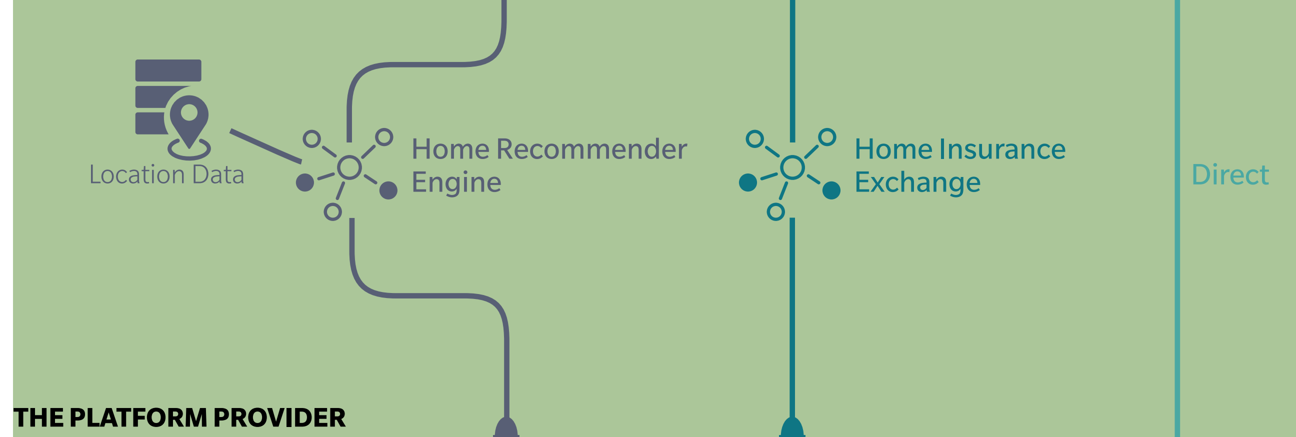


First, companies that adopt a customer engagement focus will enable the end-to-end customer experience for a fundamental need, starting with the need and working back to products. This reverses the logic for many incumbents that find themselves locked in by inertia to narrowly defined products and well-established paths to market. An example would include finding, buying, insuring, financing, maintaining, and remodeling a home – and all the products that go with those activities. Companies that focus on demand aggregation will grow the business first by addressing a wider scope of customer need, and second by providing seamless and anticipatory experiences at each step along the way.

Demand aggregators may choose to incorporate third-party products and services, often to enhance and extend the value of their own products, but repositioned as answers to customer needs and goals. As they address more scope of customer need, they increase the odds of redeploying their existing products into new experiences, backed by the power of a large balance sheet.

The expertise needed to succeed as a demand aggregator is not normally associated with financial services companies: deep insight into customer behavior, powered by data; and human-centered design expertise, to craft experiences that fit across the day-to-day journeys of customers as they use multiple devices (computer, mobile) and encounter different contexts (at home, at work, on-the-go). These capabilities are more developed in other industries like consumer packaged goods and internet technology, where "customer delight" is often set as an explicit goal.

USAA – a US bank and insurance company – is one of the best examples of demand aggregation in financial services. Over the last 5 years, USAA's Auto Circle has moved from simply providing auto finance and insurance to assisting its customers through the entire car shopping process, offering services outside the typical domain of financial services. To do so, USAA sourced white-label capabilities from TrueCar, a car comparison website, so that customers could shop for and purchase cars online. Customers usually spend 70% of their time deciding which car to buy and tend to take whatever loan is offered by the dealer once it comes to financing. By assisting customers from the beginning of their journey and showing real-time options for financing and insurance, USAA establishes itself as the preferred provider. Since the launch of Auto Circle, USAA has increased its auto finance market share by almost 40% and more than doubled its penetration of its customer base for auto loans.



THE PLATFORM PROVIDER

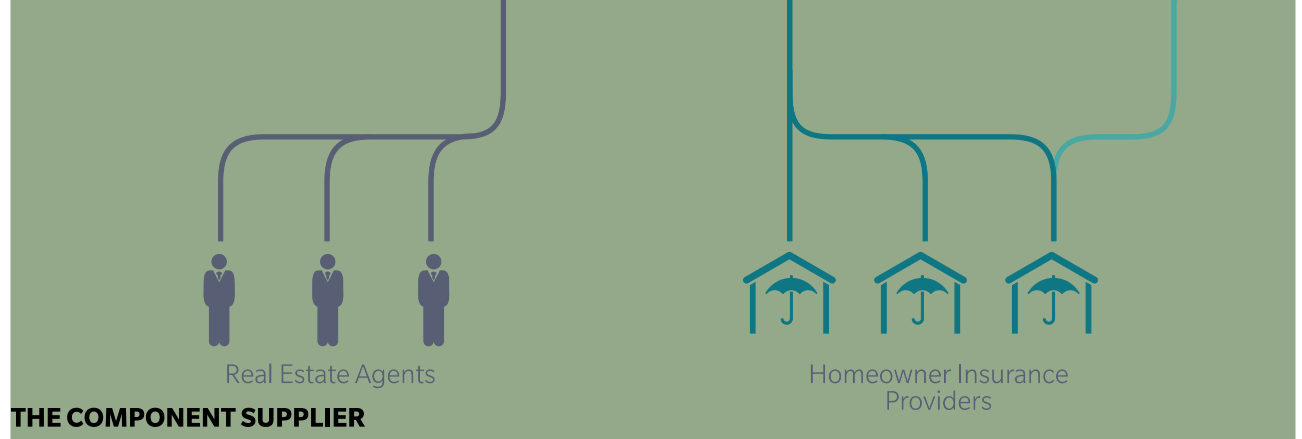
Businesses that focus on processing massive amounts of data and transactions can embrace opportunities to remove friction between customers and suppliers, particularly for needs that are standardized. They provide the platforms upon which others with customer or product focus can thrive.

These companies understand their end customers' needs, and set up the enabling capabilities that can liberate other companies to satisfy those customer needs. In some cases, they may have outposts directly or through partnerships to gain customer insight and harvest these insights to enhance and/or expand their platform offerings. For instance, a payments provider could ensure its platforms span more scope of customer need by partnering with a bank or specialized card issuer.

Platform providers earn fees (both via subscription and transaction) for the use of their platform. These companies aim to have an ever-increasing number of adopters who make money in a variety of ways from the end customers; they win by brokering more interactions between a growing number of customers and product providers.

Their capabilities include extremely high transaction efficiency, highly standardized and open protocols for their entire range of services, and rock solid reliability. They often work to co-create new offerings with their best corporate customers – the biggest users of their platforms.

Well-known examples from the tech world include Uber, AirBnB, and eBay. In financial services, both payment networks and stock exchanges are natural platforms that interconnect their users using standardized protocols. A much less known – and unexpected – example from financial services is Goldman Sachs, the global investment bank. Starting in 2013 Goldman Sachs began to provide access to its proprietary analytics capabilities to clients through its new digital platform: Marquee. One of the capabilities provided is the structured debt instruments marketplace SIMON, a fully open solution. SIMON connects brokers seeking debt solutions with banks that issue them – and on SIMON they have access to solutions from all banks, not just Goldman Sachs. While offering competitors' products through SIMON may seem risky, the strategy has been paying off: Goldman Sachs has risen from fourth to first in structured note issuance over the last 3 years. And while sales margins are thinner on competitors' products, those incremental fees come without additional capital or production costs.



THE COMPONENT SUPPLIER

Businesses that adopt a product manufacturing focus seek to maximize product value by ensuring they are best-in-class, and capable of plugging into as many customer experiences as possible – within and beyond current industry boundaries. Component suppliers can achieve growth by unbundling themselves from current distribution and white-labeling their products into more points of distribution through other demand aggregators.

These companies invest in business development capability to build partnerships with complementary component suppliers. They also invest in consumer insight as a way of (a) designing new offerings; (b) retooling existing offerings to be more flexible for more customer experiences; and, (c) plugging into as many potential customer experiences as possible – including non-traditional ones. Where demand aggregators are relentless about ecologies of demand – needs and adjacent needs, as in the home buying journey – component suppliers assemble ecologies of supply, to ensure their components can combine with others to enhance their value to more demand aggregators. Their bet is on their specialized expertise, and service delivery expertise in delivering their products with lowest total cost and cycle time.

Their top capabilities include business development, product manufacturing excellence, digital delivery methods, and plug-and-play capabilities with well-published interfaces (APIs). They actively orchestrate the ecosystems that they want to participate in, in order to be fully plug-and-play, flexible, and widely recognized as solving end-to-end customer needs.

One well-known example from the tech sector is Salesforce.com. Salesforce has built out its business around digitizing sales and marketing and making it available as a plug-and-play offering (via software-as-a-service, delivered via the cloud). Behind the scenes, Salesforce incorporates Amazon Web Services (AWS) for enabling cloud fundamentals, and then has well-publicized connectors for services from Slack (collaboration), Microsoft (email), and others. Taken together, Salesforce becomes a formidable offering for companies who are looking to have the end-to-end service resolved, as opposed to just one component (sales and marketing automation without the enabling web services and connectors).

Consumer P&C insurance penetration in China is only a third of comparable Asian countries. In 2013 Ping An, one of China's largest insurers, partnered with Tencent, a Chinese media giant, and the digital superpower Alibaba to try to drive growth. Together they created Zhong An: an insurer offering fully digital P&C insurance components tailor-made to integrate into Alibaba and Tencent's technology platforms. In one of the earliest and most successful applications, Zhong An began offering shipping insurance on e-commerce purchases on Alibaba's Taobao marketplace: 300 MM policies were sold by the end of the first year. Today, Zhong An's portfolio-based approach to developing insurance solutions has created over 200 products that are distributed via over 300 partners in China and beyond.

SECTION 3

CREATING NEW VALUE

In the digital era, sooner or later financial services incumbents face a reckoning: they will need to reposition for new ecosystems, and rationalize with a "greenfield" mentality. The path to the future might start with accelerated learning (Jason's story), then shift into high gear (Toshiro's "deep digitization"). Eventually, we believe that incumbents will have to consider Emma's approach: choose an archetype in response to industry-wide digitization, then apply that archetype to guide operating model digitization.

This raises questions: do we really have to choose? What's at stake? Given the risk that always accompanies "future casting," how can incumbents de-risk their journey to new value?

First, we emphasize that many sources of value enjoyed by today's financial services incumbents will continue. For instance, the enormous investments made by large financial services firms to meet stringent regulatory requirements will remain a formidable competitive advantage. Similarly, hard-to-replicate branch networks may continue to be valuable points of distribution for many banks. These advantages, though, are already "priced in" to the valuation of today's incumbents. Creating new value for shareholders will require finding different sources of value.

THE CASE FOR CHOOSING AN ARCHETYPE

If we look again to the tech world, we can discern patterns from digital juggernauts such as Apple, Facebook, Microsoft, Amazon, and Alphabet (Google). After all, financial services incumbents are competing with the tech giants for investor dollars, and these companies have enjoyed dramatic growth in shareholder value. What makes these – and other digital pure-plays – attractive to investors? How do they differentiate and thrive in the rough-and-tumble of tech, where business cycles are faster and regulation light by financial industry standards?

We believe that all of them make clear choices about where and how to compete, and then align their operating models to support those choices. Multi-divisional companies – Microsoft, Amazon – have adopted different archetypes for different businesses. For instance, Amazon.com is a business-to-consumer demand aggregator that has created a near-unassailable advantage in e-commerce by embedding itself in more aspects of consumer's

purchasing needs and behavior – from books to fashion; with Kindles and Echo. Amazon Web Services (AWS), by contrast, is a business-to-business platform provider that has established its leadership in cloud infrastructure by allowing businesses to outsource their digital infrastructure. In an increasingly digital world, we believe financial services incumbents will similarly need to select an archetype for each business unit (or even the firm as a whole), and then reshape all aspects of the operating model for success in that archetype, for several reasons:

Commoditization effects, driven by competition from digital attackers with efficient "greenfield" operating models, will compress profit margins for the rest of the sector to minimum viable levels. Attackers can be new entrants, or other incumbents looking to build a new business in an adjacent ecosystem – similar to what Goldman Sachs has recently done in launching online personal lender Marcus.

Scarcity of resources available to differentiate. To earn profits above subsistence level, getting to parity is not enough. Firms will need to build capabilities that are both distinctive and hard to replicate – and doing so will tax incumbents looking to keep their in-house integrated stack of capabilities. Some of the capabilities required may be altogether new – for instance, human-centered offer design, or consultative problem-solving, or data science. These are highly competitive capability areas where incumbents are already engaged in a war for talent.

Different archetype, different approaches. Different archetypes emphasize different approaches for the same function. For instance, demand aggregators, particularly in B2B settings, will need to be high-touch in how they approach large accounts, which for many will require a difficult shift from product-selling to problem-solving. In contrast, platform providers rely on brand marketing with efficient sales and service capabilities. Both have sales and service functions; but in practice, the operational approaches are polar opposites, requiring completely different management styles and metrics. These different approaches do not co-exist comfortably within the same business or division.

Regulatory pressure. In some jurisdictions, regulatory choices are accelerating these competitive dynamics. In China, policymakers have allowed a large digital ecosystem for retail financial services to grow outside of the traditional banking system. The revised Payment Services Directive (PSD2) in the European Union looks set to formalize the distinction between demand aggregators and component suppliers for much of retail banking (see sidebar).

KEY CONSIDERATIONS IN CHOOSING AN ARCHETYPE

As incumbents think ahead to choosing archetypes, a few observations are in order:

- The component supplier archetype draws on many of the competitive advantages that incumbents enjoy – highly regulated status, for instance. So it may well be a logical choice for many financial services firms. On the other hand, because it may be the "natural act" based on current advantages, incumbents who make this choice will have to work hard to differentiate sufficient to drive new value.
- Would-be demand aggregators will face stiff competition from other demand aggregators who will vie for attention with the same customers. In a digital world, personalized services on mobile devices will trump physical presence and geography. Also, barriers to entry are low: digital services can be scaled at virtually no cost. So, scarcity is customer attention, and competition for scarce attention will come from current competitors as well as near-market and out-of-industry players.
- Successful platform businesses can be incredibly valuable (see Exhibit 7). They are also rare, as the top one to two firms in a given space tend to dominate. In the tech sector, many companies vie for platform status, few achieve it, and the formula typically requires "viral" adoption from highly-committed customers, which then stimulates others to

REGULATIONS ACCELERATING TRANSFORMATION: THE EUROPEAN PAYMENT SERVICES DIRECTIVE

When it comes into effect in January 2018, the revised Payment Services Directive (PSD2) will be a game-changer for European banking. PSD2 will create the legal foundation for full openness of customer and product data across all providers of financial services in the union. Data associated with deposits, payments, loans, and investments will be available to any firm that wishes to provide related services – independently of which firm holds the customer account.

PSD2 will likely accelerate the rise of non-bank aggregators and platforms that provide a single view of all customer accounts across financial institutions. In so doing, the edge experience of personal financial management will be taken away from the banks and put into the hands of third parties that are not concerned with who provides the underlying products. These independent providers will have incentives to get the best deal for their customers by providing price transparency and facilitating hassle-free switching.

In this scenario, many incumbents may well be relegated to the role of pure component suppliers. They will be subject to fierce price competition, could have limited grip on the customer experience, and all the while remain stuck with existing risk and capital requirements. Incumbents will need to make some stark choices on how they wish to position themselves to capture future value. Some are embracing the PSD2 world, and are developing their own aggregation and platform capabilities: for example, ING has launched the bank-agnostic Yolt personal financial management app in the UK. Others may decide to retreat from the edge altogether and instead focus on becoming hyper efficient, user-friendly product suppliers – aiming to integrate into as many alternative digital sales outlets as possible.

Ultimately, regulatory change will force European incumbents to transform – and a clear-minded decision on the right archetype for the future will be critical.

build complementary offerings with platform services, which then allows the platform provider to build adjacent services that ultimately lead to network effects. Aspiring platform providers will likely already have products or businesses that have achieved widespread adoption, which increases the likelihood of achieving network effects in an acceptable time horizon.

DE-RISKING THE JOURNEY TO NEW VALUE

We have made the case for choosing an archetype to navigate through industry-wide digitization, and then applying that archetype to guide operating model digitization. And we have suggested some longer-term competitive considerations for each archetype.

We are still left with the challenge of confronting and managing the organizational inertia that leaders such Toshiro and Emma will face as they adapt their institutions to a digital economy. To manage this challenge, incumbents must not only change; *they must change the way they change*.

Once again, incumbents can adapt a page from the playbook of the tech sector. Successful, world-class growth ventures follow a systematic discipline of innovation. There are three key aspects to this approach:

- First, firms must identify which capabilities could be emerging crown jewels by line of business, and manage them to appropriate metrics. Metrics should emphasize clear milestones and cycle time required to achieve material benefit. For instance, demand aggregator metrics would ensure the development of data-driven customer insights, while a component supplier would instead emphasize service delivery and ecosystem development expertise. And some businesses may

EXHIBIT 7. TOP 50 FINTECH FIRMS BY DOMINANT ARCHETYPE.

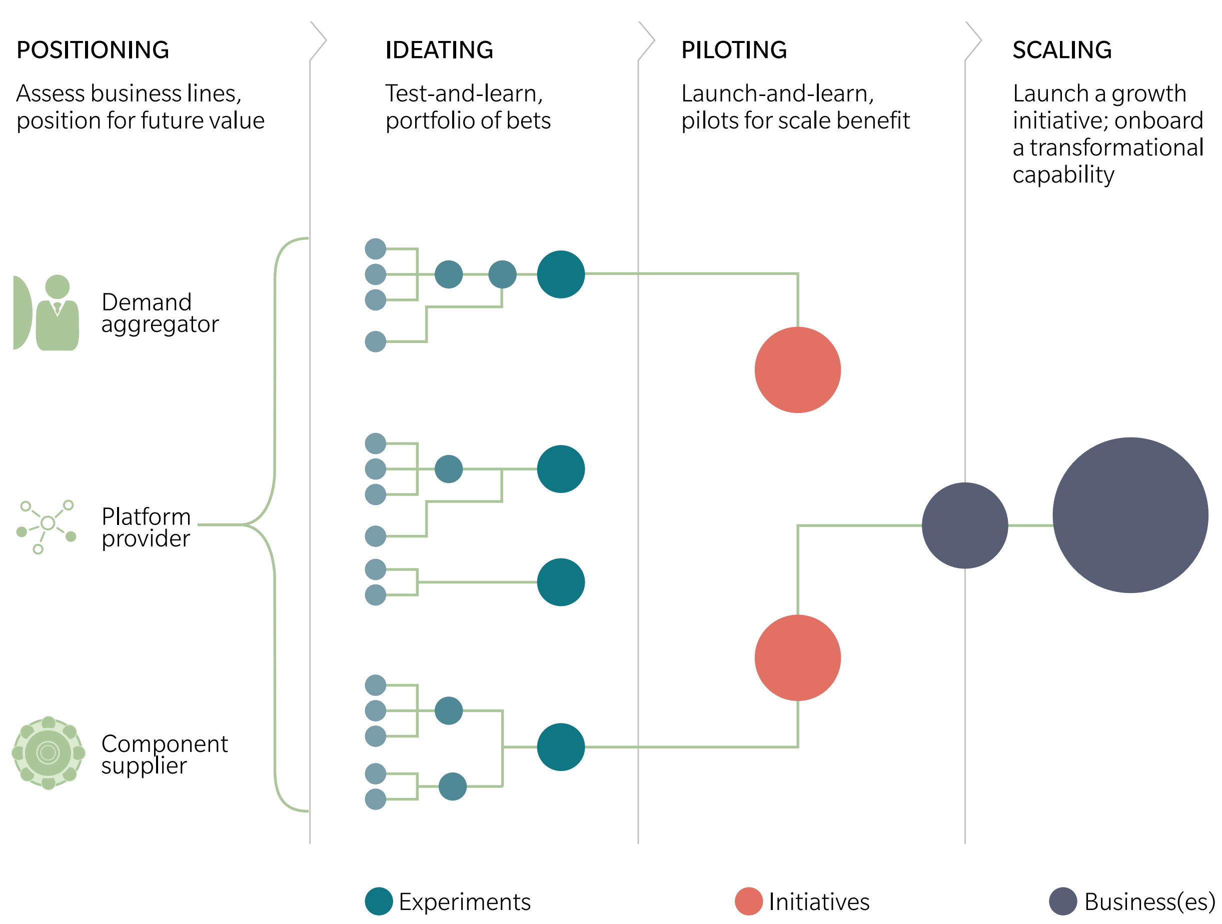
Fintech firms aiming to be...

Demand aggregators	**Platform providers**			
Combined value: $205 billion	Combined value: $820 billion			
Examples:	**Payments examples:**	**Exchanges examples:**	**Data and processing examples:**	**Lending example:**
Intuit	Visa	CME	ADP	Lufax
SoFi	MasterCard	ICE	Fiserv	
	Paypal	Hong Kong Exchange		
	Ant Financial			

- need to race to a power position, which implies more attention to milestones and time horizons.
- Second, capability development should be managed as a series of efforts, with each phase sufficient to reduce uncertainty and earn the right to a follow-on phase, based on marketplace evolution.
- Third, funding models should reflect both of the above – essentially, a model similar to venture-oriented startups with incremental funding for systematic progress.

This kind of approach allows for rapid course-correction in response to evolving customer expectations, competitive movement, and regulatory changes. This requires management attention and discipline: for every public launch of a new initiative by a financial services incumbent, we would expect dozens of ideas will have been evaluated and tested in successive stages. The key for incumbents facing an unpredictable world is to de-risk future investments, building confidence and success in stages.

EXHIBIT 8. BUILDING CAPABILITIES WITH SYSTEMATIC DISCIPLINE



THE IDEA IN BRIEF

As digital technologies change how people live and work, financial services firms need to choose how they will adapt to a broadly reordered marketplace. Virtually every financial service and product can be provided more efficiently and with greater customer delight than it is today using digital tools. To stay competitive in their existing core businesses, financial service incumbents will need to invest in digital transformation much more deeply than they have to date.

For those core businesses on which firms choose to focus their digitization efforts, dramatic cost reductions are possible. However, retooling incumbents' businesses for digital efficiency will not in itself create shareholder value. Competitive pressure will mean that most cost savings are ultimately passed on to customers. Digitizing incumbents' existing businesses, if done well, will preserve shareholder value, but not increase it.

Incumbents looking to build and sustain new competitive advantages can best do so by organizing their overall transformation journey using three modular archetypes inspired by the tech industry.

Each archetype describes a differentiated role a firm (or business unit) can play in a modular financial services ecosystem, as well as the capabilities it needs to focus on which will provide it with sustainable competitive advantages:

Demand aggregators: differentiate by providing all-encompassing experiences that remove friction for customers, centered on their needs and goals

Component suppliers: differentiate by crafting efficient products that plug in to a range of customer experiences, inside and beyond current industry boundaries

Platform providers: differentiate by providing platforms that underpin and over time broker services between many players across emerging digital ecosystems.

Incumbents need to choose an archetype for each business unit, so they can coherently invest and build the capabilities needed to create new sources of growth and increased shareholder value.

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For more information please contact the marketing department by email at info-FS@oliverwyman.com or by phone at one of the following locations:

EMEA
+44 20 7333 8333

NORTH AMERICA
+1 212 541 8100

ASIA PACIFIC
+65 6510 9700

www.oliverwyman.com

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