OLIVER WYMAN

The State of the Financial Services Industry 2017

SECTION 3: CREATING NEW VALUE

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MARSH & McLENNAN COMPANIES

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

Jason has led a large retail bank for four years.

"Stay the course"

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

"Go on offense to grow"

Toshiro became CEO of a global investment bank last year.

“Digitize to defend”

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 sufficiently 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...

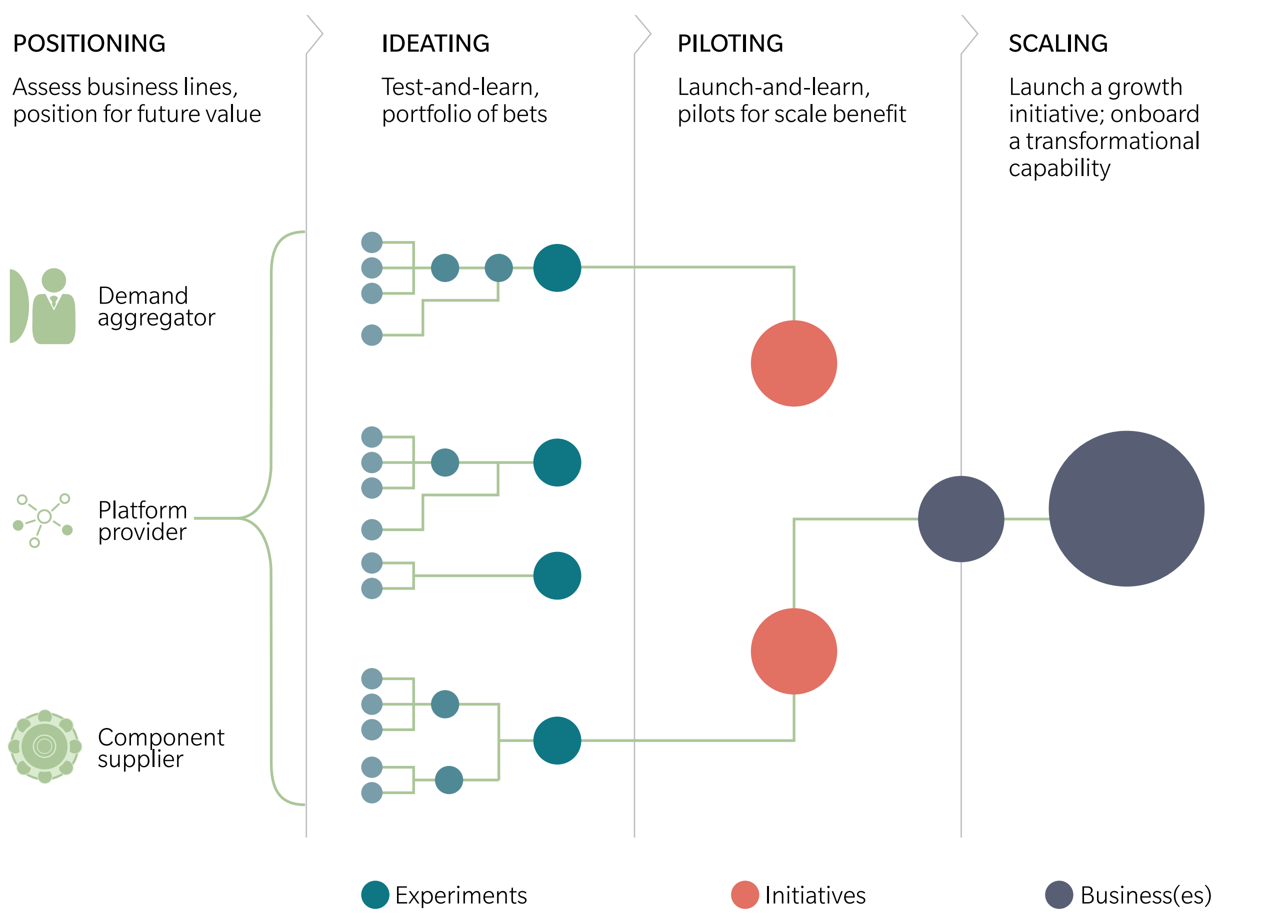
Demand aggregators	**Platform providers**			
Combined value: $205 billion	Combined value: $820 billion			
Examples:	**Payments examples:**	**Exchanges examples:**	**Data and processing examples:**	**Lending example:**
Intuit	Visa	CME	ADP	Lufax
SoFi	MasterCard	ICE	Fiserv	
	Paypal	Hong Kong Exchange		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



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