Financial services are set for transformation as their role, industry structure and commercial realities are disrupted by the major trends currently reshaping the global economy. Many businesses will be unrecognisable by the end of the decade and the list of market leaders could be very different as smart and agile players leapfrog slower moving competitors. Will your business model still be relevant in the new global economy? How can you take advantage of the shake-up ahead?

**How Are You Operating in the ‘New Normal’?**

Future trends for the FS industry and their impact on those within it
How Are You Operating in the ‘New Normal’?
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The research underpinning this document is part of a framework we have developed to help financial services businesses respond to the challenges that face them. This research and new approach is called Project Blue.
In 2012 the financial services industry is at a watershed. While most organisations are finding it difficult to look beyond the current market turmoil and new regulation, their survival and success will also depend on being able to deal with the longer term trends that are transforming the market and competitive landscape. These include the rise and interconnectivity of the emerging markets and state-directed approaches to economic development. Financial services businesses are also facing the impact of new technology, demographics, social change and mounting pressure on the world’s most critical natural resources (see Figure 1).

**Introduction**

Why the ‘New Normal’ theme?

Is there any hope that we will return to some kind of pre-2007 state? We don’t think so and what is more we believe that many of the key issues facing the FS industry have probably changed forever.

Many industry participants (particularly in the West) are focused on tactically managing the global instability that is the “New Normal” reality; however, the market is changing and opportunity exists for those who see it and can strategically align with the emerging picture.

**Figure 1: The Project Blue framework**

<table>
<thead>
<tr>
<th>Tactical Management</th>
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<tbody>
<tr>
<td>Global Instability – the “New Normal” realities</td>
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<tr>
<td>Dealing with new regulation</td>
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<tr>
<td>Navigating the “moral” dimension</td>
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<tr>
<td>Dealing with external scrutiny and social media</td>
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<tr>
<td>Living in a “Western” no growth environment</td>
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<tr>
<td>Managing Sovereign and currency risk</td>
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</table>

**Planning for transformation – the emerging picture**

**Strategic Alignment**

- **Rise and interconnectivity of the emerging markets**
  - Economic strength
  - Trade
  - Foreign direct investment
- **Demographic change**
  - Population growth discrepancies
  - Ageing populations
- **Social and behavioural change**
  - Urbanisation
  - Global affluence
  - Talent
- **Technological change**
  - Disruptive technologies impacting FS
  - Digital and mobile
- **The ‘war’ for natural resources**
  - Oil, gas and fossil fuels
  - Food and water
  - Key commodities
- **Rise of state-directed capitalism**
  - State intervention
  - Country/city economic strategies

1 PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity.

Source: PwC* Project Blue analysis
We have worked closely with a small team of main board directors and senior management at our clients in developing this agenda. One thing that has really encouraged us in putting together the conference agenda is the extremely positive comments from our clients about the direction we have chosen.

We have had comments like:

“My department needs to develop new skill sets”

“The board has a much greater fear of the media and reputational risk”

“We need to push journalists and other media outlets to report our tax perspectives”

“My department needs to be on top of changes happening in world, tax and non tax, and how they impact the group and within that its tax affairs”

“The balance in the global economy has shifted. For me and my department that is going to mean a real change of focus to different parts of the world. I would not rule out that I and we have to relocate ourselves”

We hope you enjoy this look at the world, and find it a useful catalyst to developing your own agenda for dealing with the “New Normal”.
I first joined the Board of an FTSE 100 company at the end of 1989.

I have not kept copies of the agendas of our meetings at that time, but I would hazard a guess that the phrases “social media” or “risk management” did not feature prominently. Even the word “regulation” would have been unusual. Regulators were kept at a decent distance and dealt with by lawyers, if absolutely necessary. It was a good board, well engaged with the corporate strategy, but although the group was big and global, it was rare for Directors to be troubled between meetings.

Things are a little different today. The time commitment of a main board director is radically greater than it was 20 years ago, especially in financial services businesses. As the Chair of two board risk committees, I am in regular touch with executives. Corporate governance processes are far more open to public scrutiny, and regulation cannot be regarded as an optional extra for Boards in any company.

For Directors, therefore, the “New Normal” is both more burdensome and more demanding. There is no cozy hiding place on a Board these days. It is potentially more interesting, too, though only if one can prevent the hygiene functions of the board – audit, risk etc – crowding out strategy and the oversight of business management. And that is a big “if”. The hygiene work can never be safely set aside for another day, so time must be dedicated to strategy decisions over and above the regular board agendas. It is vital for the Board to keep an eye on the longer term. Management can help by preparing broad papers for Directors, looking at the way big global trends may affect the business. How, for example, will demographic change impact the firm?

Many directors regret the changing boardroom diet, and the increased focus on compliance. I cannot say I am unambiguously enthusiastic about it myself, but I can see no prospect of a return to a more leisureed age. The expectations of board members have been increasing for some time, but a series of dramatic events, beginning with the collapse of Enron and continuing through the financial crisis, have further ratcheted up the pressure. Investors, regulators and governments now expect Boards to have far more detailed knowledge of the companies they oversee. Those expectations are unlikely to be downgraded in the foreseeable future.

The changing role of the Board has consequences for management, of course. Those who report to the Board need to understand its information needs, and especially to appreciate the Board’s interest in the company’s business ethics, its approach to regulatory compliance, and to social responsibility. Tax matters come into the mix, too. Recent cases have shown that it is now very risky for companies to adopt a simplistic strategy of tax minimisation within the letter of the law. The reputational consequences of being seen to push the envelope can be severe, and the financial consequences too, if the tax authorities are provoked to make a retrospective change.
My impression is that Boards of Directors are beginning to trace the outlines of the “New Normal” and are responding to it quickly. Western corporate governance models have shown themselves in the past to be able to adapt well to change, once the nature of that change has been understood. I hope the discussions at this conference will help participants to understand what the changes mean for them, and how best to respond.

For Directors, therefore, the “New Normal” is both more burdensome and more demanding... It is vital for the Board to keep an eye on the longer term. Management can help by preparing broad papers for Directors, looking at the way big global trends may affect the business... I hope the discussions at this conference will help participants to understand what the changes mean for them, and how best to respond.
Global instability – the New Normal realities

Regulatory changes, fiscal pressures and political and social unrest are creating an uncertain business environment. This instability makes the future of financial services difficult to predict. It also consumes a significant amount of management time, necessitating a focus on short-term optimisation and in some cases survival, potentially at the expense of long-term strategy and execution. This unstable environment challenges traditional risk methodologies and has the potential to disrupt commercial models and organisational structures. The immediate challenge for business is how to anticipate and adapt to global instability, rather than simply react to events.

Dealing with new regulation

Significant regulatory change will be a way of life for the foreseeable future, driven by the requirement to better manage risk in the global financial system, public outrage following the financial crisis and the political agenda this has engendered. The changes taking place are creating greater uncertainty and complexity now, with the prospect of further industry restructuring and unintended consequences ahead. While the reforms are still in the early stages of development, they will come to redefine the role of financial institutions and with it, their strategies and business models.

It’s vital to look beyond compliance to understand how these developments will affect product and business portfolios, how they will determine acceptable cost structures of organisations and ultimately how they will influence the fundamental design of business models in the industry.

Regulatory change will challenge businesses to identify which areas of their business offer the greatest potential and to identify the core attributes on which to establish sustainable competitive advantage.
While absolute amounts may have decreased, not much has changed! Surplus and deficit countries remain the same...

Figure 2: How trade and budget deficits moved 2008 – 2012

<table>
<thead>
<tr>
<th>Countries</th>
<th>2008</th>
<th>2012 est.</th>
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<tbody>
<tr>
<td>UK</td>
<td>-5.9</td>
<td>-7.7</td>
</tr>
<tr>
<td>Spain</td>
<td>-3.0</td>
<td>-8.0</td>
</tr>
<tr>
<td>Germany</td>
<td>1.2</td>
<td>-1.3</td>
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<tr>
<td>Italy</td>
<td>-3.6</td>
<td>-2.2</td>
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<tr>
<td>US</td>
<td>-3.1</td>
<td>-7.6</td>
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<tr>
<td>Australia</td>
<td>0.4</td>
<td>-0.7</td>
</tr>
<tr>
<td>Canada</td>
<td>0.2</td>
<td>-3.6</td>
</tr>
<tr>
<td>Japan</td>
<td>-3.4</td>
<td>-8.0</td>
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<tr>
<td>Russia</td>
<td>4.9</td>
<td>-1.0</td>
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<tr>
<td>Brazil</td>
<td>n/a</td>
<td>-2.5</td>
</tr>
<tr>
<td>India</td>
<td>-1.6</td>
<td>-5.7</td>
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<tr>
<td>China</td>
<td>0.2</td>
<td>-2.1</td>
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Fiscal pressures
Fiscal pressures are further undermining global financial stability by forcing some economies to the brink of default, threatening the solvency of weakened banks and making capital markets more volatile.

Four years after the start of the 2008 financial crisis many of the world’s economies face ongoing budget deficit pressures as Figure 2 shows, and many countries have responded by significantly increasing regulatory oversight as shown in Figure 3 overleaf.

In addition to increased regulation, there is renewed focus on the position of the financial services industry and its contribution to tax revenues. Both the IMF and the EU Commission have suggested that in some countries financial services as a sector maybe relatively undertaxed compared to other sectors of the economy. In the EU at least this type of argument has been in part to justify new taxes on financial services such as a “Tobin” or “Financial Transactions Tax” or possibly a “Financial Activities Tax”.

Another aspect of the post crisis response has been the notion that the financial services sector should make a “fair and substantial contribution” to pay for the costs of rescuing the system from collapse. This too has been used as a justification for further tax measures aimed at the financial sector, such as bank levies that we now see in 8 countries.

There is little doubt that FS groups will be expected to pay more in tax and that this will create challenges including. “How do we lobby effectively?” “What is the Board attitude towards mitigating the costs and risks of new taxes?” “Should we do more to publicise what is already an exceptional contribution to tax revenues?” And ultimately “At what point might we want to consider relocating to get to a fairer position for our stakeholders?”
The intensity of regulatory oversight has increased as a result of the recent crisis.

Figure 3: Regulation expenditure and employees in the UK and Hong Kong

**United Kingdom: FSA**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total FSA regulation expenditure, £ millions, 2002–2010</th>
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<tr>
<td>2002</td>
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<td>2010</td>
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**Financial Crisis**

- **Total 2002–07**: £1.4 billion
- **CAGR 2007–10**: 10%

**FSA regulation employees, 2002–2010**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total FSA regulation employees, 2002–2010</th>
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<tbody>
<tr>
<td>2002</td>
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<tr>
<td>2003</td>
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<td>2010</td>
<td>5,000</td>
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**Hong Kong: HKMA**

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<tr>
<th>Year</th>
<th>Total HKMA regulation expenditure, US$ millions, 2004–2010</th>
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<td>2004</td>
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<td>2009</td>
<td>600</td>
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<tr>
<td>2010</td>
<td>700</td>
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**Financial Crisis**

- **Total 2004–07**: US$1.4 billion
- **CAGR 2007–10**: 4%

**HKMA regulation employees, 2003–2010**

<table>
<thead>
<tr>
<th>Year</th>
<th>Total HKMA regulation employees, 2003–2010</th>
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<td>2003</td>
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<td>2010</td>
<td>800</td>
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**Sources:** FSA, OCC and HKMA websites; PwC analysis

**Notes:** The FSA is the Financial Services Authority, and the HKMA is the Hong Kong Monetary Authority, which are the main financial regulatory bodies for the UK and Hong Kong respectively. *The FSA’s 12-month reporting period begins in April of the year reported.*
Political and social unrest
The world has become increasingly unstable in recent years (see Figure 4).

Factors ranging from corruption and repression to fiscal austerity, unemployment and rising food prices are igniting ever-more frequent social and political unrest. In democratic elections we are beginning to see a response to this in part through the election of parties who represent more extreme solutions to the problems we face. The recent election in France and Greece are a reflection of this trend.

A further spur for change is the advent of social media, which is making it easier to communicate information, circumvent censorship and coordinate action. Even corporate entities have started to find themselves at the centre of increasingly effective social media campaigns.

It is clear that FS groups and their boards need to take into account both the economic and political stability of countries during what seems to be a period of heightened susceptibility to outright political turmoil. Considerations could include: “Do we have contingency plans?”, “Are we monitoring key countries and our exposures to them?” and “What impact does this have on our investment plans?”

Over the past three years the world has become increasingly unstable.

Figure 4: A more unstable world – Political instability index,* by country, 2007 and 2009–10

Sources: Economist Intelligence Unit ViewsWire; PwC analysis
Note: Index measured for 164 countries. “The political instability index represents the level of political instability in a country, with a greater value indicating that the country has greater instability. The chart shows the global change in political instability between 2007 and 2009/10. It plots the index against the proportion of countries with that score. For example, in 2007, around 45% of countries had a score greater than 5 while in 2009/10, around 75% did, indicating greater levels of political instability in 2009/10.”
Navigating the “moral” dimension

In many parts of the world the financial services industry finds itself at the centre of a moral debate which while not entirely new has reached a level of intensity that we have not seen before and which definitely cannot be ignored.

This moral dimension has many facets. As one senior regulator put it “some financial activities which proliferated over the last ten years were “socially useless and some parts of the system were swollen beyond their optimal size”². Later on, the speaker said that he wished he had used the phrase “economically useless”². Whatever the words, the message is clear: we should debate the social utility of financial activity.

Other facets of this moral debate include the notion of “pay back”. The EU Commission in September 2011 said “The financial sector has played a major role in causing the economic crisis whilst governments and European citizens at large have borne the cost. There is a strong consensus within Europe and internationally that the financial sector should contribute more fairly given the costs of dealing with the crisis and the current under-taxation of the sector”³. The EU Commission went on to say that “financial institutions should make a fair contribution to covering the costs of the recent crisis”³.

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² Speech by Adair Turner, Chairman, FSA, the City Banquet, The Mansion House, London
How Are You Operating in the ‘New Normal’?

These comments from the European Commission echoed earlier comments from the G20 that financial services should make a “fair and substantial contribution” to help pay for the crisis.

Most financial services organisations want to project themselves as being “responsible citizens”. The challenge for main boards and senior management teams is in working out what these debates mean for the organisation and importantly, where it wants to position itself given that there is a spectrum of possible positions it could take.

In many ways this is one of the most challenging parts of running a modern financial services organisation. And as recent high profile examples have shown getting this wrong can have enormous reputational impacts and even career impact for those affected. Difficult though the terrain may be, this is an issue that main boards and senior management teams cannot duck.

Dealing with external scrutiny and social media

Ten years ago if you had suggested that main boards and senior management should be concerning themselves with “tweeting” it would probably have been career limiting!

But as a number of FS organisations have found out new forms of social media such as Twitter can be used to create enormous and often unhelpful pressure on an organisation. Equally these media can be used in a positive way to get the organisation’s point of view across.

In this digital era there is also another fact of life which seems to hold true: if you have some data that you wish to keep under wraps and is embarrassing for the organisation, there is a high probability that it will emerge into the public domain, often at bewildering speed.

Journalists and others are becoming increasingly adept at understanding the real issues, their wider impact and also how to achieve maximum embarrassment for the organisation.

Aspects of this new era of information sharing include the possibility that CEOs or other board members may at any time have to deal with questions from well-informed journalists about such matters as how much tax they pay, why more profits are not being reported in a particular country or even, as recently, whether it is right not to pay VAT in a particular country when services are being supplied via the internet.

FS organisations need to develop a strategy for dealing with these new challenges. Key questions to address include: “How do we avoid inappropriate positions and comments in the first place?”, “How can we make sure the whole organisation knows where we stand on particular issues and can articulate it safely?”, “How does the main board communicate our position?”, and if a media firestorm emerges: “Do we have a plan to deal with it and how do we make the key decisions in responding?”.

Living in a “Western” no growth environment

For many organisations in the West or for organisations with operations in Western countries, a key issue is how to respond to the challenge of running a business in a low or no growth economic environment.

There is probably no organisation within the FS industry that does not have cost reduction on its corporate agenda in an effort to improve stakeholder returns, and pressure is intense to identify ways in which the organisation can run itself more efficiently, using fewer people, and more technology where possible to drive efficiencies. Against this, there is
significant upward cost pressure including the external and internal cost involved just to respond to the wave of new regulation and tax rules.

Couple this with new capital regulation which requires FS organisations to optimize their capital and free up resources by reducing costs and one can rapidly come to conclusion that these are almost impossible to reconcile.

The question for boards and senior management is how to achieve cost containment and drive efficiencies while responding to regulatory and capital needs and focus on growing the top line whilst putting the customer at the centre of the business. Part of this is the approach to tax mitigation.

Managing sovereign and currency risk
Eight years ago, had you suggested that the eighth largest economy in the world might have to be considered as a default risk, you might have been met with incredulous looks.

FS groups have for some time had to deal with the possibility that at any one time particular countries may face solvency and possible default risk. Such occurrences while serious could usually be navigated so that ultimately they did not threaten the organisation.

Today this is not the case. FS and non-FS organisations (and even whole countries) have to grapple with scenario planning.
and developing defensive strategies to cope with the possible failure of systemically important economies or even currency unions.

Those organisations that have undertaken such scenario planning have invariably found it very challenging, requiring them to “think the unthinkable”. But hard though it may be this is critical and can lead to sensible measures to limit downside risks and exposures, for example by taking decisions to limit exposures or activities in certain sovereigns, regions or counterparties.

Figures 5 and 6 illustrate the growing imbalances in the Global and Eurozone economies.

**Businesses will need to consider how heightened financial and political instability could affect their risk profile, especially investments and operations in countries and commercial sectors that are potentially vulnerable to protest and unrest.**

**Across the Eurozone, the gap between surplus countries (Germany and the Netherlands) and deficit countries (including Italy, Spain, France and Greece) grew.**

**Figure 6: Eurozone current account balances, US$ billions, 1995–2010**

A current account balance (balance of payments) can be expressed as 1) the difference between the value of exports of goods and services, and the value of imports of goods and services, or 2) the difference between national (both public and private) savings and investment.

Sources: The Turner Review, FSA, 2009; IMF World Economic Outlook, September 2011
Notes: Current account balance is the net transactions in all items other than the financial and capital items; the major classifications are goods and services, income and current transfers.
Planning for transformation – the emerging picture

Rise and interconnectivity of the emerging markets

The focus of global growth has shifted. Western economic dominance is a relatively recent phenomenon and the developments we see are essentially a rebalancing of the global economies. While many commentators are focusing their attention on what are considered to be the largest and fastest growing BRIC markets (Brazil, Russia, India and China), the commercial potential is far greater than these countries alone.

Along with the growth and size of the emerging markets, it’s important to appreciate the interconnectivity of the trade and investment flows between them, which are growing much faster than the traditional routes from developed-to-emerging and developed-to-developed countries (see Figure 7). Indeed, South America, Africa, Asia and the Middle East (SAAAME) are emerging as an increasingly interconnected trading zone, which, in physical terms at least effectively bypasses the West.

South America, Africa, Asia and the Middle East (SAAAME) are emerging as an increasingly important network for international trade.

Figure 7: World trade flows, SAAAME and non-SAAAME, US$ trillions, 2010

Sources: WTO; PwC analysis
Note: Russia and the Commonwealth of Independent States (CIS) have not been included in SAAAME definition because trade is largely international and/or with Europe. Mexico is excluded as it trades mainly within the North American free trade zone and less with SAAAME. Both areas remain very important growth markets and should be considered in relation to the SAAAME region.
The SAAAME region covers a significant proportion of the world’s land surface and has access to many of its natural resources. It also has substantial manufacturing capabilities and access to the labour to support this, large and growing consumer markets, and a sizeable pool of both educational establishments and well-educated professionals. Its significant liquid investable capital includes a growing (albeit slowly) proportion of global assets under management (AUM) and nearly 80% of overall sovereign wealth fund AUM.4

To make the most of the opportunities for growth, businesses will need to contend with rising consumer expectations in these markets, a more complex risk environment and the growing battle for talent. As an increasing amount of emerging-to-emerging market commerce misses out the West altogether, Western institutions also need to find ways to tap into business flows they may never physically see.

SAAAME financial institutions
Success will depend on being able to develop organisational skills to keep pace with the growth of SAAAME markets, to build the customer-centric model needed to keep pace with consumer expectations, and to construct business models and partnerships that are relevant to the markets served. Businesses need to work out how to attract and retain scarce talent when competitors and companies from other sectors are looking to lure the best people away.

Western financial institutions
The opportunities are evident, but regulation and local competition are making it increasingly difficult to penetrate SAAAME markets. Success will depend on being able to deliver products and capabilities that domestic players cannot do and being sensitive to the realities of doing business in these countries.

Our latest research anticipates that domestic credit in China could overtake the US by 2023 and India will become the third largest domestic banking sector after China and the US by 2050.5

4 Sovereign Wealth Fund Institute, 2010 and PwC analysis
5 ‘PwC, Banking in 2050’, 2011 update
Demographic change

Customers and their demands are changing. Population growth and decline in different countries, combined with an ageing population around the world, will create a markedly different consumer market by 2050.

In some European countries, the working population will decline by more than 10% and this gap will need to be filled by immigration, later retirements and productivity gains, which could be accelerated by growth of the digital ‘machine-to-machine’ economy.

While much has been made of the impact of ageing in the Western world, the most dramatic changes will be seen in emerging markets as birth rates and life expectancy around the world begin to converge (see Figure 8).

Businesses will need to anticipate demographic developments and bring products and services into line with the changing customer base in the markets they serve.

As people live longer and state support declines, the competitive frontline is likely to shift from lending towards helping people to fund and manage their retirements. Reputation and trust will be crucial in sustaining market share in an increasingly empowered and knowledgeable retirement market.

Many groups have contemplated the impact of demographic changes but many have found it a challenging subject. For each operational market a view will be needed on “Do we understand the way in which demographic change will affect our product mix?”, “Are we aligned with the likely development of new or hybrid products in these markets and their tax consequences?” and “Are we influencing the debate on the development of responses to demographic change?”

In Asia, population growth is forecast to slow as mortality and fertility rates converge.

Figure 8: Asia, total population against mortality and fertility rates, 2000–2050

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</table>

Sources: United Nations Population Division
Notes: Mortality and fertility rates are the number of births and deaths per 1,000 population; population size based on UN population figures for 2000–10 and medium variant projections for 2015–50; five-year population figures calculated using average across the five years; population forecast by UN using estimated population at 1 July 2010 and assumptions for mortality, fertility and net migration rates

The number of people aged over 65 in Japan, Italy and Spain is forecast to be 60% of the total working age population (15–64) by 2050.7

6 United Nations Department of Economic and Social Affairs, August 2011
7 World Population Prospects The 2010 Revision, Volume I: Comprehensive Tables, United Nations, 2011; PwC analysis
Social and behavioural change

Social and behavioural change is occurring at a faster pace than at any time in history.

Consumers are more informed and empowered than ever before, and old notions of value and loyalty are breaking down as digital technology allows them to both compare value and expand their choices. Continuing digital transformation is also changing the way people interact, share ideas and access products and services, with social networking now making up one in six minutes of time spent online.8

In emerging markets, increasing affluence and urbanisation are creating new and expanding markets for financial institutions. City dwellers’ average wealth and demand for financial products and services are generally much higher than their rural counterparts. Indeed, some observers now see the real distinction in the financial services sector not as emerging and developed markets, but rather city and rural areas (see Figure 9).

How companies respond to these social and behavioural changes could define their market position for decades to come, providing a once-in-a-generation opportunity to put clear distance between them and their rivals if they can align their strategies with the emerging position and a mortal threat if they don’t. The key differentiator will be the ability to anticipate where the market is going on the back of these changes and get in ahead of the competition. Experience in the travel and music industries suggests that companies that are slow to grasp the implications of change could quickly be marginalised.

Over the next 30 years the urban population is forecast to grow by almost 1.8 billion people. Most of this urbanisation is expected in Asia and Africa, increasing the world’s urban population to 5.6 billion9 and creating one of the most important competitive battlegrounds for financial services businesses.

The global middle class is forecast to grow by around 180% between 2010 and 2040. Asia is expected to replace Europe as the region with the highest proportion of the global middle class by 2015.

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Figure 9: Forecast size of middle class, by region, millions, 2010–2050

<table>
<thead>
<tr>
<th>Region</th>
<th>2010</th>
<th>2015</th>
<th>2020</th>
<th>2025</th>
<th>2030</th>
<th>2035</th>
<th>2040</th>
<th>2045</th>
<th>2050</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall</td>
<td>6,000</td>
<td>5,000</td>
<td>4,000</td>
<td>3,000</td>
<td>2,000</td>
<td>1,000</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>200</td>
<td>1,000</td>
<td>2,000</td>
<td>3,000</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Middle East &amp; North Africa</td>
<td>1,000</td>
<td>1,500</td>
<td>2,000</td>
<td>2,500</td>
<td>3,000</td>
<td>3,500</td>
<td>4,000</td>
<td>4,500</td>
<td>5,000</td>
</tr>
<tr>
<td>Central &amp; South America</td>
<td>1,500</td>
<td>1,750</td>
<td>2,000</td>
<td>2,250</td>
<td>2,500</td>
<td>2,750</td>
<td>3,000</td>
<td>3,250</td>
<td>3,500</td>
</tr>
<tr>
<td>North America</td>
<td>400</td>
<td>500</td>
<td>600</td>
<td>700</td>
<td>800</td>
<td>900</td>
<td>1,000</td>
<td>1,100</td>
<td>1,200</td>
</tr>
<tr>
<td>Asia Pacific</td>
<td>1,500</td>
<td>2,000</td>
<td>2,500</td>
<td>3,000</td>
<td>3,500</td>
<td>4,000</td>
<td>4,500</td>
<td>5,000</td>
<td>5,500</td>
</tr>
<tr>
<td>Europe</td>
<td>500</td>
<td>600</td>
<td>700</td>
<td>800</td>
<td>900</td>
<td>1,000</td>
<td>1,100</td>
<td>1,200</td>
<td>1,300</td>
</tr>
</tbody>
</table>

Sources: European Environment Agency; OECD Development Centre; PwC analysis
Notes: Data is forecast and was last uploaded by the European Environment Agency on 29 November 2010; middle class is defined as households with daily expenditures between USD10 and USD100 per person in purchasing power parity terms

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8 ComScore, July 2011
9 United Nations, Department of Economic and Social Affairs, Population Division, 2009 Revision
Technological change

Technology has always shaped society and commerce in unpredictable ways, changing customer behaviour, spawning new enterprises and wiping out existing businesses that are unable to keep pace. As the speed of technological development accelerates, the risk of falling behind becomes more acute.

Breakthroughs in biotechnology, nanotechnology and other frontiers of research and development (R&D) are increasing productive potential and are opening up new investment opportunities. Whole new industries are being created, which could have a significant impact on the size and shape of the world’s manufacturing, and high-tech sectors and the companies that operate within them. The key question for business is: “Are you ready and able to support and capitalise on these developments?” These emerging technologies and the industries they generate carry a new set of risks, which need to be fully understood to make the most of the financing and insurance opportunities.

In the digital world, the internet, mobile phones, data analytics and cloud computing are well established. Yet, many companies across all sectors are still grappling with how these developments will affect consumer expectations, the way they will need to interact with their customers and the underlying business models that support this.

While the transformational impact of digital technology has been slower to reach financial services than other fields of commerce, the sector has finally reached a tipping point. Enhanced digital interaction could offer businesses the opportunity to engage more closely with its customers and increase wallet share. At the same time, digital transformation could be highly disruptive, allowing new entrants to break into the market, pick off the most valuable revenue opportunities and seize control of customer relationships. In a digital world, it will be harder for businesses to differentiate themselves, especially if service expectations are set by non-financial competitors and the “product” on offer is not physical. The ease of switching afforded by digital technology could also drive down margins and profits and some organisations could be strained to breaking point.

There are clearly significant issues that flow from this including: “Where do we best serve and contract with our customers?”, “How and where do we recognise brand value?”, “Who owns the customer relationships and where?” and if services are being supplied across borders there are likely to be significant indirect tax issues.

The demand for branchless banking is significant in all segments of the population, regardless of geography.

More than 40% of people using social network sites in the US are interested in interacting with financial services firms via Facebook and MySpace.\(^\text{10}\)
The ‘war’ for natural resources
The expanding size and prosperity of the global population is leading to rapidly rising consumption and putting unsustainable pressures on the world’s most critical natural resources.

Even basic commodities such as water are now in increasingly short supply, providing the spur for the development of new markets, technologies and investments on the one side and the potential for unrest, commercial disruption and protectionist behaviour on the other. The growing shortages of resources will be exacerbated by climate change, heightening catastrophe risk and putting further pressure on land, water supplies and food production (see Figure 11).

The impact of global temperature rises could be extreme.

Figure 11: Possible climate impact of a rise in global temperatures (Stern Review)

<table>
<thead>
<tr>
<th>Temperature rise</th>
<th>1°C</th>
<th>2°C</th>
<th>3°C</th>
<th>4°C</th>
<th>5°C</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Water</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Small glaciers in the Andes disappear completely, threatening water supplies for 50 million people</td>
<td></td>
<td>Potentially 20–30% decrease in water availability in some vulnerable regions</td>
<td>1–4 billion more people suffer water shortages, while 1–5 billion gain water, which may increase flood risk</td>
<td>Potentially 30–50% decrease in water availability in Southern Africa and Mediterranean</td>
<td>Possible disappearance of large glaciers in Himalayas, affecting one-quarter of China’s population and hundreds of millions in India</td>
</tr>
<tr>
<td><strong>Food</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Modest increases in cereal yields in temperate regions</td>
<td>Sharp declines in crop yield in tropical regions (5–10% in Africa)</td>
<td>150–550 additional millions at risk of hunger (if carbon fertilisation weak)</td>
<td>Agricultural yields decline by 15–35% in Africa</td>
<td>Continued increase in ocean acidity seriously disrupting marine ecosystems and possibly fish stocks</td>
<td></td>
</tr>
<tr>
<td><strong>Health</strong></td>
<td></td>
<td></td>
<td>1–3 million more people die from malnutrition (if carbon fertilisation weak)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reduction in winter mortality in higher latitudes</td>
<td>Up to 60 million more people exposed to malaria in Africa</td>
<td></td>
<td>Up to 80 million more people exposed to malaria in Africa</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Land</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Permafrost thawing damages buildings and roads in parts of Canada and Russia</td>
<td>Up to 10 million more people affected by coastal flooding each year</td>
<td>1–170 million more people affected by coastal flooding each year</td>
<td>7–300 million more people affected by coastal flooding each year</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Environment/ Ecosystems</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>80% bleaching of coral reefs, including Great Barrier Reef</td>
<td>High risk of extinction of Arctic species, including polar bear and caribou</td>
<td>20–50% of species facing extinction (according to one estimate)</td>
<td>Loss of around half Arctic tundra</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Abrupt and large-scale impacts</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Atlantic thermohaline circulation starts to weaken</td>
<td>Potential for Greenland ice sheet to begin melting irreversibly, accelerating sea level rise and committing world to an eventual 7 m sea level rise</td>
<td>Rising risk of abrupt changes to atmospheric circulations, e.g. The monsoon</td>
<td>Rising risk of collapse of West Antarctic Ice Sheet and Atlantic thermohaline circulation</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Low growth scenario</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Higher growth scenarios</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Stern Review, 2006

Water stress is often localised. For example, within the high population areas of the North China Plain, aquifers are reported to have depleted significantly. The North China Plain is home to around 10% of China’s population and includes the cities of Beijing and Tianjin. 11

How Are You Operating in the ‘New Normal’?

The ‘war’ for natural resources is likely to play out on multiple fronts. Examples include the response to the increase in water withdrawals, which are forecast to rise dramatically. Food production will naturally gravitate to more plentiful sources of water, which may be outside a country’s border and therefore extend the supply chains of and potential cost of food production.

In turn, demand for energy is forecast to increase by around a third by 2030. While alternative energy sources will gain market share, the overall global demand for oil, gas and coal is forecast to remain strong, particularly as technology transforms currently uneconomic sources of oil.

Globalisation is creating global supply chains that are tying countries together through trade as never before. China and other manufacturing-based economies depend on emerging markets in Africa and South America to supply their industries. Conducting business in some of these countries is likely to require new investment models and fresh approaches to understanding and mitigating risk.

Economic disparities are likely to spur short-term responses in production and consumption that undermine long-term sustainability. Shortages could cause social and political instability, geopolitical conflict and irreparable environmental damage.

The war for natural resources and the impact of climate change are phenomena that will have a fundamental impact on the way people live and companies do business. It’s likely to become one of the main, if not the key driver, of government policies. It will also open up new markets and business models for organisations that both understand the changing dynamics of supply and demand, and know how to mitigate the risks.

Global scientific consensus is that temperatures could rise between 2°C and 5°C by the end of the 21st century.

As environmental risk increasingly impinges on their customers (examples include higher resource costs, pollution damage and changes in productive land), financial services businesses will need to assess the impact on their loan book, risk profile and policy, pricing and investments.

Issues could include: “How will the knock-on impacts of this work through to product design and mix?” and “What will the impacts be on the tax position and on the skills we need in the tax department?”

The rise of state-directed capitalism

The pendulum swing away from the free market towards state-directed capitalism in the wake of the financial crisis is manifesting itself in governments’ increasing direction of financial services and the wider economy. Governments are also becoming more competitive in the way they vie with other states for talent, investment and the primacy of key financial, industrial and other productive centres in the countries they govern.

Payback for support

Western governments have spent considerable sums to stabilise their financial systems (see Figure 12). Greater state intervention and pressure on financial institutions to support the real economy (e.g. through increased bank lending to small businesses) are likely to be a key part of the ‘payback’ required.

The high public cost prompts many Western governments to take a more active role.

Figure 12: Costs to governments of supporting the financial sector, percentage of GDP, as at December 2009

Pledged and utilised support, % of GDP, 2009

<table>
<thead>
<tr>
<th>Category</th>
<th>Pledged and utilised support, % of GDP, 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advanced G20 economies</td>
<td>6.0</td>
</tr>
<tr>
<td>Emerging G20 economies</td>
<td>3.5</td>
</tr>
<tr>
<td>Average G20 economies</td>
<td>1.5</td>
</tr>
<tr>
<td>UK</td>
<td>14.0</td>
</tr>
<tr>
<td>US</td>
<td>12.0</td>
</tr>
</tbody>
</table>

Sources: A fair and substantial contribution by the financial sector, IMF, June 2010
Notes: Data based on International Monetary Fund (IMF) survey sent to all G-20 members in December 2009
PPP (Public–Private Partnerships)
investment around the world rose from US$50 billion in 2002 to US$170 billion in 2010.¹³

Greater intervention is the payback for the bailouts
Profitability and growth are likely to be more dependent on the fortunes of the real economy than before the financial crisis, which will in turn be more closely tied to government policies.

As such, it will be important to work with industry and consumer groups to help influence and shape government policies. It will also be important to develop a strong relationship with government to make sure business strategy anticipates and is aligned to government priorities and investment plans. Globalisation is intensifying the competition between countries and cities. Local leaders are ever more aware of their sources of competitive advantage and how to attract the businesses, facilitate investment in infrastructure and the secure supply chains needed to make the most of this potential. As cities expand and develop, local and central government face the challenges of how to attract the necessary investment in housing and infrastructure while balancing the inevitable strains on natural resources.

Many governments, particularly in the SAAAME states, realise that the private sector cannot finance and deliver important national economic and social priorities on its own. As a result, we’re likely to see an increase in Public–Private Partnerships (PPP), particularly in emerging markets, as well as government-to-government agreements to mitigate sovereign risks, mobilise sovereign capital and piece together industry supply chains.

¹³ World Bank, Infrastructure Database, data extracted from database on 30 November 2011; PwC analysis
Disruption to long-established business models is the one clear certainty that the future holds. The key question is whether the various forces shaping the sector present an opportunity or a threat to your business.

**Taking control of your future**

Being able to see into the future and judge the implications will give businesses an invaluable edge. Project Blue is designed to provide you with a framework for organising your views of the global developments ahead, the implications for your business and your resulting vision for the future.

**Project Blue assesses the impact of these changes on all aspects of the leadership agenda.**

**Figure 13: The CEO agenda**

1. **Shaping the future**
   - Economic rebalancing
   - Industry structure
   - Fiscal and monetary policy
   - Regulation
   - Social policy
   - Investor expectations
   - Community engagement

2. **Rethinking the strategy**
   - New stakeholder objectives
   - Short-term adaptation
   - Alignment to global trends
   - Determining risk appetite
   - Redefining performance targets
   - Portfolio rebalancing
   - Relative competitive advantage

3. **Reinventing the organisation**

   **Governance**
   - Board composition and qualifications
   - Executive remuneration
   - Regulatory compliance
   - Risk management
   - Financial reporting and controls

   **Target operating model**
   - Legal and physical structure
   - Tax and capital efficiency
   - Allowable cost structure
   - Technology
   - Partnership structure
   - People and resources

   **Competitive advantage**
   - ‘Seeing the future’
   - ‘War for talent’
   - ‘Constant reinvention’
   - ‘Product innovation’
   - ‘Strategic agility’
   - ‘Operational alignment’

Sources: PwC analysis
Shaping the future
It’s vital that your business plays an active part in the debate over the changes ahead. This includes engaging as closely as possible with clients, regulators, governments, consumer and community groups, and other key stakeholders to make sure the full impact is understood and help get important messages across to policymakers – ultimately driving an improved financial system for all.

Rethinking your strategy
The pressing challenge for all organisations is how to balance the tactical management effort and actions needed to deal with the current instability with the longer term realignment of strategy, operations and business focus demanded by the drivers identified in Project Blue. Businesses can gain significant market share if they adapt to the reforms and changing commercial realities faster than their competitors.

Reinventing your organisation
At the heart of sustainable commercial models are the organisational capabilities and flexibility needed to identify and respond proactively to changing customer and market demands. Operations will need to become more agile to accommodate changing conditions. Risk and finance teams also need to become more proactive in managing a rapidly changing and often uncertain risk and regulatory environment. Organisational and people strategies will be key differentiators in determining which businesses are most relevant going forward.

As the CEO agenda highlights, the underlying considerations include the kind of leadership required in this complex and uncertain environment, how the risk profile is likely to change, and what kind of governance and reporting systems will be required to plot a successful course through the changes ahead.

The businesses that come out on top will have a superior capacity for innovation and constant reinvention, agile enough to quickly capitalise on emerging opportunities and with the strategic approach to talent needed to make sure that the right people are available in the right places at the right time. Businesses that are constantly scrambling to keep pace with unfolding events, are likely to find themselves on the back foot competitively and risk losing out.

A reshaped sector
Dealing with the mega-trends highlighted in Project Blue can’t be put off while contending with seemingly more immediate concerns. Some developments such as the increase in regulation, state intervention and possible protectionism that form part of the rise of state-directed capitalism are already manifesting themselves. Others, such as the increasing ageing and urbanisation of emerging market populations and their impact on product and growth strategies are moving rapidly onto the horizon. How you plan and invest now will determine your future chances of success.

So how will strategies change and what kind of financial institutions will emerge from the shake-up ahead?

**SAAAME financial institutions**
Many emerging markets remain relatively under-penetrated and have considerable room for further development in both the size and sophistication of the financial services sector. Traditional models are still viable in these markets, but new partnership models with telecommunications and retail companies to reach the unbanked will continue to grow. Businesses will need to keep pace with steadily increasing customer expectations and associated changes in the regulation, complexity and risk profile of operations. The pressing priorities also include the need to engage in the ‘war for talent’ to make sure the organisation can develop the right skills to meet the challenges and seize the opportunities in its markets.

**Western financial institutions**
The constraints on funding and domestic growth will make it increasingly difficult to be all things to all people (‘ubiquity’). Successful institutions are therefore likely to adopt a more ruthless focus on their core relationships and sources of value (‘precision’). We’re already seeing sharper customer segmentation, greater discipline in deploying resources and withdrawal from markets that offer little prospect of delivering an economic return. This is underpinned by a better understanding of component costs and real returns.

The key considerations are: “What exactly are my core sources of value, who will be my most important customers and who will be my main competitors in ten years from now?” – in short, continually re-evaluating what needs to be done to ensure the business model remains relevant.
Making sense of an uncertain future

We’re working with a range of financial services organisations to facilitate discussions on the impact of the mega-trends shaping their industry and where and how they can compete most effectively. If you’d like to discuss any of the issues raised in this document, please contact me, or your usual PwC contact.

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