Piecing the jigsaw: The future of financial services*

Executive Summary

*connectedthinking

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Introduction

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Crystal ball gazing is never a good start for developing an organisation's strategy but a certain degree of looking into the future to identify new trends is a must for companies who want to remain leading institutions of tomorrow. Being able to track and understand the potential impact of current and future changes in our environment is a key requisite to maintaining a competitive advantage.

At PricewaterhouseCoopers, as well as helping financial services organisations deal with the myriad of here and now issues, we also look ahead to what the future may bring so that we can advise our clients on how best to manage for change in a highly competitive environment.

Piecing the jigsaw is a paper focusing on the future of the financial services industry over the next three years and considers the drivers, risks and opportunities, as well as the impact and responses for existing and potential players in the industry.

The study identifies five principal drivers that will affect all financial institutions: **Politics, Demographics, The Economic Cycle, Regulation and Reporting** and **Technology**.

To support the development of this study we set up a number of expert communities within the global network of PricewaterhouseCoopers, covering the different financial services sectors and different geographies to consider the implications of the drivers on the industry. The findings were further supplemented by significant desk research, and we worked with the Economist Intelligence Unit to help pull all of the findings together into this report.

I am confident that you will find this paper insightful and if you would like to discuss any of the issues raised in more detail please speak with your usual contact at PricewaterhouseCoopers.

J L Scott

Jeremy Scott
Chairman, Global Financial Services Leadership Team

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Executive Summary

'Understanding a customer's needs and meeting them capably, in the long term, is all that stands between us and some new form of competitor.' The quote, from the head of strategic planning at an Australian bank, dates from 1996[1]. The sentiment is anything but dated.

This report, on the drivers of change in the financial services industry over the next two to four years, argues that many of the imperative for success identified in our original 1990s research have, if anything, become more salient with the passage of time. From the importance of trust to the need for life-cycle wealth management, from the value of technology to the significance of branding, the blueprint for the customer-centric institution outlined then is largely valid today.

As institutions seek to achieve growth and improve the customer experience while relentlessly managing the challenges of costs and compliance, we believe that the shape of the industry will change. Scale will become less important than a focus on core competencies. Institutions will simplify their offerings and organisations around the activities and markets in which they excel and exit the areas in which they don't.

Distinctions between banks, insurers and asset managers will come to mean less as organisations increasingly position themselves in niches that cut across sectors, from a focus on information-processing services to expertise in a set of emerging markets, from the value of a proprietary branch network to the sophistication of in-house risk models. The financial services industry of tomorrow will look like a jigsaw, with individual sectors, functions and institutions interlocking more and overlapping less than they do today.

This report identifies five principal forces –

1. Demographics
2. Economic cycle
3. Politics
4. Regulation and reporting
5. Technology

These will continue to affect all financial institutions over the coming years. Some, such as regulatory change, are already having a significant impact on the industry and demand immediate attention. Arguably the most powerful force of all affecting the industry – population ageing – will have huge and far-reaching consequences but does not yet require a revolutionary response. But the successful institutions of the future will understand, adapt to and exploit all of the following drivers of change.

1 **Tomorrow's Leading Retail Bank**, Economist Intelligence Unit and PricewaterhouseCoopers, 1996.

1. Demographics

The greying of populations in the world's developed markets is set to strain publicly funded pensions and healthcare systems to the limit. Policymakers in many countries have so far been tentative, and occasionally self-defeating, in grasping the nettle of pensions reform, but the need for individuals to save more and to work longer in order to provide for their own retirement is inescapable.

As in other sectors, such trends will naturally impact upon financial services providers in their capacity as employers. Unlike most other sectors, the industry will focus primarily on the business opportunities brought by population ageing. Inflows of retirement-related funds into capital markets will increase appreciably over the next few years. For working-age savers, products offering the promise of faster capital growth than traditional investment products will grow in popularity.

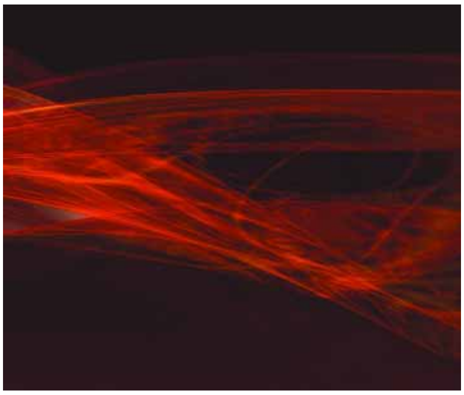
For workers who are close to retirement and for retirees themselves, stable and predictable income is critical. In the US, Fidelity and Merrill Lynch have designed cash management accounts for retirees that will pull in income not only from investments at the brokerage firms, but also from monthly social security and pension benefits. As the share of elderly in the population rises, smart financial services providers will also increasingly focus on wealth transfer-related products such as trusts, life insurance and annuities.

Population ageing is not just a developed world phenomenon, of course, but emerging market demographics are defined primarily by population growth and rising affluence. Forecasters predict that demand for financial services in China and India, the twin Asian behemoths, will be boosted by rapid rates of growth in GDP, personal disposable income and the stock of domestic savings. The continuing growth potential for consumer finance products in these emerging markets and others is striking.

As more and more customers in developed and emerging markets come to use, depend on and directly manage financial products – either in areas where the state used to be the main provider or in areas where institutional investors controlled investment decisions – the consumer culture will become increasingly powerful. Recent scandals involving financial institutions have made education and protection of consumers of financial products a live political issue. At the same time, customer loyalty is declining. Price transparency is increasing thanks to Internet-based information and service providers, as is the ease with which customers can switch accounts and products. Acquiring, retaining and satisfying customers in this environment will become ever harder.

The industry response

- **Many financial institutions will spend the rest of this decade positioning themselves to meet the demand for long-term savings products and for life-cycle wealth management services. Those organisations that offer life-cycle wealth management services and predict changes in consumer preferences through the cycle will be most successful, at least in developed markets. Branding, product mix, customer service and performance metrics must all support the goal of building a long-lasting and multi-faceted relationship with the customer.**
- **All institutions must build a high-performance culture centred around the customer. Staff incentives linked to customer satisfaction and service levels will become more prevalent. Timely and insightful metrics on customer attitudes will become a greater priority. Successful institutions will think about the customer experience first and their internal processes second.**



2. The economic cycle

Following a heady 2004, when the world economy recorded its fastest growth for two decades, the financial services industry can expect leaner times over the medium term in developed markets. Economic forecasters expect the next few years to be characterised by a gradual deceleration in output and demand growth, with the slowdown being most marked in the US. Japan's mini-revival is widely forecast to lose momentum and the performance of the euro zone is likely to remain disappointing. A number of downside risks, from a dollar crash to a hard landing in China, could make the prognosis gloomier still.

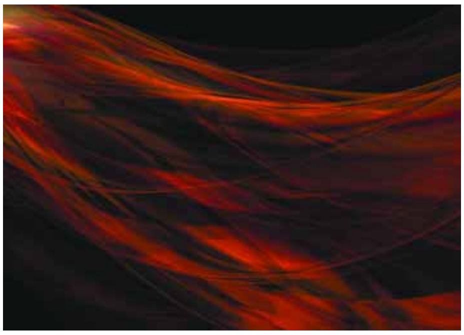
Growth will still be relatively robust by historic standards but financial institutions will have to overcome a number of challenges to make money over the next few years. The pace of borrowing in many developed markets will slow as worries over debt levels continue to rise. Stock markets are not pricing in a significant increase in corporate earnings in the medium term and investment yields are likely to remain low. Competition and disintermediation caused by the arrival of new entrants will further erode margins, particularly in the retail sector.

In their search for growth, expansion by financial institutions into new markets is likely. China and India catch most eyes, although other less-vaunted markets, such as the Middle East and Indonesia, may also come to the fore over the medium term. But the challenges of successful and sustainable entry into emerging markets, from emergent domestic competition to the regulatory and compliance issues of operating in multiple territories, will encourage most institutions to adopt an incremental approach to geographic expansion.

On the product side, institutions will keep their eyes peeled for innovative sources of revenue. The continued rise in alternative investments available to individuals – private equity, for instance, or structured products offering guaranteed returns – will reflect the demands of a growing class of investor hungry for greater yields than those afforded by conventional investment products. The pressure to innovate will again be balanced by the need to offer transparent products that are both easy for consumers to understand and acceptable to regulators.

The industry response

- **Rising competitive pressures will force institutions to differentiate themselves more aggressively, whether through their product mix, their market focus, or their branding proposition. Restructuring will focus on entrenching existing areas of strength, not developing entirely new ones. Conglomerate strategies will wear less well than competency-led ones – even if managers are keen, shareholders won't be.**
- **Cost-efficiency will remain key. Expect a further acceleration in the outsourcing of non-core functions and greater emphasis on performance improvement as institutions seek to increase the efficiency of back-office processes. Expect compensation packages to be more closely tied to performance too.**



3. Politics

The responsibilities and ethics of the financial services industry are already under close political scrutiny and there are several reasons to believe that the level of scrutiny will intensify. Governments will look to the private sector to help put their pensions and healthcare systems on a sustainable footing. The rising affluence of consumers in emerging markets will focus policymakers' attention on the standards of care that the industry applies in educating and protecting its customers.

The industry's buffeting in recent years at the hands of politicians, regulators and, most visibly of all, Eliot Spitzer, New York's vigorous attorney-general, is likely to continue. Financial institutions must be proactive and forward-looking in their response. Conformity with industry practice is no defence against investigation and censure.

Over the last two years much attention has been paid by regulators and other stakeholders to transactions involving what is termed 'financial engineering', comprising either accounting or taxation arbitrage or both. Whilst there is no agreed definition of what financial engineering is, it is clear that some financial engineering is now regarded by some stakeholders, and especially government institutions, as unacceptable. Until greater clarity in this area can be achieved between all the stakeholders involved, financial institutions will need to ensure that transactions they enter into or design for their customers are considered carefully in the light of the views being expressed by regulators and other parties. It may be that some elements of business will no longer be appropriate.

Other political forces will be at work over the coming months and years. One will be continued geopolitical risk, much of it related to the so-called war on terror. Political risk will pose a direct threat to the assets, people and loan portfolios of financial institutions in less stable parts of the world. It will also have a wider impact on the industry through high-profile political initiatives to crack down on money-laundering activity – estimated by the IMF to account for flows of money worth 24-25% of world economic output.

The tension between protectionist and liberalising sentiment within and across countries will be another critical political driver. The forces of competition will be given freer rein within borders, whether through industry deregulation in emerging markets, such as China and India, or consolidation in developed markets such as Japan, Germany and the US. A pick-up in M&A activity is likely to continue as a result, particularly in banking, although acquisition strategies will tend to be incremental rather than transformative. Private equity firms will gain particular momentum in regions where the scope for economic restructuring is greatest, such as continental Europe.

Constraints on cross-border liberalisation will remain high, given stumbling progress in global trade negotiations, political sensitivities over foreign acquisitions and the cultural barriers (not least in a nominally united Europe) to successful integration. Here too, however, the prevailing trend is towards greater openness – witness the web of free-trade agreements under negotiation in Asia and Latin America, the scheduled further expansion of the EU to include Romania and Bulgaria and (occasionally faltering) steps towards capital-market integration in Europe.

The people angle

Threading through the issues confronting the CEOs of financial institutions is the perennial challenge of managing people effectively and, more broadly, of ensuring that the right talent is in the right place at the right time. According to a recent PwC survey of more than 1,300 CEOs across industry, over half believe that the loss of key talent is a major threat to future business success. The fight for skilled staff isn't helped by forecasts that the number of jobs to be filled globally will grow by 14% in the next ten years, yet the global workforce is set to expand by just 8% in the same period.

People challenges manifest themselves in other ways too – from the pull of employees to work longer as a result of poor financial planning for retirement, through to the push of businesses to manage costs more effectively and therefore to seek alternative HR solutions, including offshoring, outsourcing and the development of shared service centres.

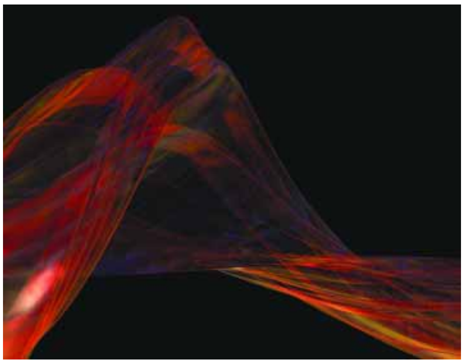
Paying greater attention to how institutions manage people is also key to how they manage business risk. An effective control framework can only be achieved if a coherent management team is in place and if clearly defined reporting structures are in place throughout the organisation.

The reality of penetrating new markets, moving employees into more cost-effective geographical locations and new employment patterns (multiple careers, longer careers, continuous learning, remote working and the like) will require employers to think in more imaginative ways about the following questions, among others:

- **How to recruit talent** – where will employees be based, at what stage of education will they be recruited, what will the competitors offer, and what will employees want?
- **How to reward** – with a more diverse workforce, and with a (potentially) longer career, what is the appropriate reward mix at different stages of an economic cycle (from the company's perspective) and at different stages in an individual's career?
- **How to manage performance** – how do organisations recognise and reward good performance, and how is poor performance identified and dealt with?
- **How to manage people and HR risks** – what processes are in place to make informed decisions on people and HR risks, and how is the effectiveness of these processes reviewed?

The industry response

- Organisations should expect their products, pricing and policies to be judged through the eyes of the customer. Leading institutions will solicit and act on customer feedback at all points of the business, from product launch to product sunsetting. The office of the ombudsman will rise in importance within retail banks. The simplicity and transparency of products will be a key ingredient of success.
- As institutions continue to internationalise, whether through increased offshoring activity or expansion into new markets, political risk will preoccupy the industry further. An informed view on developments in China and India, as well as neighbouring countries, will be essential to boardroom discussion. Executives from both of these countries will appear on global boards with increasing frequency.



4. Regulation and reporting

Financial services firms in developed markets can expect a growing volume of regulation – for starters, consider Basel II, IFRS, the USA Patriot Act, or the 42 components of the EU's Financial Services Action Plan (FSAP) exercise – and more rigour in applying them. The intensity of regulatory scrutiny will be milder in emerging markets, but here too the trend will be towards a heavier compliance burden.

New regulations bring new risks, most drastically closure and loss of income in the event of a severe failure of compliance. Other risks include higher compliance costs, potential loss of reputation from non-compliance, product offerings cramped by changing and uncertain regulatory frameworks, and potentially more volatile earnings resulting from fair-value accounting. Among other effects, these risks will have a dampening impact on the speed of M&A deals as would-be buyers spend more time on due diligence. On the plus side, liberalisation will open new markets, regulations will fuel new businesses like environmental liabilities insurance, and institutions with strong reputations for ethical behaviour may derive competitive advantage as a result.

A tighter focus on capital management, through Basel II and the planned Solvency II initiative, will encourage corporate restructuring and disposal of non-core activities. The focus on governance will foster enhanced risk management, improved management processes and more risk-aware performance cultures. The introduction of International Financial Reporting Standards, which came into effect for Europe's listed companies in 2005, will further reinforce the trend towards prudential capital and good governance by ensuring greater transparency around institutions' finances.

The industry response

- Institutions will either abandon low-return businesses altogether or seek to improve margins through automation and process improvement. Greater visibility surrounding the true profitability of individual lines of business will hand more power to the ratings agencies, and to investors, to judge institutions' real value. Product performance will be monitored more closely, leading to more frequent changes in pricing and guarantees.
- Enterprise-wide risk management systems will mature and proliferate. Management will receive timelier, more accurate information on the performance of individual lines of business. Employees will be incentivised and assessed against measures of good governance.
- A truly global footprint entails a hugely complex compliance challenge. Ensuring that multiple regulatory requirements are met has the potential to worsen the customer experience, but failing to meet these requirements has the potential to sink the business. For most institutions, international expansion will be focused on a few key markets.

5. Technology

New technology continues to deliver more capability at lower cost. Improvements in compression technology, the spread of consumer broadband and the impending shift to Internet Protocol (IP) communications networks will give the financial services industry the infrastructure it needs to deliver on the promise of e-finance.

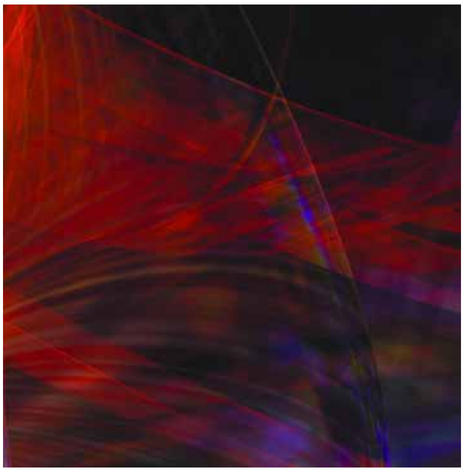
On World Bank estimates, e-finance penetration among Internet users will increase from between 40% and 50% in major markets such as the US, Japan and the UK in 2005 to 90% by 2010, with penetration rates in emerging markets rising from less than 20% in 2005 to 60%-70% by 2010. Institutions that do not offer an efficient multi-channel distribution strategy will not be competitive.

In an environment of decreasing customer loyalty and increasing customer sophistication, technology is both problem and solution. Electronic distribution will continue to enable easier price comparisons and changes of financial provider. But technologies for enhancing CRM and improving customer experience will assume much greater importance as financial services firms seek to build new customer relationships in fast-changing mass-market segments such as pension products.

Risk management has implications for technology strategy, too. The use of predictive models will continue to expand fast throughout the financial services industry over the coming years, from refining insurers' estimates of losses, to reducing card issuers' acceptance of risky customers and honing the trading strategies of investment banks and hedge funds.

The industry response

- Upgrading technology to track risk exposure accurately and swiftly across the whole firm will be crucial. Allocating capital to maximise returns relative to risks, real-time knowledge of the firm's total risk exposure, and an effective, transparent dialogue with regulators, rating agencies and the capital markets will represent the minimum standards for the well-governed financial services firm.
- CRM will move away from its conventional focus on assembling historical data on the customer towards anticipating how customer needs will evolve throughout the life cycle. Institutions will invest much more in predictive approaches to customer data. Downstream, technology will be used to mass-customise products, services and distribution.
- Security will be a significant differentiator for financial institutions. The reputational and operational risks from breaches in security are growing, and franchises and brands can suffer immense damage from unauthorised release of data, or leaks from their own or an outsourced database.



The institution of the future

What do all these drivers add up to? The successful financial institution of the future will be characterised by a pervasive customer-centric culture and three broad hallmarks: a **focus** on its areas of competitive advantage; adaptation to forces of **fragmentation**; and the **flexibility** to exploit new opportunities.

Focus does not mean the end of convergence or consolidation. Instead of seeking to dominate in every segment and territory in which they operate, many institutions will temper their ambitions, looking to expand regionally instead of globally or focusing on particular customer segments. Size will still be important to many institutions, not least as a means of deterring potential predators, but there will be an emphasis on simplification, both of processes and platforms inside the organisation and of the service offering to the customer. The upshot will be the rise of competency-led enterprises, institutions that develop and excel in particular areas.

Fragmentation is the natural corollary of this competency-led approach. Rather than seeking to build a broad footprint across all markets and sectors, institutions will outsource more functions and processes, decentralise distribution and sell off more businesses that are not core competencies. There will be plenty of acquisition activity but of a highly targeted variety. Sellers will dismantle and divest non-core or underperforming parts of their business; buyers will acquire businesses that fit neatly with their focus and can be integrated quickly. Following the paths set by many other industries, the management of alliances, suppliers and distributors will become a critical skill as organisations define their areas of expertise more tightly and co-operate more closely with others to deliver value to the end-customer.

As well as honing their strengths, tomorrow's leading institutions will also have the **flexibility** to seize opportunities. In recent years, many organisations have performed well because the economy and the markets have performed well, buoying consumer debt and inflating investment fees. Flatter markets, heavier regulation and fiercer competition mean that institutions will have to think laterally and move nimbly to define and defend market niches. From pensions to structured products, from China to India, there are plenty of areas of high potential. But seizing them will take greater entrepreneurialism than institutions have been prone to show in the past.

Not all of these forces are in perfect alignment. Flexible organisations will be pulled towards non-traditional revenue opportunities that may not fit their current focus. Nevertheless the organisations that can balance these imperative best will be the most successful. Those that cannot – the institutions that attempt to do everything and the ones that fail to evolve at all – are headed for failure.

Five action points for the CEO

There is no single, pre-determined route to success over the coming years. An insurer in China will face different challenges and adopt differing solutions from an asset manager in the United States. Yet as the leaders of today's financial institutions think about the shape of tomorrow's leading players, their strategies should embrace five key principles:

1 Identify and articulate what your institution does best. Conglomerate strategies will lose their remaining lustre. A well-defined corporate identity, in the minds of customers, investors, regulators and staff, will be critical. That identity might be founded on traditional differentiators, such as particular customer segments or chosen markets. Or it might reflect less conventional ones, such as the distinction between distribution and manufacturing, differences in levels of risk appetite or skills in information processing. Whatever an institution's core activity, it should be at the heart of its strategy.

2 Simplify the offering to customers ... Whatever its core activity, trust will be an organisation's most precious asset. Fiercer regulatory scrutiny and a widening consumer base means that complexity is out and simplicity is in. Products should be transparent and easy to understand; risks should be clearly defined and explicitly understood; and product performance should be reported on regularly and objectively. The interface with the customer should be designed to be user-friendly above all else. Customer satisfaction metrics will sit at the heart of management decision-making processes.

3 ... and simplify the enterprise itself. As an institution's corporate identity and product offering simplify, so will the organisation itself. Technology platforms should be consolidated and integrated, aided by continued outsourcing to third-party providers. Risks should be assessed and managed on an enterprise-wide basis. Performance data should give a panoramic view of the institution. Cost efficiencies will arise as a result. More importantly, silos will fade nd teams will collaborate more effectively across the organisation. There will be little room for hierarchies, whether based on products or functions, in tomorrow's leading institution.

4 Hone market positioning in line with demographic trends. Whether seeking to take advantage of the growth potential of the emergent middle class in developing markets, or targeting fast-expanding sub-populations within countries through ethnic products and services, or pursuing life-cycle strategies aimed at tomorrow's pensioners, successful institutions will put demographic trends at the heart of their business plans. To drive growth effectively, institutions should identify a core of high-potential customers and build their offering accordingly.

5 Don't forget the most important ingredient – people. The industry landscape may change but the importance of people is permanent. No institution can thrive without high-quality employees at all levels of the organisation. What is changeable is the skills base of those employees. The next few years will see two pronounced and convergent trends in employee capabilities – towards better data analysis and towards enhanced customer-facing skills. We believe that institutions should think very carefully before outsourcing their customer-contact activities.

Contacts

If you would like to discuss any of the issues addressed in more detail please speak with your usual contact at PricewaterhouseCoopers.

This report is supported by PricewaterhouseCoopers Global Financial Services Leadership Team:

Jeremy Scott
Chairman, Global Financial Services Leadership Team
44 20 7804 2304
jeremy.scott@uk.pwc.com

Thomas F. Barrett
1 617 530 7363
thomas.f.barrett@us.pwc.com

Etienne Boris
33 1 56 57 10 29
etienne.boris@fr.pwc.com

Javier Casas Rúa
54 11 4891 4550
javier.casas.rua@ar.pwc.com

Diana Chant
1 416 365 8207
diana.chant@ca.pwc.com

Rahoul Chowdry
61 2 8266 2741
rahoul.chowdry@au.pwc.com

Ron Collard
44 20 7212 6827
ron.p.collard@uk.pwc.com

Richard Collier
44 20 7212 3395
richard.collier@uk.pwc.com

Ian Dilks
44 20 7212 4658
ian.e.dilks@uk.pwc.com

Simon Jeffreys
44 20 7212 4786
simon.jeffreys@uk.pwc.com

Chris Lucas
44 20 7804 9652
christopher.g.lucas@uk.pwc.com

John Masters
61 2 8266 7265
john.masters@au.pwc.com

David Newton
44 20 7804 2039
david.newton@uk.pwc.com

Phil Rivett
44 20 7212 4686
phil.g.rivett@uk.pwc.com

Tim Ryan
1 646 471 2376
tim.ryan@us.pwc.com

John S. Scheid
1 646 471 5350
john.scheid@us.pwc.com

Nigel Vooght
44 20 7213 3960
nigel.j.vooght@uk.pwc.com

Brett Yacker
1 646 471 9983
brett.yacker@us.pwc.com

Akira Yamate
81 3 5532 2518
akira.yamate@jp.pwc.com

For information on this and other PricewaterhouseCoopers Global Financial Services reports and publications please contact Áine O'Connor, Director, Head of Global Financial Services Marketing, on 44 20 7212 8839 or e-mail at aine.r.oconnor@uk.pwc.com

For copies please contact Alpa Patel at PricewaterhouseCoopers on 44 20 7212 5207 or e-mail at alpa.patel@uk.pwc.com