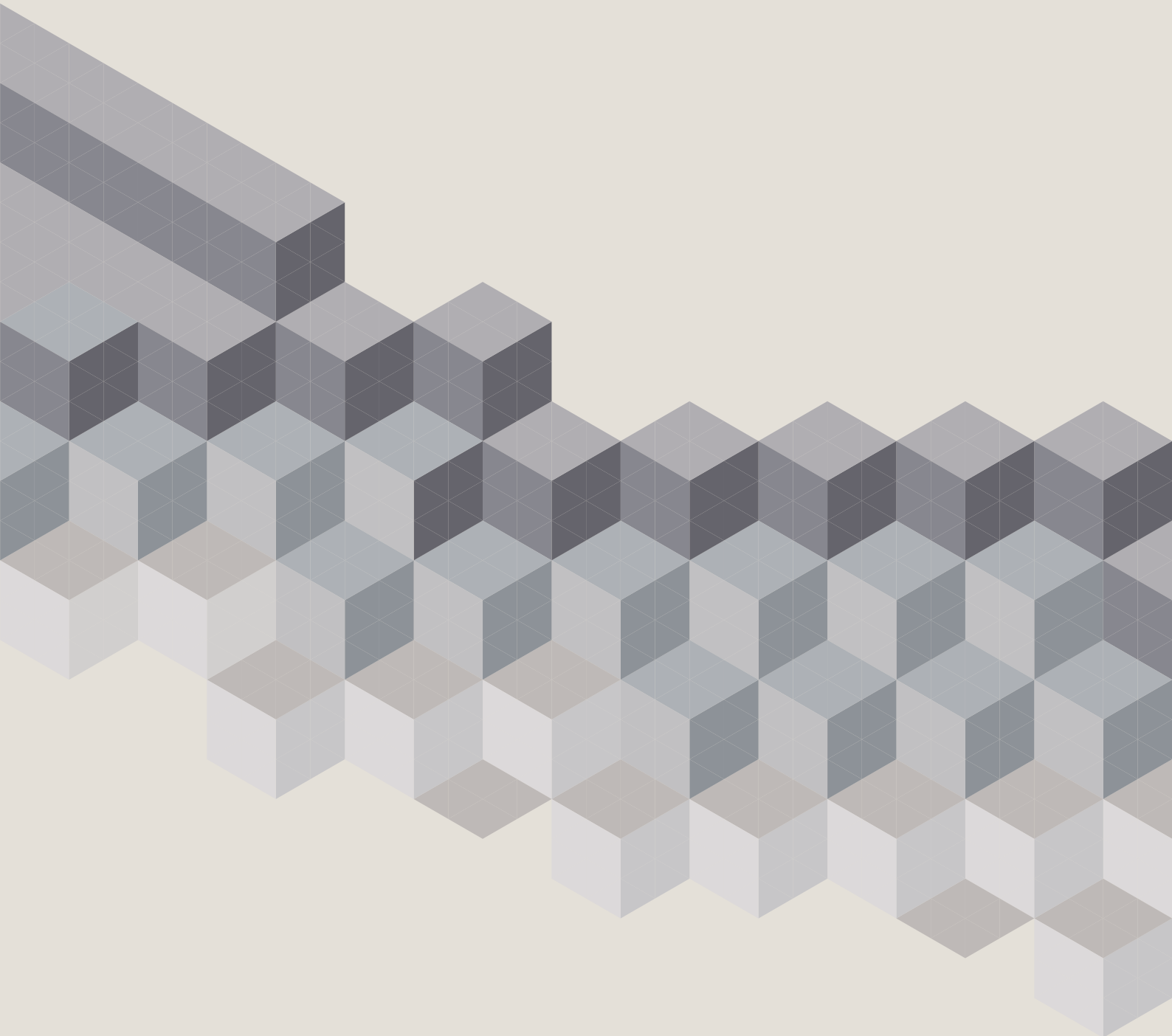


The State of the Financial Services Industry 2017

## **SECTION 1: DIGITIZE TO DEFEND**



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

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Jason has led a large retail bank for four years

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

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A man in a dark suit, white shirt, and dark tie is seated at a table in a restaurant. He is looking off to the side with a thoughtful expression. The background features ornate, dark wood paneling and a window with a view of the outdoors. The lighting is dim, creating a professional and serious atmosphere.

**Toshiro became CEO  
of a global investment  
bank last year**

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

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TOSHIRO: 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

+6% increase in ROE

Digitization of wealth and trading platforms

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



## 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 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

**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

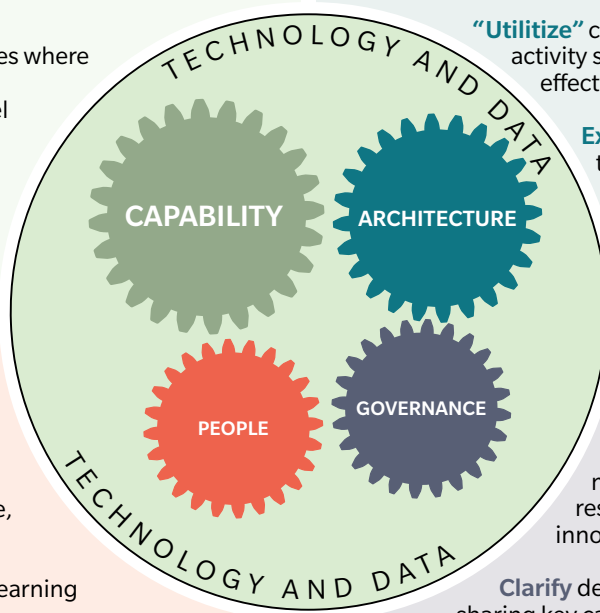
**REDESIGN BUSINESS ARCHITECTURE** FOR SIMPLICITY AND LEVERAGE

**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



**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.

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For more information please contact the marketing department by email at [info-FS@oliverwyman.com](mailto: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](http://www.oliverwyman.com)

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