OLIVER WYMAN

The State of the Financial Services Industry 2017

SECTION 2: IDENTIFYING NEW SOURCES OF VALUE

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.

EMMA: 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’

New digital partnerships & services driving growth

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	8%	19%	
Expense ratio	27%	22%	

Machine learning initiative lowered loss ratio by 5%

ROE increase of more than 10%!

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.

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:

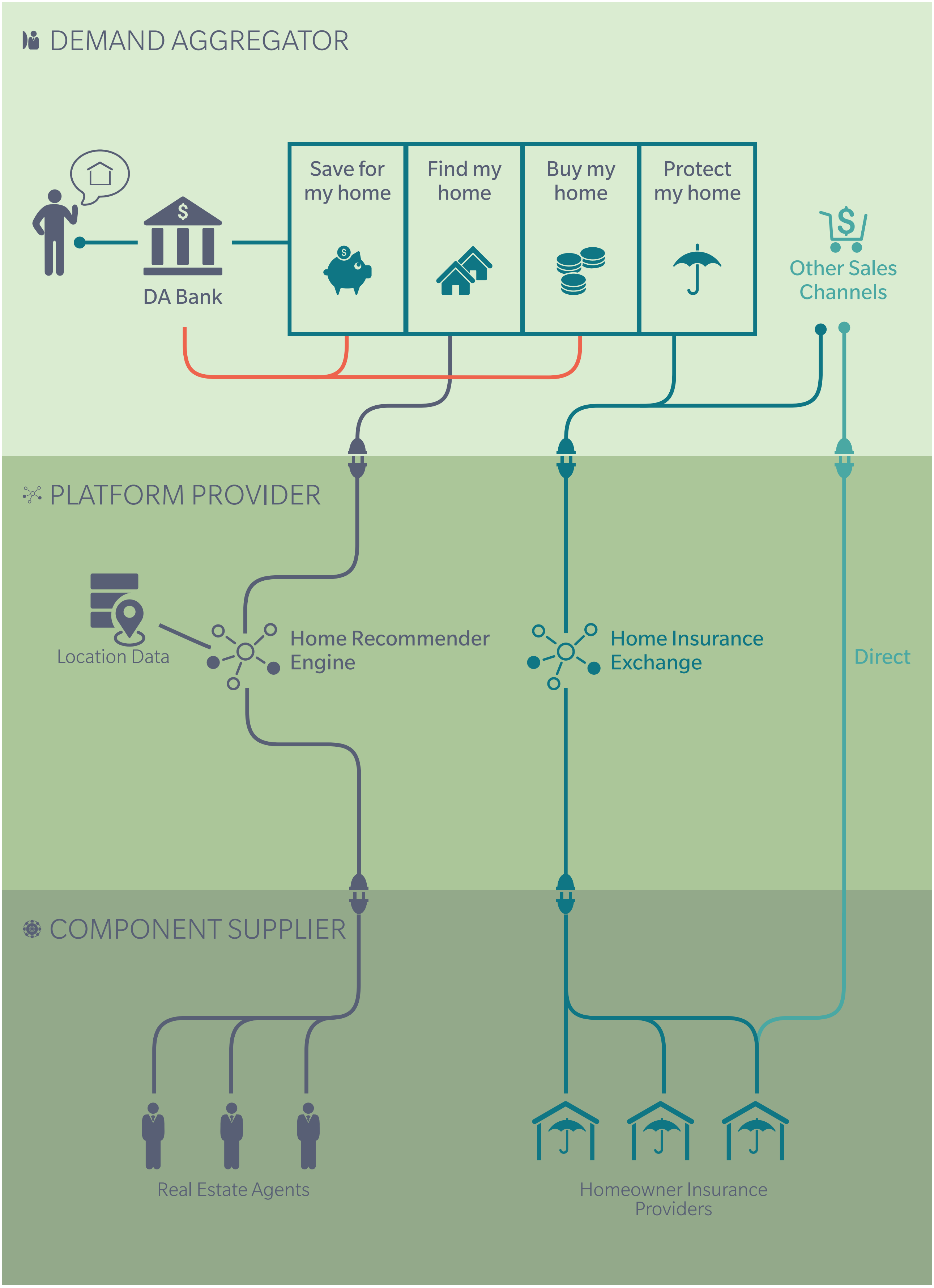
- Demand aggregators: differentiate by providing all-encompassing experiences that remove friction for customers, centered on their needs and goals

- 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

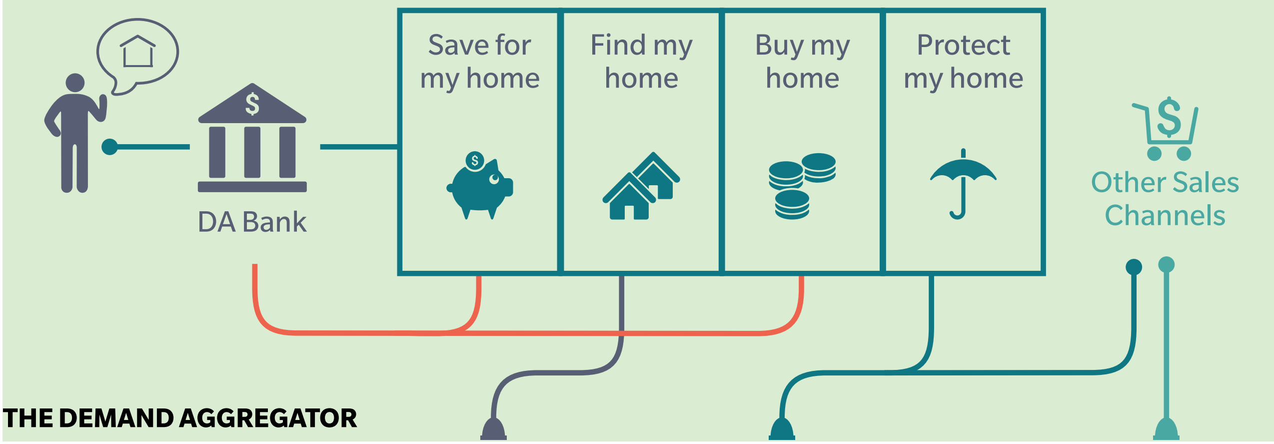
The following pages provide an example of how different archetypes interact in an ecosystem to serve an ultimate customer's needs (Exhibit 6).

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



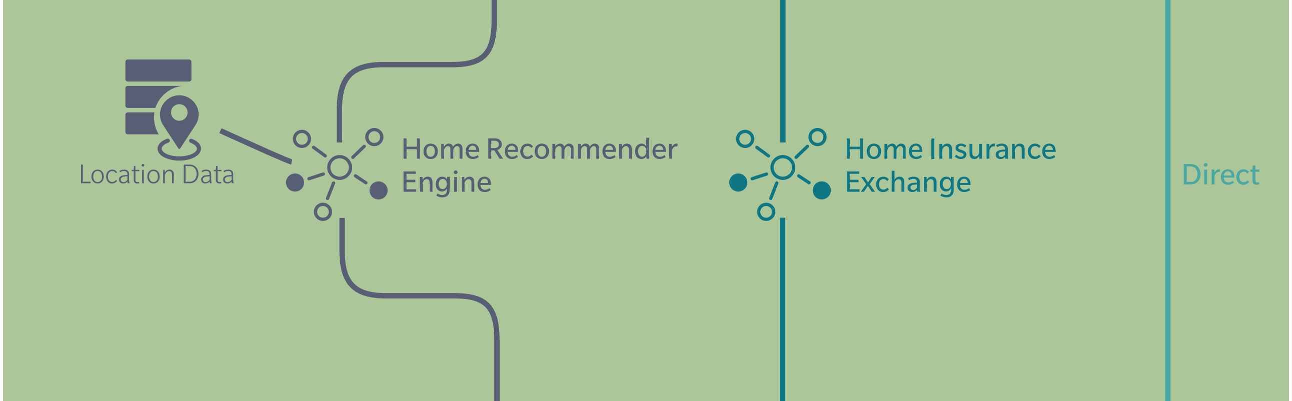
THE DEMAND AGGREGATOR

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

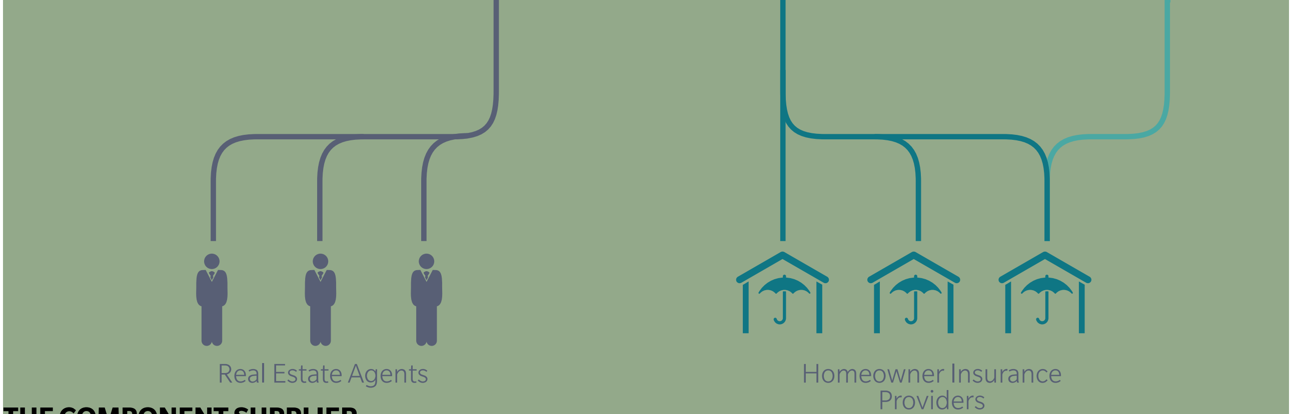
Businesses that focus on processing massive amounts of data and transactions can embrace opportunities to remove friction between customers and suppliers, particularly for needs that are standardized. They provide the platforms upon which others with customer or product focus can thrive.

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.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialised expertise in strategy, operations, risk management, and organisation transformation.

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	NORTH AMERICA	ASIA PACIFIC
+44 20 7333 8333	+1 212 541 8100	+65 6510 9700

www.oliverwyman.com