Introduction

Piecing the jigsaw: The future of financial services

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.

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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. 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 imperatives 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. The 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. 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.
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 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.
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?
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 imperatives 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.
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 and 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.
1. Demographics

- The greying of populations in the world’s developed markets will thrust the burden of pensions and healthcare provision increasingly onto the private sector;

- The rising affluence of customers in the developing world will stimulate demand for financial products;

- Migration patterns and growth rates of ethnic minorities within populations will encourage the development of products and services aimed at particular ethnic and religious groups; and

- These factors will reinforce the power of the consumer and the need for financial services institutions to concentrate more of their energy on customer service and branding.
The tectonic plates of demography shift slowly. The trends we describe in this chapter are largely long-term in nature: their most dramatic effects lie beyond the two to four year time horizon of this report. But they will have a considerable impact over the shorter term too: on policy, on savings behaviour and on the industry’s offering, as governments, individuals and financial institutions face up to the prospect of older populations and longer retirements.

The problem of population ageing is not restricted to the developed world, but it is far more acute there. Today in the developed world, 15% of the population is elderly (65 and above). By 2030, according to UN projections, the share will be closing in on 25% and by 2050, it will be approaching 30%. What’s more, the elderly themselves are getting older. The number of people aged 80 years and over is increasing at nearly twice the rate of that of those over 65.

Some countries and regions are in better shape than others. According to IMF estimates, the dependency ratio – the ratio of working-age adults (aged 15 to 64) to elderly – will fall by 2050 to 1.5 to 1 in Japan, to 1.4 to 1 in France, and to 1.2 to 1 in Germany. In at least one country, Italy, it may sink beneath 1 to 1, meaning that more people will be collecting benefits than paying taxes. The United States, by contrast, is blessed with a relatively high fertility rate, although it too must absorb the imminent shock of the retirement of the baby boomer generation.

The potential fiscal impact of population ageing is enormous, as governments are forced to spend more on pensions, healthcare, and long-term residential care. Policymakers in many countries have started to edge nervously towards pension and healthcare reform and a greater role for the private sector and personal provision in both areas, as they seek to keep costs under control, but progress has often been limited, and occasionally self-defeating.

In Germany and France, for example, the pension reforms of 2001 and 2003 respectively are designed to scale back pay-as-you-go benefits promises and expand access to funded private alternatives. However, much more will need to be done to increase the labour-force participation rate, raise retirement ages and grow privately funded pensions from where they stand today.

That will mean more emphasis on occupational pensions, although companies will continue to shift from defined-benefit schemes to defined-contribution schemes to reduce their own liabilities. But more fundamentally, it will mean that individuals in developed markets will be expected to take more responsibility for their retirement, by saving more and by taking greater control of investment allocation.

Changing individuals’ mindsets will take time, of course. In the UK, often held up as one of the most advanced countries in terms of pensions reform, the total assets of private pension funds were equivalent to an estimated 90% of GDP in 2003, the third highest proportion in the world after the Netherlands and Switzerland. But the national savings rate remains low, and hasn’t been helped by the withdrawal of tax credits on tax-exempt savings vehicles and government plans to tax private pensions pots that breach a threshold of £1.5m ($2.7m).

In the United States, most workers have saved little for retirement. According to a recent Employee Benefit Research Institute survey, only 21% of households have accumulated more than US$100,000 in retirement savings and 35% say they have accumulated nothing at all.

But the latter percentage will start to drop in the coming years and many financial services providers are already working hard to position themselves to take advantage of the expanding retiree market. 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.

How will older populations and greater private pension funding affect investment strategies? Changes in savings behaviour will take time to emerge, of course, but some clues are already to hand from the US, where the baby boomer generation is approaching retirement. A 2003 survey of affluent baby boomers found that 43% of respondents – compared with only 26% in 1993 – said that their single greatest economic concern was having adequate resources in retirement. The usage of individual retirement accounts (IRAs) among this group as a primary investment vehicle had risen strongly (up to 40% in 2003 from 17% in 1993), while reliance on money market accounts went down to 14% from 23% in 1993. Mutual funds and life insurance products are also significant vehicles, reinforcing the view that the flow of retirement-related funds into capital markets will increase appreciably over the next few years.

In tandem, alternative investments are set to rise in importance as increasing numbers of long-term savers seek to diversify their portfolios and realise higher returns than conventional investment products. Among the other likely beneficiaries will be property, whose cycle tends to lag the economic cycle, so that its correlation with the equity markets is relatively low. Hedge funds and private equity will move into a new, more mature phase over the next two to four years. Many hedge funds will struggle while markets remain listless, as regulators scrutinise them more closely and as greater inflows of capital hamper their agility, but those that survive will move further into the mainstream of investment thinking. Similarly, a report by Goldman Sachs and Russell Investment Group indicated that the strategic allocation of private equity investments in 2003 was 3.6% of a pension fund’s total assets in the UK and 4.2% in continental Europe. Both proportions are set to rise in the coming years as private equity activity gathers momentum.

Investment patterns change later in life, of course: research suggests that people become likelier to reduce their exposure to risk as they get closer to, and enter, retirement, when consumption becomes more important than saving (see box). The pressure on financial services institutions to provide products with guaranteed returns will rise as a result, although the risks in this area will need to be carefully managed. Increasing longevity is putting pressure on pension funds that offered guaranteed pay-outs to retirees based on unrealistic forecasts of investment returns and mortality rates. In some countries, this has given rise to accusations of mis-selling or of inappropriate investment advice, resulting in legal action and the requirement to pay compensation that has pushed some institutions into insolvency.

Later still in retirement, wealth transfer rises up the financial agenda, as thoughts move to bequests and inheritances. According to a report from Cerulli Associates, a research firm, more than US$20trn will move from US baby boomers to their heirs and to charities between 2001 and 2046, if the estate tax expires as planned in 2010. As the share of elderly in the population rises, smart financial services providers will increasingly focus on wealth transfer-related products such as trusts, life insurance and annuities.

As for changes to healthcare provision, the demographic shift is likely to signal both greater customer interest in long-term care insurance and a realignment of pricing for a customer base that will be increasingly old and increasingly susceptible to medical intervention. The debate over the ethics of predictive genetic testing as the basis for insurance pricing and cover will also heat up as technology advances in this area.

One of the primary solutions to population ageing is to grow the working-age population through increased levels of immigration. Although this area will remain politically inflammatory for the foreseeable future, managed inflows of working-age

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2 AXA Nest Egg Study, a 2003 poll of 701 US baby boomers born from 1946 to 1964, with annual household incomes of $75,000 and above.
The longer view: Asset meltdown in 2030?

As the burden of providing for pensions and healthcare switches away from the state and towards the individual, the incentives for people of working age to save will increase. But what will happen when today’s workforce becomes tomorrow’s elderly? Some have argued that an increase in retirement-related investments over the medium term will give way over the longer term to an asset meltdown as retirees withdraw and consume their capital and sell their stocks to a smaller pool of buyers, forcing stock prices to fall.

A review of the literature on this topic in the IMF’s September 2004 World Economic Outlook finds the theory has some substance. Real post-war stock prices in the United States have been positively associated with the relative size of the population to be aged between 40 and 64 years of age, when demand for stocks and other financial assets is at its peak. As the number of people in this age group shrinks, runs the argument, so stock prices will decline.

A note of caution is in order, however. The period over which the relationship between share prices and demographics has been observed is comparatively short. Changes in policy, such as raising the retirement age or encouraging greater participation rates among women, have the potential to ease the imbalance between the working-age and pensioner populations. Economic theory would also suggest a higher premium for holding equities in old age, when the risks associated with a downturn in stock prices and erosion of savings is greater. There may well be pressure on equity prices when the retiree population expands, in other words, but the rewards for the braver older investor could be higher.

Demographic change and equity markets

![Graph showing demographic change and real stock prices](source: IMF World Economic Outlook, September 2004)

As the size of the ethnic minorities within countries’ borders grows, aided in some cases by higher fertility rates, the economic case for financial services institutions to create products aimed at those groups will also strengthen. The population of Hispanics in the US, for example, reached 39.9m in July 2003, a phenomenal growth rate of 13% over the previous three years. Over the same period, the number of US residents who reported being Asian grew by 12.5% to 13.5m. In the UK, the size of the local Islamic population has already persuaded HSBC to issue the country’s first occupational pension fund compatible with Islamic law. The HSBC Life Amanah Pension Fund avoids shares in certain industries, including production or distribution of alcohol, pork products, tobacco and conventional financial services. Other products, such as Islamic mortgages, Islamic life insurance and Islamic bonds, are also growing fast in Europe and the US.
While the developed world confronts the problems of population ageing, emerging market demographics are defined primarily by population growth and rising affluence. China and India dominate attention by dint of their sheer size.

China has a population of 1.3bn and the overall market size of the economy is likely to exceed US$2.3trn (at market exchange rates) by 2009. Although GDP per head will remain low, at US$1,790 in 2009, that still represents a significant improvement compared with US$1,120 in 2003.

Demand for financial services in China will be boosted both by rapid overall rates of GDP growth and by even faster growth in the stock of domestic savings, as reforms aimed at improving the efficiency of the economy reduce job security and raise the cost of welfare provision, and as China too wrestles with the long-term challenges of population ageing. The growing stock of savings will increase demand for a greater variety of investment vehicles in addition to the plain-vanilla bank deposit accounts that have traditionally formed the home for most of China’s household wealth.

China’s insurance market will be particularly dynamic. Recent research from Swiss Re forecast that non-life insurance premiums collected in emerging markets are expected to double from US$123bn in 2003 to around US$250bn by 2014, at constant prices. Life premiums will increase even faster, from US$188bn to US$450bn over the same period.

India remains, as a whole, a very poor country – GDP per head is little more than US$600 a year – and financial activity is correspondingly undeveloped. Lending as a percentage of GDP totalled just 60.3% in 2004, compared with more than 170% in China. Yet this low base suggests room for strong growth as the economy accelerates. According to the Economist Intelligence Unit, personal disposable income will grow at an average annual rate of almost 15% in 2005-09.

India and China are not the only populous emerging markets worth watching. Indonesia may finally start to fulfil its potential under its newly elected president. Brazilian income levels are set to recover gradually after precipitous falls earlier in the decade. Memories of Russia’s 1998 financial crisis have proved short: Russia is tipped by the Economist Intelligence Unit to suck in significant amounts of Foreign Direct Investment (FDI) over the course of the next five years. In each of these markets, and others beyond, rising wealth levels and relatively low penetration rates spell potential for financial services providers.

### Personal disposable income (US$bn)

<table>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>332</td>
<td>283</td>
<td>257</td>
<td>289</td>
<td>360</td>
<td>440</td>
<td>461</td>
<td>488</td>
<td>525</td>
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</tr>
<tr>
<td>China</td>
<td>568</td>
<td>626</td>
<td>701</td>
<td>782</td>
<td>858</td>
<td>937</td>
<td>1029</td>
<td>1133</td>
<td>1241</td>
<td>1,357</td>
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<tr>
<td>India</td>
<td>333</td>
<td>333</td>
<td>358</td>
<td>431</td>
<td>530</td>
<td>645</td>
<td>746</td>
<td>836</td>
<td>921</td>
<td>1,011</td>
</tr>
<tr>
<td>Indonesia</td>
<td>99</td>
<td>94</td>
<td>116</td>
<td>129</td>
<td>133</td>
<td>142</td>
<td>150</td>
<td>165</td>
<td>178</td>
<td>192</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>136</td>
<td>170</td>
<td>201</td>
<td>263</td>
<td>332</td>
<td>403</td>
<td>462</td>
<td>512</td>
<td>577</td>
<td>628</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit
In both developed and emerging markets, these demographic trends will reinforce another critical theme of the next two to four years: a more robust consumer culture. The development of this culture will be driven by a number of interconnected factors:

- More people in more countries will come to depend on more financial products to realise their goals at all stages of their lives. As the state gradually reduces its role in areas such as pensions and healthcare in developed markets, and as more people in emerging markets are given access to credit, customers will wield greater choice in how they run their finances.

- Broad trends of deregulation and moderating economic growth will increase competition to acquire and retain customers. As standard retail products commoditise, a recent PricewaterhouseCoopers survey shows that financial services providers increasingly differentiate themselves by the quality of their customer service and the power of their brand. It follows that institutions will need to focus more of their efforts on recruiting, retaining and incentivising their front-office staff.

- 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.

- Consumer protection concerns are trending upwards, as new customers come online among the lower social classes in developed markets and the emergent middle classes in developing markets. Recent scandals involving financial institutions have made education and protection of consumers of financial products a live political issue.

- Rising privacy concerns, driven by the increasing popularity of electronic distribution channels and the data storage requirements of enhanced risk management systems, will further reinforce this trend towards greater protection of consumer rights.

What does this strengthening consumer culture mean for financial services institutions? Two things, at least. One is an increased focus on building a high-performance culture centred around the customer. That will mean balancing a continued focus on cost savings, as providers seek to remain competitive on price, against the need to provide top-quality service. Incentives for staff that are explicitly linked to customer satisfaction and service levels are likely to become more prevalent. Timely and insightful metrics on customer attitudes will become a greater priority. These imperatives will apply to outsourcing service providers as well as the financial institutions themselves, as third parties continue to take on more complex and valuable processes.

The second consequence of the rising power of consumers will be the growing importance of branding, an area where the industry arguably falls down by comparison with others. Recent research by NOP World in the UK found that the financial services industry suffers from relatively low levels of advocacy, the process whereby customers advocate particular products and influence others to use them. Changing this will be hard, say marketers – unlike cars and mobile phones, few people see the details of their financial products as a fun topic of conversation or as adding lustre to their public persona. But being able to command a brand premium in a marketplace where competitive pressures are rising and where differences in product offerings are often imperceptible, will be a goal for many over the next few years.

### Which areas of your business are the key sources of competitive advantage for your organisation in the marketplace? Please choose up to three areas.

#### Source: PricewaterhouseCoopers/Economist Intelligence Unit Survey – November 2004 ‘From aspiration to achievement: Improving performance in the financial services industry’

<table>
<thead>
<tr>
<th>Area</th>
<th>Percentage (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactions and processing</td>
<td>24.18% (44)</td>
</tr>
<tr>
<td>Compliance</td>
<td>8.97% (16)</td>
</tr>
<tr>
<td>Sales, branding and marketing</td>
<td>46.7% (85)</td>
</tr>
<tr>
<td>Customer service</td>
<td>49.45% (90)</td>
</tr>
<tr>
<td>Product development</td>
<td>26.02% (51)</td>
</tr>
<tr>
<td>Human resources</td>
<td>12.64% (23)</td>
</tr>
<tr>
<td>Quality performance of actual products and services</td>
<td>37.91% (69)</td>
</tr>
<tr>
<td>IT management</td>
<td>9.89% (18)</td>
</tr>
<tr>
<td>Finance and accounting</td>
<td>8.79% (16)</td>
</tr>
<tr>
<td>Procurement</td>
<td>1.1% (2)</td>
</tr>
<tr>
<td>Risk management</td>
<td>24.18% (44)</td>
</tr>
<tr>
<td>Speed and quality of management decision-making</td>
<td>15.38% (28)</td>
</tr>
<tr>
<td>Other, please specify</td>
<td>3.85% (7)</td>
</tr>
</tbody>
</table>

0 20 40 60 80 100%
2. The economic cycle

- The financial services industry can expect leaner times over the medium term as the world economy’s growth rate slows;
- Tougher competition and squeezed profitability will encourage focus on alternative investment products and new geographical markets as sources of growth;
- Cost efficiency will be a priority, leading to an acceleration in levels of outsourcing and offshoring;
- Disintermediation by new entrants will pose a particular threat in the more commoditised retail market; and
- Continued capital shortages will restrict insurers’ freedom of movement.
The world economy: Moderating growth

The world economy grew in real terms by 5.1% in 2004 (at purchasing power exchange rates), the fastest pace of growth for more than 20 years. That heady rate of expansion is not expected to last. On Economist Intelligence Unit forecasts, global economic growth will fall to 4.2% in 2005 and dip further thereafter.

Importantly, this projected slowdown does not represent a poor global economic performance in absolute terms – the rate of growth expected in 2005 and 2006 is robust in comparison with the rate achieved during much of the 1990s. But after several years when the global economy has improved, the next few years are likely to be characterised by a gradual deceleration in output and demand growth.

The softening is expected to be marked in the US, with growth falling from 2004’s cyclical peak of 4.4% growth. High levels of debt are likely to weigh on consumers as interest rates rise. The ending of tax incentives for business investment will eat into capital expenditure. High oil prices will also take their toll. Consequently, we expect the pace of economic expansion during 2005 and 2006 to be considerably more modest than this year.

Japan’s mini-revival is forecast to fade as the export stimulus fades. World import demand is now moderating, as the US and China slow, and Japanese exporters will increasingly find it difficult to maintain the recent strong growth in sales volumes during 2005 and 2006.

The picture in the euro zone is somewhat brighter, but performance will remain disappointing. The appreciation of the euro over the past two years, coupled with a slowdown in global import demand, suggests that trade will become less of a growth driver over the next two years. Moreover, although consumer demand will improve, consumers are likely to remain cautious in the face of rising pension and healthcare costs.

Emerging markets will continue to be the source of the most dynamic growth in the global economy, but they too face tougher conditions. Rising US interest rates are reducing international liquidity, putting pressure on emerging economies that have large financing needs. The financing situation for emerging-market economies has been unusually favourable over the past two years, as real negative interest rates have encouraged investors to seek out investments in overseas markets. As capital flows back to developed markets, weaknesses could emerge in some markets.

<table>
<thead>
<tr>
<th>World summary</th>
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<tbody>
<tr>
<td>(%) 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009</td>
</tr>
<tr>
<td>Real GDP growth</td>
</tr>
<tr>
<td>World a 4.6 2.3 2.8 3.9 5.1 4.2 3.9 4.1 4.1 4.2</td>
</tr>
<tr>
<td>Regional growth summary</td>
</tr>
<tr>
<td>North America 3.8 0.8 2.0 3.0 4.4 3.3 2.9 3.0 3.0 3.0</td>
</tr>
<tr>
<td>Western Europe 3.9 1.7 1.3 1.2 2.5 2.0 2.1 2.3 2.3 2.3</td>
</tr>
<tr>
<td>Transition economies 7.0 4.2 3.8 5.9 6.6 5.5 5.0 4.6 4.4 4.4</td>
</tr>
<tr>
<td>Asia &amp; Australasia 4.2 1.8 2.6 3.7 4.7 3.4 3.4 3.5 3.9 3.9</td>
</tr>
<tr>
<td>Latin America 3.7 0.3 -0.5 2.0 5.8 4.0 3.6 3.3 3.6 3.6</td>
</tr>
<tr>
<td>Middle East &amp; North Africa 5.2 2.0 2.0 4.4 5.5 4.9 4.6 4.3 4.2 4.2</td>
</tr>
<tr>
<td>Sub-Saharan Africa 4.5 3.3 3.6 5.0 3.9 4.0 4.0 3.8 3.8 3.6</td>
</tr>
</tbody>
</table>

a At purchasing power parity.
Source: Economist Intelligence Unit
The worry is that this picture of slower but still healthy growth could prove too rosy. A Chinese slowdown, further upward pressure on oil prices, a fall in house prices as interest rates rise – all of these eventualities could alter the trajectory of the global economy for the worse. More menacing still is the risk that the current decline in the US dollar could turn into a headlong slide. If investors holding US dollar assets (including foreign central banks) decide to reduce their holdings of the depreciating currency significantly, the dollar could crash. This would have significant negative implications both for the US economy, sending interest rates sharply higher and choking off domestic demand growth, and for the global economy, which will be deprived of its most important growth engine of recent years.

China: The new engine of the world economy?

China’s economic boom of the last few years has played a significant role in driving forward not just the Asian economic recovery but also a global recovery. Soaring domestic demand has fuelled strong import growth, lifting sales from exporting countries worldwide. Global commodity prices have, until recently, been driven up, boosting export earnings for commodity producers, and foreign multinationals have been able to increase sales and profits in one of the world’s fastest-growing markets.

Financial services institutions are just as smitten by China’s potential as other sectors. Take China’s life insurance sector. Swiss Re estimates that total life premiums in China grew at an average annual rate of 32% in 1998-2003, reaching US$32bn in 2003 and ranking second behind South Korea among emerging life insurance markets. Foreign life ventures in China have just 2% of the market at the moment, but growth prospects are significant, especially as restrictions on these ventures loosen.

But there are growing risks associated with the current Chinese economic expansion. The country has experienced an investment bubble in some sectors and, although credit creation and investment have slowed recently, anecdotal evidence continues to mount of excess capacity build-up in some industries, including consumer durables and property. This has raised concerns that recent investment by domestic and foreign firms may ultimately prove unprofitable.

The government continues to enact policies aimed at slowing credit and investment growth and allowing the bubble to deflate gently, and these policies may yet be successful. But success cannot be guaranteed – China is not a market economy and slowing demand in runaway sectors may prove difficult. If investment resumes its rapid growth and spare capacity in key sectors continues to rise, there is a danger of a further build-up of bad loans and an economic slowdown in future years as companies retrench. Equally, there is a risk that Chinese policy action proves too effective, stalling economic growth. In either case, this would be damaging, not just for businesses operating in China, but also for companies with operations in the rest of Asia or other regions around the world that have come to rely on robust Chinese demand growth as a source of revenue growth.
The search for new sources of growth

Moderating economic growth will increase competitive pressures on financial services, of course. Gains in profitability at major financial services companies in 2003-04 – which have taken return on equity to the largest international banks to 20% or more, and at the largest insurance companies to the high teens – are now peaking. Maximising shareholder value in the next, slower stage of the economic cycle will require closer scrutiny of the most efficient use of capital.

These pressures are global and will broaden the trend for outsourcing and offshoring beyond the US, Europe and Japan. South Korea is one of the latest countries to have considered the sensitivities of lettings back-office processing go offshore. Service providers will feel the heat of increased competition, too: at the moment, India is reckoned to account for about 80% of the low-cost offshore market but rivals, especially from China and Eastern Europe, are lining up to challenge India for outsourcing and offshoring business.

Bubbling emerging markets will continue to attract cross-border investment, as institutions seek expansion into faster-growing areas of the industry. China’s potential is widely appreciated (see box), but India’s banking market will also become an important focus for growth.

So, assuming greater political and economic stability, might less obvious markets. In the Middle East, for example, oil exporters will continue to benefit from high oil prices (although prices will decline over the coming years, they will remain high compared to their long-term average), and a slew of major oil and non-oil projects will need financing.

In Indonesia, too, the easing of political uncertainty following the 2004 election of Susilo Bambang Yudhoyono as president has improved confidence in both the consumer and business sectors. Interest rates and inflation will fall, and the government is expected to offer tax and other incentives to encourage investment. The continued sale of state assets, liberalisation in the utility sectors and reform of the mining laws will provide additional incentives to both domestic and foreign investors.

Expansion by financial institutions into new product areas is also likely. New opportunities in wealth management arise from increased demand for products answering two needs: more active management in an era of lower overall returns, and products that help to manage wealth over the consumer’s life cycle. In the capital markets, equity valuations remain high in historic terms and there appears to be little risk of further bubbles in the next two to four years. With slower growth in the tail end of this cycle in prospect, stock markets are not anticipating a significant increase in corporate earnings in the medium term. The rise in alternative investments available to individuals – hedge funds, private equity, and structured products offering guaranteed returns – will reflect disillusionment with conventional investment products on the part of many investors.

Despite pressure for growth, however, financial services companies are unlikely to be distracted by visionary conglomerate strategies. Banks will be interested in selected life assurance or asset management acquisitions to give them enhanced capability in long-term savings products. But there will be little incentive to buy wholesale into the capital problems of the insurance sector or the growth problems of conventional asset management companies. Conversely, insurance companies will not have easy access to the capital markets for strategies other than strengthening their existing business – as the UK’s Prudential found when it went to the market for a £1bn (US$1.8bn) rights issue in the fourth quarter of 2004.

Institutions will look to execute restructuring strategies incrementally, undertaking purchases and divestments only if they fit neatly into a coherent strategy and forming greater numbers of alliances and joint ventures. 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 financial products and services. As a result, there will be emphasis on what might be termed competency-led enterprises, institutions that develop and excel in particular areas.

Even for the leading international players, it will be successful execution and growth in specific product areas that will enable further consolidation. The bancassurance leaders in Italy and Spain, successful consolidators of their domestic life insurance markets, are the natural predators for life insurance assets elsewhere in Europe. It was BSCH’s strong domestic growth record that allowed it to be the unchallenged bidder for Abbey in Europe’s largest financial services cross-border consolidation.
The threat of the new

As competitive pressures increase, disintermediation and disaggregation of parts of the value chain will challenge integrated companies in all financial services sectors. In each case, the crumbling of old structures opens up opportunities for expansion or for new entrants. Every product innovation or potential cost saving holds out the potential for wresting part of the value chain away from an incumbent provider.

In asset management, for example, parts of the core business are being disintermediated by alternative investments, while the administration component of the value chain is being widely outsourced. Investment banks face the risk of Internet-based IPO auctions – first tried on a major scale with the Google IPO – disintermediating the highly profitable book-building process in IPOs, while M&A fees are coming under pressure from in-house corporate finance teams.

Retail banking is especially vulnerable to e-finance business models for delivering commodity products. In just eight months from start-up in the UK in May 2003, ING Direct, the ING Group’s low-cost distribution channel for developed markets, signed up 305,000 customers with €11.5bn of deposits. In Germany, Volkswagen Bank allied with the national car club ADAC in March 2004 to finance private sales of used cars, targeting receivables of €1.2bn within five years, making Volkswagen one of the fastest growing banks in Germany.

Life insurance companies in Europe will also have to compete against new entrants seeking access to the impending mass market for savings products as consumers provide for their own pensions. Growth of property and casualty insurance companies is at risk from the continuing rise of self-insurance, captives and risk-retention groups. Increasing insurance rates since the end of 2001, and lack of capacity in areas such as workers’ compensation and medical malpractice, have accelerated the use of alternative risk-transfer mechanisms at the expense of insurance companies.
A question of capital

Even more threatening to the insurance industry are serious capital shortages in parts of Europe and Japan. In the UK, Germany and Switzerland, the recovery in equity valuations since early 2003 has averted a crisis that originated with a toxic combination of over-reliance on equity investments by insurers – particularly in the UK, generally ranging from 30% to 40% of assets – and a commitment to guaranteed pay-outs that could not be met once the bull market ended. But it has not resolved the capital shortage. In the UK, the FSA is pushing for higher capital reserves against with-profits policies, and similar worries about under-capitalisation will be repeated elsewhere in Europe as the industry prepares for the introduction of the new Solvency II regime in the next three to four years. In Japan, the mutual life insurance companies, still seriously short of capital, will continue to make gradual progress overhauling their capital structures, cost base and product range.

Banks are in a very different position. Major banks in the US and Europe were unscathed by the turn of the interest cycle in 2003, with much of their credit risk laid off on the insurance sector. Two years of steeply rising profits have left capital ratios strong ahead of Basel II. New weaknesses will emerge in Japan and China, however. The IMF is pointing to the weak capitalisation of Japanese regional banks, with 44% of the country’s non-performing loans, as an area of heightened risk as deposit insurance is cut back in 2005. And while China has recapitalised two of its largest banks, much of the rest of the banking sector is short of the capital it will need against loans to ailing state-owned enterprises.

Opportunities can crop up where companies benefit from their competitors’ shortage of capital, of course, or where surplus capital becomes available from changing regulation. More strongly capitalised reinsurers will continue to benefit from capacity constraints of primary underwriters. Bancassurance players in Europe stand to gain from more sparing use of capital for retail operations under Basel II.

Moreover, growing private equity funds will be a source of innovative and flexible finance to the industry. Two deals in the fourth quarter of 2004 illustrate this trend. In Japan, Nikko Asset Management, with $65bn under management, sold a combined 38% shareholding to a group of private equity investors, as part of a strategy of putting its asset management business at arms’ length from the parent company. Warburg Pincus, Government of Singapore Investment Corporation and Nikko Principal Investments each gained a 12.5% holding in Japan’s fourth largest asset manager.

In another innovative deal, Apax, a private equity firm, provided equity alongside management for the start-up of Picture Financial Group, an ambitious UK consumer finance start-up specialising in flexible secured loans sold through brokers, with £500m in credit lines from Merrill Lynch. Private equity funds have been major investors in financial services. They will play a significant role in deals that prise out profitable operations from integrated financial services players, or that offer fast growth via disintermediation of established competitors.
3. Politics

• As governments look to the private sector to help put their pensions and healthcare systems on a sustainable footing, they will require institutions to exercise due care in providing these essential services to their citizens;

• The rising affluence of consumers in emerging markets, and the rising indebtedness of consumers in developed ones, will further focus policymakers’ attention on the ethics of the industry;

• Geopolitical risk, much of it related to the so-called war on terror, will threaten the assets, people and profits of certain institutions and impose a higher compliance burden on all institutions, thanks to tougher anti-money-laundering rules; and

• Broad progress towards deregulation and competition will be faster within borders than across them.
Access: Prospects for globalisation and deregulation

Whether developing their own businesses or supporting those of their clients, international financial services institutions are some of the principal beneficiaries of globalisation and deregulation. Broadly speaking, the next few years will see the forces of liberalisation gain further ground around the world, within the industry and beyond it. But progress will not be uniformly smooth.

Global trade and investment flows will enjoy buoyant growth over the medium term. World trade growth is expected to average 7.3% over the next four years, down on the peak years for trade expansion but still sufficient to imply rising import penetration in most markets. Global FDI inflows are projected to grow faster still, after the sharp declines of 2001-03. Both of these numbers will bring rising levels of corporate finance activity.

But globalisation will remain a highly politicised area. In particular, progress in the Doha round of international trade liberalising negotiations will remain halting. The original deadline for a final settlement of January 2005 was abandoned as unachievable. The next ministerial meeting will be the December 2005 summit in Hong Kong, but this is more likely to prove a staging post than the final round of talks – most analysts are assuming negotiations will drag on into 2006 or even 2007, assuming that agreement can be reached at all. Agriculture is the biggest sticking point in the negotiations, but progress in liberalising trade in services, including financial services, will also suffer as a result of further delays.

While global policy initiatives to liberalise trade stutter, the real action will be at the regional and national levels. Asia and the Americas, in particular, are in the midst of a free-trade stampede. Policymakers around the region are rushing to propose, negotiate and sign ever more free-trade agreements (FTAs) and economic partnership agreements, both with their immediate neighbours and with more distant economies. These arrangements range from relatively straightforward bilateral affairs to proposals for pan-regional initiatives such as the creation of a Free Trade Area of the Americas ‘lite’.

This increasingly complex web of free-trade agreements has its drawbacks – each imposes administrative costs and their differing requirements and external tariffs have the potential to distort trade flows rather than create them. But their net impact on the financial services sector will probably be beneficial: first, an increase in multinational clients and higher trade flows will attract large local and foreign banks to service the international commercial sector. Then, as freer trade takes hold and currencies and markets become less volatile, the large banks will move into domestic operations in the smaller countries to provide financing and other services, both to small businesses and to consumers.

Such effects will take time to emerge, of course, but one major lesson of the most spectacular free-trade success of the immediate past – the 2004 enlargement of the EU to 25 member states – is that integration begins to occur well before formal agreements come into effect. For that very reason, forward thinkers in European financial services are turning their attention to the next countries in line for membership of the club. The admission of Romania and Bulgaria is likely to take place in 2007. Further EU enlargement to include other countries in the Balkans and eventually Turkey (which poses special challenges) is also likely, and the next few years will see rising levels of direct and portfolio investment interest in all of these countries.

<table>
<thead>
<tr>
<th>World trade and investment</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
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<tbody>
<tr>
<td>World trade (goods)</td>
<td>5.5</td>
<td>10.5</td>
<td>7.0</td>
<td>7.0</td>
<td>7.5</td>
<td>7.8</td>
</tr>
<tr>
<td>Global FDI inflows</td>
<td>–16.5</td>
<td>40.4</td>
<td>30.2</td>
<td>17.8</td>
<td>9.8</td>
<td>8.1</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit, April 2005
Institutionally, the swelling of the EU to 25 members cannot help but impede decision-making: don’t expect too many radical initiatives from Brussels over the next two to four years. But the absorption of the new members is likely to add weight to the liberalising faction within the Union. Poland aside, most new members are likely to play a modest individual role in policymaking, given the limitations imposed by their small size. But collectively, they will share a similar stance on a number of issues, notably an opposition to attempts to force corporate tax harmonisation.

In the European financial services arena specifically, the Financial Services Action Plan is due to be implemented in 2005. The biggest impact will be on capital markets. Allied to the introduction of International Financial Reporting Standards (IFRS), rules to harmonise listing prospectuses and rules on market manipulation will speed consolidation of capital markets as well as initiatives in the clearing and settlement systems underpinning them.

Research in 2002 by London Economics in association with PricewaterhouseCoopers predicted that financial market integration across Europe would reduce the equity cost of capital by 40 basis points. That goal is still some way off, however. As the UK’s response in October 2004 to consultation about next steps for the FSAP expressed it, ‘agreeing regulation, in the form of EU legislation, does not automatically lead to an efficient, integrated single market in financial services’.

Insurers too will feel the impact of EU deregulation: the Insurance Mediation Directive, for example, permits intermediaries to sell insurance throughout the EU, provided they meet certain criteria in their home markets.

It’s a different story in European retail banking, where the cultural, linguistic and political barriers to cross-border integration will not be easily dismantled. The 2004 acquisition of the UK’s Abbey by Spain’s BSCH will be closely watched as a test-case for integration but is likely to remain the exception, rather than the rule, particularly if efforts to pass a long-delayed EU Directive on takeover bids remain stalled.

Consolidation and restructuring within borders rather than across them is likely to occupy most attention within banking circles in developed markets. This is particularly true of Germany, one of the world’s more fragmented markets (see table), whose traditional three-tiered banking system will come under further pressure as state guarantees for public-sector banks are phased out and privatisation of these institutions creeps higher up the agenda. In the US, another

### 2004 estimates

<table>
<thead>
<tr>
<th>Series</th>
<th>Unit</th>
<th>Romania</th>
<th>Turkey</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP per head</td>
<td>USD</td>
<td>3,290</td>
<td>4,050</td>
</tr>
<tr>
<td>Population</td>
<td>million</td>
<td>21.7</td>
<td>72.3</td>
</tr>
<tr>
<td>Total lending/GDP</td>
<td>%</td>
<td>18.6</td>
<td>64.7</td>
</tr>
</tbody>
</table>

Source: Economist Intelligence Unit, April 2005
highly fragmented market, restrictions on institutions undertaking both commercial and investment banking operations, along with other financial sector businesses such as insurance, have been stripped away and there is also plenty of opportunity to use M&A to broaden banks’ national geographic coverage. And in Japan, continuing concerns over asset quality will encourage further mergers, particularly among the wobblier regional banks.

Cross-border acquisition and growth opportunities are greater in less mature markets. In China, the four state commercial banks continue to dominate the sector, but competition from smaller domestic banks and, especially, foreign institutions, is increasing. Regulatory changes – most recently a relaxation of controls on foreign investment in local banks – will lead to greater foreign participation in investment banking, fund management and venture-capital financing. Restrictions on foreign insurers are also being peeled away.

In India, the rise of successful private institutions such as ICICI Bank and HDFC Bank, and the growing presence of foreign players, has forced the state-owned sector to begin a process of restructuring. The Middle East, risky though it is, is also an area to watch, particularly as the rivalry between Dubai and Bahrain to become the region’s financial centre heats up.

If the broad trend is towards deregulation and competition, however, domestic political considerations are always capable of stalling progress. The Indian authorities have sent decidedly mixed signals about the extent of foreign incursions into the financial services sector, for example. And in more dirigiste developed markets, too, bailouts and interventions to protect national champions remain possible.

| Assets of the top 10 banks as % of the assets of the banking system, 2001 |
|-----------------------------|----------|
| Brazil                      | 67.8     |
| India                       | 64.7     |
| Taiwan                      | 63.6     |
| United Kingdom              | 59.1     |
| Russia                      | 46.7     |
| Greece                      | 46.1     |
| Germany                     | 44.3     |
| United States               | 33.0     |
| Finland                     | 27.5     |

Source: Economist Intelligence Unit
The allure of emerging markets as growth opportunities is undeniable. But so are the risks associated with them. The past three years, from the events of September 11 to the war in Iraq, have dramatically raised the profile of geopolitical risk and its capacity to impact the financial services industry, whether as direct targets of terrorist attack, frontline players in the war on terror, or victims of the economic and financial fallout of political chaos.

Looking ahead, the Middle East will remain the crucible of geopolitical concerns. The risks of continuing chaos in Iraq remain high. The prospects of a return to any form of peace process between Israel and Palestine remain low. More alarming, because less obviously factored into risk premia, is the threat of political upheaval in Saudi Arabia. States such as Saudi Arabia could be particularly at risk if deepening conflict between Sunni and Shia groups in Iraq amplifies tensions between the same communities in their own countries. The risk of continuing attacks on Western nationals also poses a threat to the Saudi economy, which is structurally dependent on expert Western workers across key sectors.

Elsewhere, ongoing antagonism from nuclear-armed North Korea towards both its neighbours and the US could result in instability in north-east Asia. Suspicions that Iran is failing to disclose full details of its nuclear-development programmes to international inspectors may flare. The states of the Western CIS will remain institutionally fragile, particularly as the door to EU membership appears to have swung shut.

Countries with highest levels of political risk

- Azerbaijan
- Pakistan
- Ukraine
- Iran
- Venezuela
- Ecuador
- Bahrain
- Nigeria
- Saudi Arabia
- Kenya
- Peru
- Morocco

Note: The Economist Intelligence Unit rates 100 countries on 11 separate measures of political risk.

Source: Economist Intelligence Unit, April 2005
Hanging over any discussion of political risk is the threat of another major terrorist attack to rival the events of September 11. Another incident on that scale in one of the world’s major financial centres is an eventuality that will continue to preoccupy financial institutions, from insurers pricing their policies to investment banks planning their business continuity systems.

A far more certain outcome of the terrorist threat is the rising compliance burden on financial institutions as they are called on to assist governments in cutting off sources of terrorist financing. Relatedly, efforts to crack down on money-laundering activity – estimated by the IMF to account for flows of money worth 24-25% of world economic output – will retain a high political profile over the coming two to four years. Legislation such as the USA Patriot Act will raise the pressure on financial institutions in developed markets to scrutinise a wider range of business transactions and to conduct much more detailed due diligence on the identity and activity of customers. Institutions will need to work hard to minimise the impact of these requirements on legitimate customers while meeting their regulatory obligations.

Expect issues such as money-laundering to feature more highly in emerging markets too, particularly where the US government is involved. Financial institutions in countries such as Nigeria, Indonesia and the Philippines, all of which are listed as non-cooperative countries by the Financial Action Task Force on Money Laundering, an inter-governmental organisation, should prepare for more stringent requirements over the coming years.
Ethics: Educating and protecting the consumer

Joining the war on terror and money laundering isn’t just a compliance issue, of course. There are reputational issues involved for financial institutions and jurisdictions too, and questions over the industry’s ethics and standards of behaviour will be a significant political issue in many markets over the medium term, for a number of reasons:

- The industry has been found wanting in the past. Public revelations have run the gamut from private-banking pricing abuses in Japan to overcharging by retail banks in Ireland, from cartel pricing among German insurers to pensions mis-selling in the UK. Eliot Spitzer, New York’s energetic attorney-general and Wall Street’s bête noire, has widened his sights from investment bank research to mutual fund market timing abuses and now to price rigging at insurance brokers. Few would bet against him, or others like him, opening up fresh prosecutorial fronts over the coming months and years.

- Economic and demographic dynamics are bringing more and more people into contact with a wider range of financial products. Rising income levels in emerging markets are introducing a credit culture to markets in parts of Asia and Central Europe for the first time. In certain Asian countries, governments are actively encouraging domestic demand growth as a complement to already strong export growth. But the evidence from the recent credit-card binge in South Korea underlines the duty of care the industry has to these new customers. The government in Seoul has launched a so-called ‘bad bank’ to absorb a large proportion of the nearly 4m credit-card loans that are in arrears and around 1.8m card users are thought to be eligible for the bad bank’s debt relief scheme.

- Levels of consumer ignorance are disturbingly high in developed markets too, and the problem will be exacerbated as previously abstruse investment vehicles, from venture capital funds to hedge funds, become increasingly accessible to the mass market and as the state scales back its involvement in pension and healthcare provision.

- High personal debt levels make the threat of unsustainable consumer borrowing a particularly sensitive political issue in certain countries. In the UK, for example, personal debt topped the £1tn (US$1.75tn) mark for the first time in July 2004. Debt-servicing costs are still manageable, but a rise in unemployment, further increases in interest rates or a collapse in house prices could trigger a sharp consumer retrenchment. It’s a similar story in the US, where the waning impact of tax rebates over the next two years will force consumers to bring their spending back into line with earned income growth. Rising interest rates and high oil prices will also eat into consumers’ ability to spend on discretionary items.

\[
\begin{array}{c|c|c|c|c|c|c|c}
\hline
\text{Cases} & 4 & 10 & 14 & 19 & 19 & 32 & 58 & 49 \\
\end{array}
\]

1 Excludes ‘PO laundering’, ‘Analyst,’ and ‘Mutual Fund’ cases.
2 Fourth quarter lead plaintiff data is not yet available. The projected total has been estimated based on the trends of the first three quarters of 2003.
What does all this mean for financial institutions? It might mean tougher regulations and a higher compliance burden: UK legislators are among those reviewing the transparency of retail lending practices, for example. It will almost certainly mean closer scrutiny of the industry from a variety of actors, from regulators to consumer groups to media. To take one emblematic example, recent independent research into the proxy votes of US mutual funds at corporate annual meetings, which funds are now obliged to disclose, showed that a majority of the nation’s 100 largest mutual funds opposed all social issue shareholder resolutions that came to votes in the first half of 2004. As transparency increases, reputational risk for the industry in developed markets will remain high.

There are opportunities here, too. Financial institutions that are associated with transparency, openness and honesty can acquire a competitive advantage as a result. It is also important to remember that concerns over standards of corporate behaviour cover many more industries than just financial services, and that the investment management side of the industry will be under pressure to play a more important watchdog role of its own. Recent research from PricewaterhouseCoopers shows a steady rise in the number of cases of private securities litigation in the US where public pension funds have taken the role of lead plaintiff.

The longer view: Climate change

Gloomy predictions about global warming and greenhouse gases are nothing new. Much of the science of climate change remains controversial, and the pace of climate change is gradual, not abrupt. But the issue is steadily moving to the centre of political discourse in the developed world and the next two to four years will see rising awareness of the issue among financial services institutions.

Insurers in particular will spend more time grappling with this area than ever before. Incidence of extreme weather is on the rise, as are associated losses. Insurance claim payments for the series of hurricanes which battered the eastern seaboard of the US in 2004 are expected to exceed US$22bn, according to the Insurance Information Institute (III). A recent report by the Association of British Insurers estimates that weather risk in the UK property insurance market is rising at a rate of 2-4% a year. Insurers and reinsurers are already responding by spending more time assessing climate-related risk and by adjusting pricing and deductibles terms accordingly. If and where premiums rise significantly, government intervention may be required to fund coverage. Alternative risk transfer mechanisms such as catastrophe bonds and weather derivatives may also gain in popularity.

Other parts of the financial services industry are not so obviously affected by climate change issues, but there are impacts. Emissions trading regimes, so far fragmented and embryonic, will begin to look more coherent and integrated over the next two to four years. An EU-wide trading scheme is due to launch in 2005, joining existing schemes in the US and UK. As market liquidity deepens, financial institutions will take a closer interest in its potential.

Greater awareness of environmental issues will feed through into other areas too. Environmental compliance requirements are rising, particularly in developed countries, creating potential liabilities to take into account when offering corporate financing. The market for environmentally responsible investment vehicles is likely to grow, too.

3 Most Mutual Funds Opposed All Social Proposals, Investor Responsibility Research Center, 30/09/2004
4 A Changing Climate for Insurance, Association of British Insurers, June 2004
4. Regulation and reporting

- Regulatory challenges will focus on three main areas – better, risk-calibrated capital requirements, higher standards of governance, and new standards of financial reporting;

- A tighter focus on capital management will encourage corporate restructuring and disposal of non-core activities;

- New standards of governance will be embedded into the running of businesses and daily operations through enterprise-wide risk management programmes and incentive structures related to good governance; and

- The introduction of IFRS will result in an increasing alignment of accounting and financial reporting.
On the up: The intensity and volume of regulations

The growing level and intensity of regulatory oversight will be a central feature of the financial services landscape globally in the next few years. Financial services firms in developed markets can expect a growing volume of regulation – for starters, consider Basel II, IFRS, anti-money-laundering and anti-terrorist financing measures, or the 42 components of the EU’s Financial Services Action Plan (FSAP) exercise – and more rigour in applying them.

New regulatory activity over the next two to four years will be focused particularly on three inter-related areas: new capital requirements, higher hurdles for corporate governance, and more transparent reporting regimes. For each of these areas there is an emblematic initiative – Basel II, Sarbanes-Oxley and International Financial Reporting Standards (IFRS), respectively – as well as a host of other rules and regulations.

Underlying new regulatory capital requirements is the need to ensure financial stability in global markets by matching prudential capital more closely to the risks financial institutions take on. Basel II provides a framework for moving towards the common goal of both regulators and major banks, a system in which each bank can be relied on to generate its own accurate ‘real-time’ assessment of all its risks and allocate the capital to support them. A worthy goal, except that reaching it may take years, and in the meantime, planning efforts for Basel II will be hampered by the discretion left to national regulators to implement the regulation and assess the need for further capital against operating risks.

On a slower timetable, the Solvency II exercise in Europe is building towards a similar regulatory regime for life and non-life insurance companies. Again, the uneven pace and uncertain direction of change carry risks of their own. EU regulators are keen to bring in capital requirements for reinsurance that match those of primary insurers for a transitional period until Solvency II becomes effective. This could have a major influence on the ability of the European reinsurance industry to compete on a global basis.

A tighter focus on capital management will have a significant strategic impact on the industry, through corporate restructuring and disposal of non-core activities. Expect to see more challenging questions asked of banks with mainly retail customers, for example, about more risky and hence capital-hungry operations they may have in structured finance or securities trading. Investors will want to have good reasons for holding securities of financial services companies with a broad range of businesses exhibiting very different risk characteristics. The capital markets’ natural aversion to conglomerates with diverse earnings streams will extend, with greater disclosure, to scepticism about companies blending widely varying risk profiles.

Greater discipline on capital will have knock-on effects elsewhere. Less capital will flow to low-return businesses. Surplus capital will migrate from areas like retail finance, where Basel II will allow more sparing use of capital resources to new businesses and new jurisdictions. Asset and liability management will be tightened up as economic capital measures are more accurately applied. Product margins will be monitored more closely as interest rates change. More accurate costing of capital and higher compliance costs will encourage financial services companies to review their entire cost structure.

Enhanced risk management will be central to another area of acute focus for regulators – corporate governance. Corporate governance is to this decade what shareholder value was to the 1990s: a general framework for thinking through what managers and their companies ought to be doing. Implementation of improved governance structures, processes and cultures will be one of the major challenges facing financial institutions over the coming two to four years.

Many changes have already been made, of course. The passage of the Sarbanes-Oxley Act, governance reforms pursued by the World Bank and IMF since the Asian crisis in 1997-98 and new codes of ethics in jurisdictions from the Netherlands to Australia have all intensified the focus on internal controls (and driven up D&O insurance premiums as a result). But further regulation should not be ruled out, particularly if there are fresh revelations of poor decision-making and inadequate controls at financial institutions.

Even in the absence of more regulation, enhanced standards of governance have yet to be embedded into the running of businesses and daily operations. What that means in practice is enhanced risk management, improved management processes and more risk-aware performance cultures. There is a pressing need to strengthen enterprise-wide risk
management systems, particularly around aggregation of risk and allocation of capital to competing activities. Management processes must ensure business models and positioning are continually re-assessed, implying major advances in management information and reporting.

Underlying any sustained improvement in processes is an improvement in how institutions manage people. 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. Human capital programmes, succession planning, and the construction of incentives and remuneration packages that reward a culture of good governance – these are all inputs needed in the new regulatory age.

Governance concerns will also lead to heightened sensitivity around certain areas of financial activity. Tax is one example. There is a cultural shift in the approach to avoidance in the tax world – recent changes in UK rules on notifying tax planning are one sign of this – that means financial services companies will need to be more sensitive to the relationship, real or perceived, between tax planning and good governance.

Reinforcing the emphasis on both good governance and prudential capital will be a drive towards greater transparency, both inside the organisation, through new reporting requirements such as IFRS. These reporting requirements will also influence tax reporting, once IFRS goes beyond consolidated accounts, and will drive decisions on implementing technologies for enterprise-wide data management and risk aggregation.

Although many countries are preparing to adopt IFRS, Europe is in the driving seat, given the European Commission’s commitment to have IFRS applied to all 7,000 or so listed companies in the region from 2005. However, lobbying by major continental banks led the European Commission in October 2004 to limit the scope of IAS 39, on recognition and measurement of financial instruments. This effectively blocked the introduction of full fair value accounting for liabilities, a key component of the new rules for the financial services sector. The UK’s Accounting Standards Board countered immediately by recommending that UK companies should comply with the IASB’s original proposal and not the diluted European version. So the debate about closing the gap between financial institutions’ historic and fair value accounting goes on, although its ultimate destination – reporting that reflects current values – is not in doubt, even if the timing of change is.

Greater transparency will also affect the relationship between financial services companies and their sources of capital. Investor relations will need to be fine-tuned to reflect more detailed reporting, greater potential volatility in earnings and the risk profile and capital position of each company, and also more intensive dialogues with ratings agencies and regulators. At the same time, financing opportunities can be expected to grow with the increasing diversity of capital structures needed to support a wider spectrum of different risks.

Rating agencies will emerge with a much more central role. They and other research intermediaries will use enhanced disclosure to further differentiate each firm’s capital requirements and signal more accurately when and how much capital is needed. This will be the basis for financial services companies to free up resources in some areas, such as consumer lending, and for impending strategic decisions to specialise in, or exit from, businesses with more demanding capital requirements. The growing influence of rating agencies is also reflected in their development of ratings for corporate governance, a clear indication that capital markets no longer distinguish between compliance and good governance.
The costs and benefits of heavier regulation

More rules means a higher compliance bill, and not just as a result of paying for increasingly sought-after compliance professionals. More importantly, the bill for compliance also covers the cost of changing the whole basis on which a financial services business reports and reaches decisions, plus the risk of paying fines and compensation imposed by regulators.

Such costs have potential effects on new entrants to financial product markets, not just as a result of direct costs, but also as a result of the competitive advantage in the capital markets that major institutions will build up through a reputation for being able to manage and disclose their risk profile accurately.

The reputational cost of failures to comply with regulations will continue to grow. Not only are expectations of corporate governance standards higher, regulators worldwide are also alert to what their peers are doing, and recent examples have shown that failure to comply in Tokyo or New York, say, may then become an issue in another market, such as Seoul. The 40% decline in the share price of Marsh & McLellan in October 2004, following the announcement of an investigation by New York’s attorney-general Eliot Spitzer into insurance broker commissions, helps to quantify the potential penalty for loss of reputation and concern about non-compliance. In the worst cases, the penalty for non-compliance can be more severe still – closure and permanent loss of income.

There are other risks related to regulation as well. Changing product structures can expose producers or distributors to the risk of breaching new regulations whose precise implications will only be worked out through precedents set over a number of years. While these precedents are being established, financial services providers will be subject to unforeseen risks from product innovation.

The knock-on effects for tax of IFRS could pose additional risks for financial services companies, such as tax regulatory changes to reflect IFRS and possible threats to tax neutrality between savings product structures. And fair value accounting is likely to increase the volatility of earnings in the financial services sector, and with that, an increase in the tendency of rating agencies to make more frequent adjustments to credit ratings and hence to the cost of capital.

But regulatory upheaval will bring opportunities as well as obligations. More accurate costing of capital will continue to force financial services players out of non-core businesses, allowing stronger competitors to expand along the value chain. The large financial services companies rapidly absorbing the administrative operations of asset managers provide one example. New markets for insurers are being created by environmental liabilities regulations. Regulatory action against distressed or insolvent companies will be windfalls to stronger players as policyholders are transferred.

The EU’s harmonisation of financial markets through FSAP will knock down some barriers to entry, though detailed implementation on the ground is as important as changes to the rules. Worldwide, the move towards a level playing field in regulation and reporting will add momentum to liberalising markets. This marks a major and positive change from the principal driver of liberalisation in the early part of this decade, when system failure and crisis, most notably in Japan, finally overcame the aversion to foreign capital in financial services.
• Technology investment in the next two to four years will be determined by three major priorities: optimising profitability from a more demanding customer base, increasing distribution capabilities while reducing costs, and achieving a step-change in the management of risk, including the resilience of IT systems themselves;

• Predictive approaches to customer data will enable institutions to anticipate and react to customer demand with greater precision and intimacy;

• Advances in compression technology, the spread of consumer broadband and the impending shift to IP networks all give the financial services industry the infrastructure it needs to deliver on the promise of e-finance; and

• Grid computing and offshoring are two of the primary ways in which technology will help institutions to realise greater levels of operational and cost efficiency.
Whether they are buying banking, insurance, securities or any other financial service, today’s customers are becoming more sophisticated, less loyal and more demanding. They take the speed and price transparency of Internet-based services for granted. But they also want personal service and the benefit of longer term relationships to purchase more complex products, such as the long-term savings vehicles that an ageing population needs in the US, Japan and Europe.

To optimise profitability from these customers, the financial services provider must deliver new products, develop and nurture customer relationships, measure and manage the risk involved, and do all this at lower cost. This requires a continued evolution of the technology now deployed for customer relationship management. CRM needs to move away from its conventional focus on assembling historical data on the customer and ensuring efficient processing inside the financial services firm towards anticipating what each customer needs, and then meeting that need with enough precision to create a ‘virtual intimacy’ with the customer.

That means investing much more in predictive approaches to customer data. High-quality data about how different segments of the customer base are likely to react to product, pricing and cross-selling proposals at different stages of the life cycle are essential for the dynamic customer service and on-demand capabilities that CRM technology now needs to deliver. Relationship managers and call centre agents increasingly need to respond in real time to a customer, using systems that generate proposals tailored to each customer’s current and future needs and that reflect major changes in personal lives such as marriage, children and bereavement. Targeting, acquisition, sales, retention, cross-selling – all these customer-related tasks are more productive as a result of predictive modelling, which enables fewer people to crunch more variables and generate more effective management of customers at a lower cost.

Rapidly changing demographics illustrate why marketing by banks, insurance companies and securities firms needs to be more targeted and more focused on predicting future demand. While ageing populations throughout the industrialised world will put pressure on those in work to save more, the savings requirement in Europe will be dramatically increased by the inability of the state to pay for pensions. Millions more customers will be looking for long-term savings products and advice, and major European financial services players will be relying on their CRM capability to predict the needs of an entirely new type of customer with a lower net worth and different risk profile from the traditional buyer of long-term products.

The opportunity for new technology to reinforce customer relationships also extends to improving customer experience. The automation of many customer contact functions, effectively outsourcing to the customer, may be reaching its limits, as competitors seek to differentiate their offerings and to enhance customer loyalty by personalising their interaction with each customer. The revival of branches by some banks is one instructive sign of this trend.

But technology does offer the potential for extending online capabilities to meet the need for greater personalisation on a mass-market scale, with smarter front-end systems. These start with improved management of customer data, software for generating recommendations, and customer contact systems that facilitate handing the right customer over to relationship managers at the right point. Growing availability of video calls over broadband connections could enable banks, for example, to offer consumers virtual branches. Technologies for enhancing CRM and improved 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.
Distribution: Greater complexity, lower cost

The imperative for enhanced distribution at lower cost will drive technology investment by financial services companies in two areas: Internet-based delivery, along with the automation of workflows to support it, and cost efficiencies, mainly via outsourcing and offshoring.

Internet-based delivery is increasingly central to distribution of financial services. 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. Much of this growth is being driven by the rapid spread of broadband, enabling richer content to be delivered at greater speed to individual households. The remarkable growth in mobile phone ownership in emerging markets suggests that they too will become a significant distribution channel for financial services, particularly electronic payments, over the coming years.

Electronic distribution delivers lower costs and facilitates faster expansion – witness the success of ING Direct in penetrating the UK retail savings market without a physical branch network. But it has its drawbacks. Increased bandwidth has handed consumers unprecedented information on pricing, leaving financial services providers with a potential trade-off between expanding distribution of a product online and exposing it to the threat of lower margins from transparent price comparisons.

Internet distribution also spells more complexity, as financial services providers seek to integrate their offerings on multiple physical and electronic distribution channels: branches, third party sales, call centres, Internet, PDAs, and ATMs. Automating distribution further will take the same basic tools as broader CRM goals – high-quality data, predictive models, web-based workflow for marketing and sales, tools for personalising customer interaction – combined with the flexibility needed for addressing different electronic channels.

In the back office, communications technology advances continue to support offshoring and in/outsourceing, with abundant bandwidth on major routes enabling low-cost virtual private networks for connecting up remote sites. The convergence of voice and data on public IP networks – not just on Virtual Private Networks (VPNs) – also opens up new opportunities, such as delivering personal advice to customers on a low-cost basis using remote video links.

Since the financial services industry manufactures and distributes digital products and is global in scope, it is uniquely positioned to benefit from the arrival of an all-IP communications environment by the end of this decade.

Indeed, outsourcing and co-sourcing by financial services industries is often motivated by access to technology, not just enabled by it. A recent European Central Bank survey of European banks’ motives for outsourcing predictably shows cost reduction scoring highest (89%), but this was followed by 60% of respondents who rated access to new technology as a reason for outsourcing. The current wave of mergers and outsourcing of back-office functions of asset managers demonstrates that this push for lower costs goes hand in hand with the desire to get access to superior technology that is now beyond the means of smaller independent players.
Risk management, the third major driver of technology investment, has escalated to a top priority for every player in the industry. Each dimension of risk management has implications for technology strategy. Operational risk has increased with the growing complexity of new products, with the reliance on models for valuing financial instruments and positions, and with the use of outsourcing and shared services for increasingly important functions. 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.

Upgrading technology to track risk exposure accurately and in real time across the whole firm is crucial to survival. 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 – these are now minimum standards for the well-governed financial services firm.

Major investment is therefore likely over the next two to four years as financial services firms adopt corporate performance management systems for firm-wide risk management and reporting to regulators and securities holders. Approaching risk management at the enterprise level is not just an urgent task for ensuring a proper degree of managerial control and meeting new regulatory and reporting requirements. It is also an opportunity to take out costs. The transformation of reporting tasks for internal risk management and financial and regulatory disclosure through standardising data around the XBRL format is the most powerful example of these potential efficiencies.
Advances in technology promise greater operational efficiency, wider distribution and more intimate customer relationships. But what are the risks to this scenario of technology as a major strategic driver for financial services companies? The first, most important risk is that while the necessary technology may be in place, its effective adoption requires a fundamental overhaul of the organisation’s culture, reward system and IT infrastructure – to re-define target customers, match products to their needs, automate the processes for delivery, and generate and apply the information for finding, cross-selling and retaining these customers.

Internally, adoption may be slowed by a lack of readiness for the major organisational change needed to earn a return on the investment. One case in point: the slow pace at which XBRL reporting is being adopted, relative to the powerful benefits of this technology for delivering improved risk management and reporting. XBRL makes most sense as part of an enterprise-wide revolution in data management, which is still too big a departure for many financial institutions, particularly in Europe.

Poor returns on existing IT investment also inhibit adoption, as does poor data integrity – though both of these factors reflect weaknesses in past processes or decisions, rather than on the potential for new technology. A further brake on adoption of new technology, in this case e-finance, is the regulation of financial services delivered on the Internet. Widely varying rules in different jurisdictions on remote intermediaries lag far behind the global potential of Internet distribution.

Another major source of risk for the success of strategic investment in technology is legacy systems. The inability to link disparate legacy systems leads to costly and complex network infrastructures. Legacy systems are also rooted in old organisations and processes. In key areas for financial services firms, such as risk management, reporting and CRM, the choice between building on an inadequate legacy or introducing new technology combined with new processes will have to be scrutinised very closely.

One likely solution will be increased adoption of grid computing, a technology which links diverse computers to create greater processing power and which is particularly suited to data-intensive processes such as pricing derivatives. The Tabb Group, a financial markets technology strategy consultancy, expects global grid spending in the financial services market to skyrocket to US$683m in 2008 from $59m in 2003, at a compound annual rate exceeding 60%.
Grid computing has other benefits, too, not least in enabling improved business continuity systems through the flexible redistribution of computing power within and across organisations. There are other examples of how technology can enhance security around financial transactions, such as the widespread adoption of Chip & PIN electronic transactions at retail outlets in Europe.

But technology is itself a source of security risk, particularly as the growth of e-finance and web-based services increases the threat of fraud and sabotage. Customers worldwide are clearly worried about security and confidentiality of e-finance transactions. Disruption through viruses and spamming, or phishing, is reaching epidemic proportions; the Anti-Phishing Working Group reports that in May-July 2004 the incidence of phishing attacks was growing by an average of 50% per month. For financial services providers, 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.
Conclusion
What do all these drivers add up to?

Financial services institutions clearly cannot afford to stand still. The complexity of the environment in which they operate will only increase, as disintermediation continues, regulations proliferate and competition sharpens. There are significant areas of growth to exploit, in high-potential emerging markets such as China and India, and product areas such as life-cycle wealth management. Greater transparency, particularly around institutions’ risk profiles, will expose the true profitability of individual lines of business. Critically, the power of the customer, fostered by technology and competition and reinforced by political and regulatory activity, will grow further, encouraging institutions to turn themselves from product-led enterprises to ones in which reward systems, organisational structures and technological advances are all geared to nurturing a customer-centric culture.

All of this will force players in the industry to consider where their true competencies lie. In an environment where being global creates as many compliance headaches as it does revenue opportunities, institutions must decide whether it is better to be international, national or even regional. In an industry where commoditisation and disintermediation can happen rapidly and damagingly, institutions must hone their brand in the markets and product areas where they are strongest. The competency-led enterprise, not the conglomerate, will win out as the rest of the decade unfurls.
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