

Inside

Triannually insights
from Deloitte

Issue 12
June 2016

Luxembourg House
of Financial Technology

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Review of Top 10 Digital
Initiatives to transform your
Business and lessons learned
from the Market

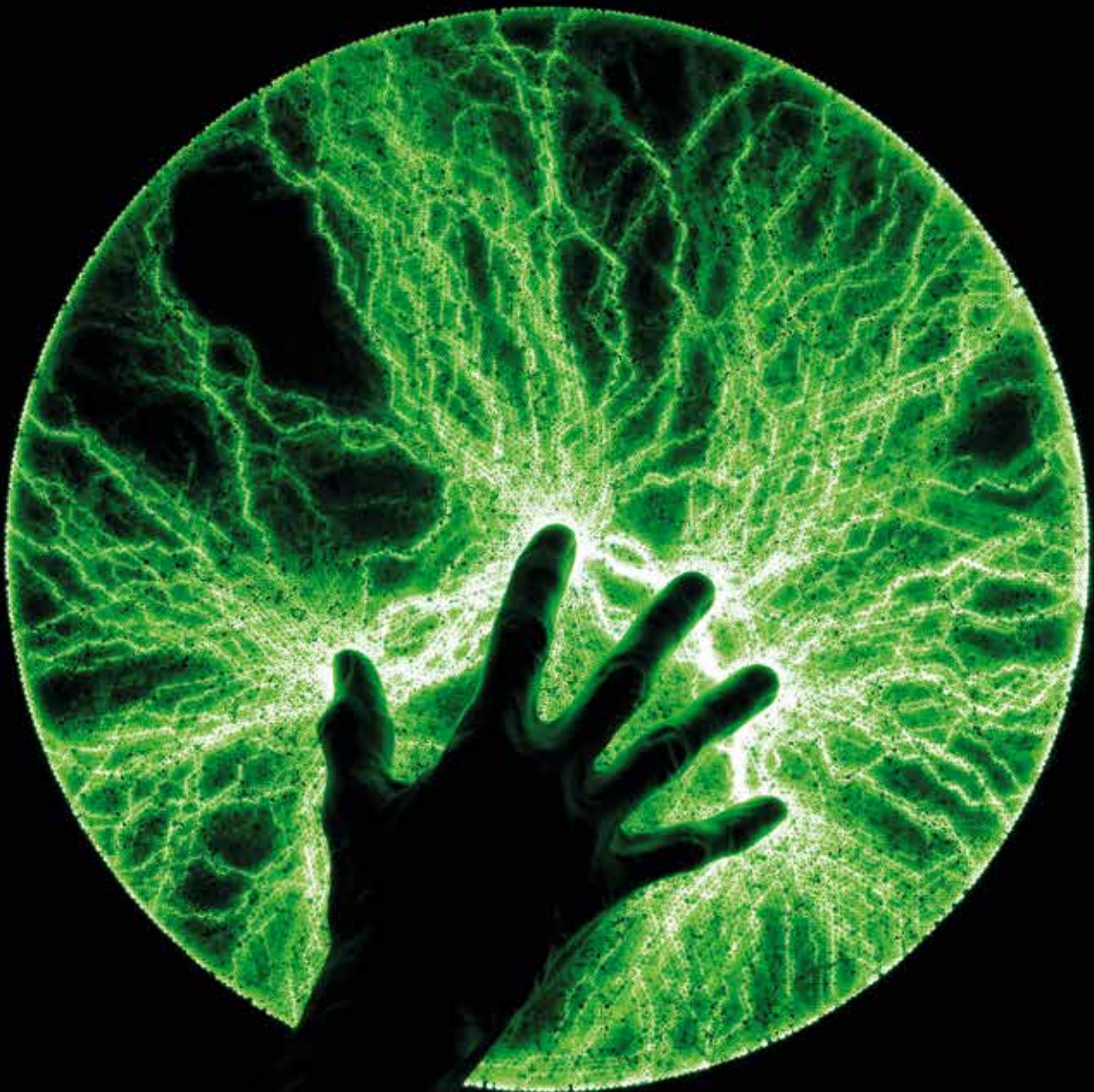
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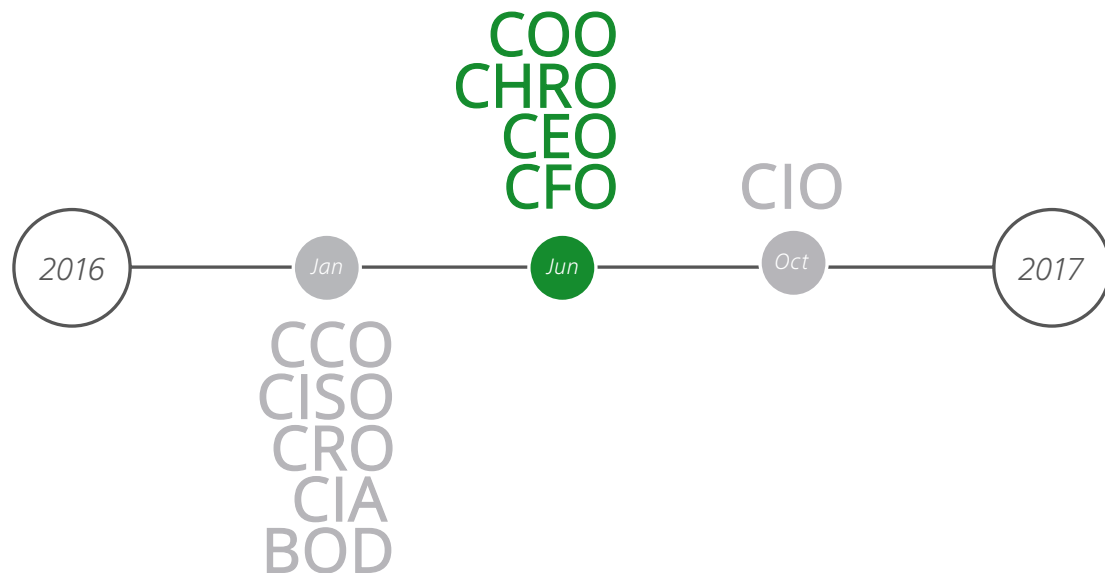


Deloitte.

COO
CHRO
CEO
CFO

EDITION
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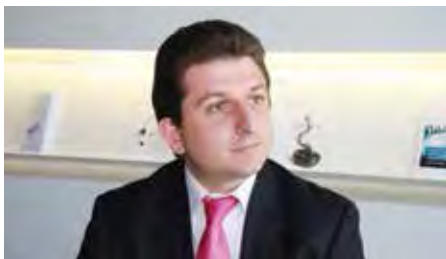
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Foreword



Dear readers,

It is with great pleasure that we introduce this new issue of Inside magazine dedicated to Chief Executive Officers (CEOs), Chief Financial Officers (CFOs), Chief Operating Officers (COOs) and Chief Human Resource Officers (CHROs).

Over the past three years, our triannually publications have offered you an exclusive insight into the latest practices, trends and opportunities in the financial services industry and beyond. In this twelfth edition, we react to the increasing interaction between the roles of CEO, CFO, COO and CHRO by providing a single issue for all four functions, while presenting the redesigned layout of our magazine. We are thus able to combine a wealth of thought-provoking material on topics of interest to such key leaders from various points of view, including strategic, financial, operational, and human capital considerations.

This redesigned edition aims to provide you with information on ground-breaking developments relating to the essence of business leadership in the modern-day market. Against the backdrop of an environment that is evolving at lightning speed through new regulations, decision makers face new situations requiring innovative strategic and financial choices. Consequently, we will touch upon how business strategies can be redefined by taking advantage of new technologies, and how executives can optimize their profits and margins through product profitability

analysis. This is a particularly relevant topic as organizations continue to be affected by regulations such as MiFID II, PSD2, T2S and CRD IV.

Alongside these strategic issues, today's leaders face new and different challenges that put pressure on business operating models and organizational structures. To keep their companies running smoothly, executives find themselves having to enhance their processes efficiently without neglecting the need for leaders who can motivate a diversified group of people and work across organizational boundaries. Our articles on digitally-fit organizations combined with social and sustainable management will provide you with food for thought on this topic.

Inside magazine embodies our conviction that the strength of our firm comes from its collaborative dimension. We are delighted that once again, Inside has been enriched by external contributions including interviews and knowledge-sharing by Luxembourg for Finance, Luxembourg Stock Exchange and the Bill & Melinda Gates Foundation. We hope that the views they provide combined with the collective participation of our experts will help you manage the current and future challenges of an evolving business with effective leadership.

We wish you an enriching and insightful read.

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Editorial

Dear readers,

It should be clear to everyone following the news nowadays that the economy has never been in such a state of rapid evolution, being disrupted by continuous innovation while being subjected to external pressures such as increased regulation and new competitors that put profits at risk.

Our Inside edition aims to provide the leaders (CEO/CFO/COO/CHRO) of today with the keys to decrypting the global trends that are already—and will continue to be—impacting the financial services industry in the short and medium term.

Digital disruption is still one area of focus, with new players and innovative solutions coming onto the market every week, revolutionizing the way banks, investment funds, insurance companies and other financial services providers are working, and with it their business models and sources of revenues.

As the world at large is moving fast, companies are still looking for means to preserve their profits and margins while under pressure from external factors such as regulation. But the latter also give rise to good opportunities if companies are able to use constraints and turn them into competitive advantages, especially when working abroad.

All of these trends are not worth considering, however, if we neglect the human capital, with people adapting themselves to the future and being directly affected by the changes in the end. The scale of disruption is so wide that all the layers of the organization are being impacted, requiring not only changes to how it is structured in order to become more flexible, but also the way human resources strategies are defined and adapted to this new approach.

The financial services industry seems to be in turmoil, but these challenging times are also ideal for fostering rapid transformation and conceiving the companies of tomorrow.

We wish you an inspiring read and hope this edition will contribute to successfully bringing your organisation forward in the next stage of its development.



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Part 01

From a digital
perspective ➤

Luxembourg House of Financial Technology

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Luxembourg is a universally recognized financial center and is primed to position itself as one of the top global centers in the sphere of digital financial services, as well as a hub for financial technology underpinned by the combined efforts of the financial industry, FinTech innovators, public research bodies and government.

There are three key requirements to ensure the sustainability of our collective success and cement Luxembourg's position as a leading financial center in Europe and beyond. Specifically, we must enhance our ability to attract the brightest minds, anticipate industry trends and act

strategically and decisively. There is no other financial center in the world where the distance between the office of a bank's CEO, public research bodies, VC firms and the vision of a FinTech entrepreneur is shorter than it is in Luxembourg.

There is little doubt that the paradigm shift in the financial industry would not be happening without help from labs and incubators focused on FinTech; major financial centers around the world such as New York, London, Hong Kong and Singapore each boast a seemingly endless list of such spaces and initiatives. FinTech incubators are hotspots of talent and ambition, and the development



of innovation ecosystems where banks, fund managers, entrepreneurs, engineers and public research bodies work closely together on new win-win solutions holds enormous promise. And that is why work is underway to establish the Luxembourg House of Financial Technology—the LHoFT.

The LHoFT will be a one-stop-shop for members of the vibrant FinTech community, whether they are entrepreneurs keen to base themselves in Luxembourg to conquer the European market, innovation-hungry financial institutions, or investors. The LHoFT will federate and connect FinTech actors and resources, strengthen collaboration and

focus on issues that are of direct relevance to the Luxembourg financial industry, such as for example RegTech. The LHoFT will also double as a powerful platform for identifying new trends and business opportunities.

We thus encourage all those interested in being part of this initiative to reach out to the LFF team to enquire about different ways to get involved. Let us once again pool our strengths as we have done many times in the last 25 years. ●

The LHoFT will be a one-stop-shop for members of the vibrant FinTech community.



Review of *Top 10* Digital Initiatives

to transform your Business and lessons learned from the Market

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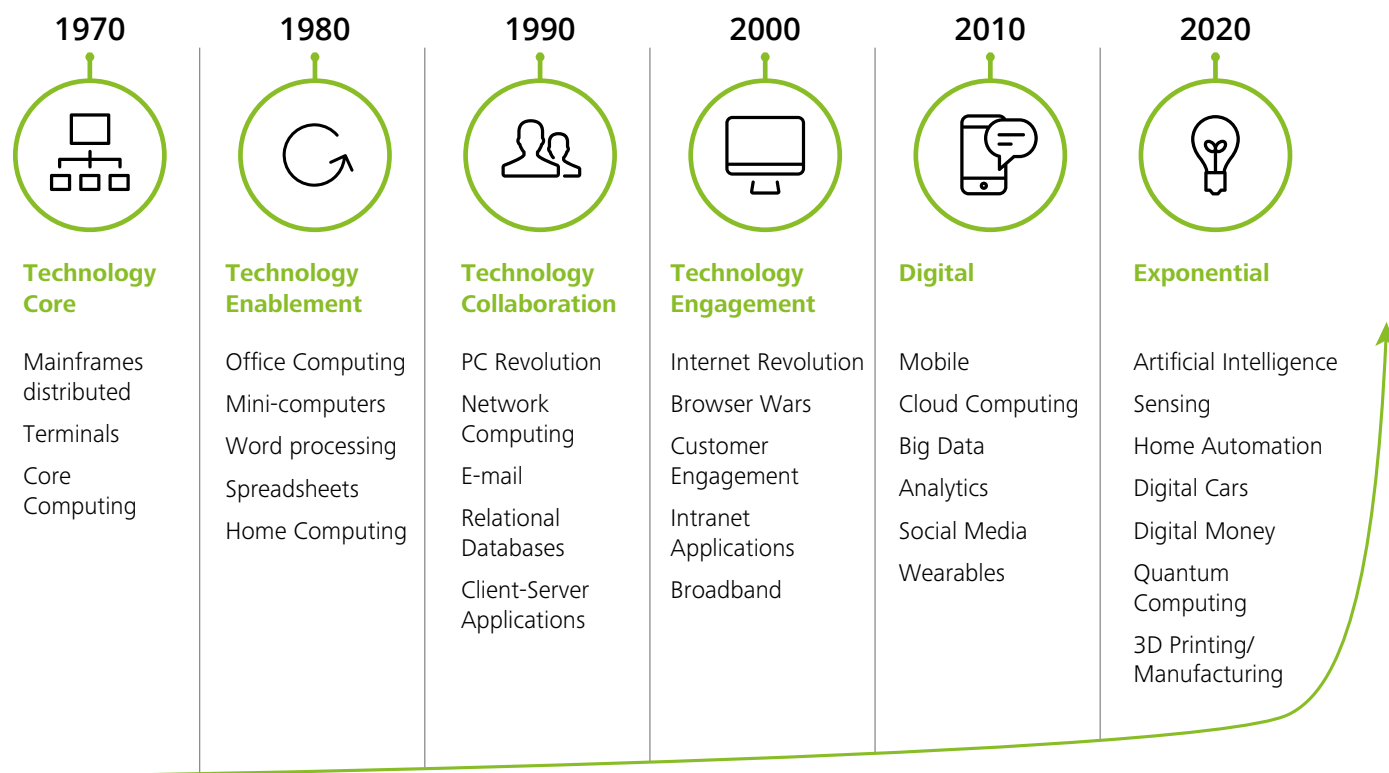
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With 1 billion digital natives joining the labor force in the next seven years, 70 billion connected computing devices by 2020 and the amount of data doubling every 18 months, digital is the new era of business across all industries. It is a stepping stone in the evolution of the modern world, made possible by the exponential growth in the use of new technologies. The digital era requires a new way of thinking about how to compete, which influences the way products, services, campaigns and operating models are designed and delivered.

The banking industry is no exception with 35 percent of banking revenue put at risk due to the digital revolution. This article reviews the top 10 digital initiatives that banks have undertaken in recent years with various levels of success, highlighting their related benefits and the lessons learned, based on case studies observed on the market. ➤

Technology eras are characterized by exponential growth and connectivity



Our studies demonstrate that the banking and securities sector will lead digital market spending with relative market size growing from US\$5 billion to US\$8.8 billion by 2020 at a worldwide level. Like many other industries, the banking sector is facing a changing environment with digital disruptions taking place in several spheres.

- With regards to customers, their expectations of digital experiences have been raised by non-banking players. Personalized, integrated services and holistic solutions for diverse financial needs are now expected. Next-generation customers also expect banking services to be available when and where they want them.
- Regarding the competition landscape, non-traditional players and startups (FinTech) are picking off high-value areas of the value chain where banks have ignored opportunities, or white spaces that are not important enough to current bank operations or not economically relevant with their legacy operating model.

- Operational wise, banks are forced to address front-to-back simplification and transformation due to aging infrastructure and servers, uncompetitive cost structures, and increasing pricing pressure in the transaction space.

As a consequence, huge investments have already been made by the banks as they seek to either become a digital leader, or try to catch up with their peers and competitors. Such efforts have met with varying levels of success. Going digital would allow banks to deliver an end-to-end and tailored customer experience across all channels, focusing on the habits and expectations of new generations. Furthermore, they would be able to retain and even expand their customer base, preventing customers from switching to non-banking competitors. Finally, banks could also lower their operational costs through the digitization of their repetitive and time-consuming processes, i.e., account opening or loan origination, thanks to the increased support of front-end activity by digital channels.

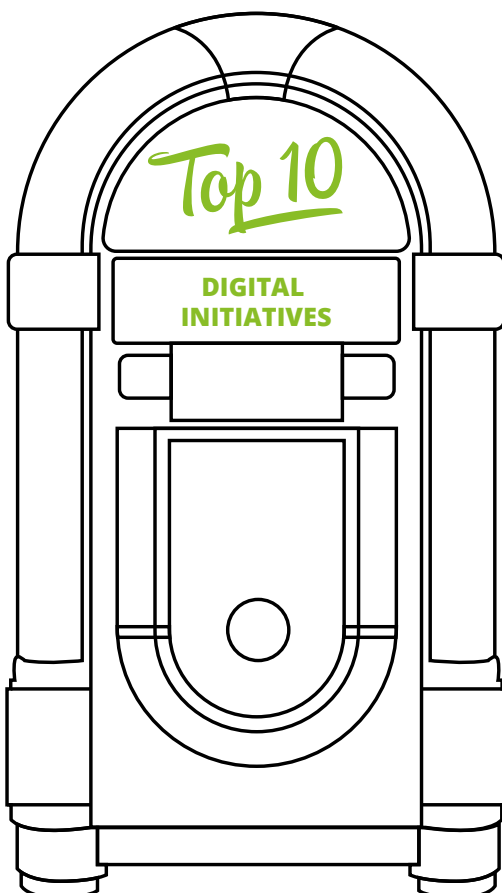
Becoming a successful digital organization requires more than a one-time investment. It requires ongoing evolution based on accurate and timely feedback from internal and external customers, which will only become possible if the organizational model is agile enough to cope with the pace of change and increased client interaction.

Today, digital is the common denominator for both challenges and opportunities faced by banks, creating a sink-or-swim situation for traditional players. Banks that forgo typical bespoke, iterative approaches and invest in integrated and forward-thinking transformation are achieving success in the digital era. In this context, many digital initiatives have been launched in the world of banking over the past few years.



“Technology is changing how companies are organized and run across all industries, and ours is not different”

Brian Moynihan,
CEO of Bank of America



1. **Digital strategy:** adopting a digital strategy in line with your business strategy
2. **Digital customer segmentation:** adapting customer segmentation drivers to new digital habits
3. **Customer lifecycle journey:** removing friction from the customer journey
4. **Digital operating model:** digital strategy driving the adoption of a digital operating model
5. **Agile transformation:** starting with digital as a project and ending with digital as a core value
6. **Digitization of processes:** transitioning from manual and paper-based processes to digital processes
7. **Mobile and omni-channel:** providing a seamless user experience across all digital channels
8. **Cyber security:** transforming the cyber security threats into opportunities
9. **FinTech:** leveraging FinTech via a win-win strategic alliance
10. **Analytics:** shifting from a “data-capturing” to a “data-leveraging” approach

Hereafter, we describe each initiative’s connection with current market trends, and provide insight on the benefits and the lessons learned, as well as case studies observed from the market. ➤



Digital strategy is the foundation that underpins the future state of the organization when it reaches digital maturity.

1. Adopting a digital strategy in line with your business strategy

Today, mobile devices provide unprecedented access to information, products and services. Businesses need to create a seamless experience and a consistent customer journey, projecting their brand clearly across the many touch points, channels, and devices their customers use. Digital strategy helps banks define a bold vision for their entire digital journey. It is the gateway that leads to all other digital initiatives. They need to reimagine how profits are made, rethink how relationships are created and managed, reshape how they operate, and rewire the competitive fabric of the entire banking industry. Such a digital strategy should be considered alongside a more agile operating model and optimized banking processes to allow banks to become more intuitive enterprises.

By participating in ideation and prioritization workshops, organizations create a backlog of digital initiatives that can be tailored to align with their corporate strategic objectives. An enterprise-wide digital strategy helps companies to become more effective in acquiring new customers and drives greater loyalty to retain their existing customer base. Furthermore, by

combining a business-centric lens with a customer-centric viewpoint, a modern digital strategy can increase product penetration and customer satisfaction, while maintaining or improving business performance.

Digital strategy is the foundation that underpins the future state of the organization when it reaches digital maturity. Over time, clear differences have been identified between banks at the early stage of their digital maturity and those that are already mature. There are visible and less visible aspects of this maturity, cutting-edge technology being one of the most visible elements.

When trying to adopt new technology, the main reason for failure usually lies in the fact that organizations have not changed the culture and mindset of their employees. Leading digital banks not only have a clear and coherent digital strategy but they are also excelling at communicating it, often dictated by a single person or a limited number of people who demonstrate digital fluency to their colleagues. Banks have also different objectives in terms of strategy depending on their level of maturity. Less mature organizations are using digital to improve efficiency and

customer experience, while developed banks focus on transforming their business to stay at the cutting edge of the competition landscape, reflecting a vision beyond technologies.

In terms of culture, digitally developed banks have a more risk-taking approach than their less mature peers. They are also in better shape to implement digital initiatives by leveraging the benefits from cross-departmental collaboration. Being comfortable with risk and a collaborative mindset are key factors behind innovation.

For an Australian bank, digital banking was at the center of the transformation agenda. It focused on a long-term digital strategy comprising channels, data, agility and FinTech. They created UBank, which is their digital-only offering aimed at customers who wish to deal exclusively online or via their mobile. In 2014, the bank invested in the development of API, a programming interface layer that exposes some of the bank's functionalities and how certain services operate. The bank also launched an innovation hub created in the vein of start-up methodologies. In 2016, the bank announced a \$50 million innovation fund to invest in start-ups.

Banks must understand that the opportunities offered by digital transformation are not embodied by the technology as such, but rather arise from the way banks are integrating new technologies to transform their business, their customer journey and how they map digital capabilities to their organization's roadmap.

2. Adapting customer segmentation drivers to new digital habits

New generations (Y and Z) customers who grew up with the Internet expect an immersive, personalized and frictionless digital experience with banking products and services. According to the millennial disruption index, 53 percent of millennials think that their bank does not offer anything different from others and 33 percent believe they will not need a bank at all in five years' time. Moreover, 73 percent would be more excited about a new financial service offered by Google, Amazon or Apple, rather than by their bank.

With increasing competitors' brands and online-only offerings, including those offered by players from other industries, customers are looking to new alternatives and are expecting exceptional value-added services that go beyond core service offerings, breaking with previous industry standards. Failure to meet expectations is costly for banks, as some customers leave their traditional bank and look for more innovative players as a result of having lost trust in the big players.

Banks should already be segmenting customers to ensure targeted services and content depending on the client's digital habits, thus providing a customizable online service, which will propel improvements in the customer experience. Improved segmentation of their clients leads banks to create experiences that truly differentiate them in the marketplace, resulting in improved cross-selling. They will be able to better adapt products and services to key customer segments and strengthen their customer retention with improved customer knowledge. Aside from this, operational efficiencies will also be optimized through alignment to the defined segments.

Since digital banking services are not exclusively used by Gen Y and Z customers, the usual segmentation based on behavior should prevail. **A leading universal bank in Russia** implemented a new customer segmentation strategy based on customer income. The focus was on high and middle income segments (affluent and mass-affluent) with tailor-made products and services with a dedicated financial advisor and personal relationship manager respectively. The bank learned that they should pay attention to customer retention instead of customer attraction and that their segmentation strategy should involve an omni-channel seamless experience with a focus on utilization. Finally, they identified remote access channels as essential tools if banks wish to become leaders within the most profitable customer segments. ➔





Using an incremental test-and-learn approach provides early access to the most valued features and allows banks to learn from continuous feedback.

3. Removing friction from the customer journey

Once banks have defined their target client segments and relevant products, they need to make sure the customer journey is consistent across the channels for all their services. This requires the entire business to be integrated to demonstrate value at each and every customer touchpoint, from the contact center to digital, mobile and social interactions, and throughout the customer lifecycle.

Growing competition, globalization and consumer empowerment have eroded the traditional product-based advantage, forcing companies to shift to a new battlefield: customer experience. Waiting until the customer walks into a branch and subscribes to a banking product or service is no longer a sustainable strategy. Given that customer expectations are changing rapidly, they now expect to be able to transact digitally on any device and for the experience to be joined up across all channels.

To deliver a seamless experience across touchpoints, banks should adopt an incremental process.

First, banks need to connect customer opportunities to business operations, and create a single view of customer activity and data. Creating this single view unlocks opportunities to improve the customer experience and align investments in

technology and operations. Starting with customer ethnographic research, data and insights are collected and assessed to create the customer-business journey.

Secondly, as online banking penetration in advanced economies exceeds 50 percent and mobile banking approaches 30 percent, digital self-service continues to grow—and this trend is expected to continue over the coming years. Therefore, banks need to develop deep user/design experience and user interface skills. Responsive web design and an intuitive customer experience are key contributors to creating a compelling customer experience where all touch points are customized to a customer's stage in the journey.

Finally, banks need to interact with their clients in the most appropriate manner at every touchpoint of the customer lifecycle journey experience. This is only possible through a comprehensive combination of analytics, marketing and design, encompassing all capabilities in line with the digital service design.

A European bank enabled a whole new digital customer experience in Denmark, Finland and Northern Ireland by executing their customer move to mobile, direct and omni-channels. In terms of lessons learned, they made "customer needs" the center of the solution, rather than basing their solution on the bank. They started by designing a mobile solution and then early-produced prototyping and mock-ups of the customer experience, before a project realization method was selected. Moreover, user involvement was conducted with real customers before and during development, but also after the solution was launched. Finally, they monitored and adjusted the solution in order to maximize the benefits generated for the bank, but most importantly the perceived value for customers.



Generic



Specific

“Less is more in the customer experience. Some banks will realize they can’t hit mobile users who log in 30 times a month with the same five product pitches and will offer content like The Onion, letting customers design their experience and perhaps share it with friends.”—

Tom Groenfeldt, writer for Forbes

4. Digital strategy drives the adoption of the digital operating model

Strategic elements are key at the start of the digital transformation journey, but it will only be successful if the related operating model is able to support them.

Given the speed at which digital is disrupting the market, traditional operating models that were previously used by banks are no longer appropriate. Depending on the current level of digital maturity and the specific targets in terms of organization, products, customers and markets, banks should select the most appropriate way to embrace the digital transformation journey. Indeed, not every operating model is suitable when considering the implementation of the bank’s digital strategy. Banks should identify and define the cost and prerequisites of adopting a given operating model. The new operating model should be the driver of digital projects, not the other way around.

It is expected that a customer-centric digital operating model will drive an increase in overall revenue by meeting customer needs in a more effective way. Aside from this, restructuring the operating model to deliver superior customer experiences affects pipeline conversion rates and reduces customer sensitivity to competitor pricing. Finally, it will reduce organizational waste by removing duplicated processes

and thereby delivering market-leading customer experiences that can be repeated with speed and discipline.

Banks should consider their path toward digital transition success as a two-step process. After the definition and implementation of a specific digital strategy, they should evaluate the current level of digital maturity of their own structure. Once this state has been determined, banks will have two ways to execute their digital transition journey and these could be executed together. Firstly, banks could exploit their current capabilities and operating model to set up relevant digital initiatives that will spread across the organization. Secondly, they could globally shift to a more mature operating model in order to improve the implementation of major digital transformation projects with better agility.

In order to be among the leading digital players that have turned digital threats into opportunities, banks need to take their digital strategy to the next level. However, this should be done with an appropriate and sizeable digitally enabled organization. While improving their digital capabilities, banks must also consider the adoption of a new cultural organization, with small, cross-departmental teams working together through a test-and-learn approach and rapid iterations.

5. Starting with digital as a project and ending with digital as a core value to become agile

Given the difficulty of predicting the lasting impact of digital disruptions and capabilities, embarking on the digital transformation cannot be a one-stop journey; rather, it should be an incremental one. Banks need to shift their culture from the classic waterfall methodology to a more agile delivery approach. Based on the desired business value results for the transformation journey, digital transformation should be delivered within a solution-driven and test-and-learn approach.

The agile approach is based on iterative and incremental development cycles, where requirements and solutions evolve through collaboration between empowered teams, necessitating direct customer feedback. Each development cycle has design, development, testing, and learning tasks that end in a solution demonstration in which work is accepted and eventually released.

Using an incremental test-and-learn approach provides early access to the most valued features and allows banks to learn from continuous feedback. Depending on their level of maturity, banks should leverage proof of concepts and pilots to shorten the time-to-market of new digital products. This approach will provide early insights about the benefits and project pitfalls. The greatest benefit of agile is that it allows companies to instill an adaptive mindset and culture that enables the organization to be nimbler in response to shifts in technology or business requirements—accepting that these priorities can change as the solution evolves—and thereby refine their strategy step by step. ➤

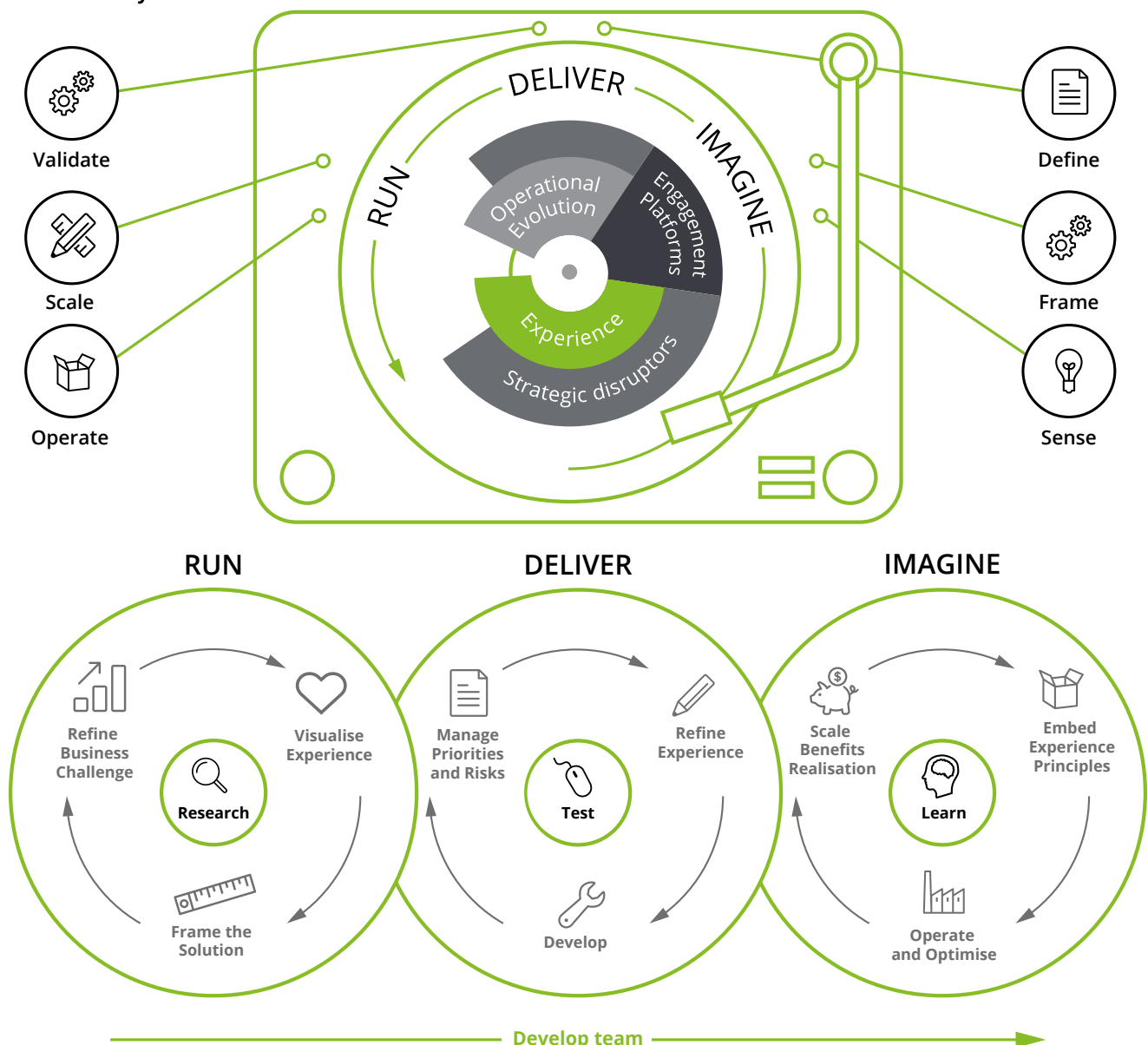
Banks should consider the development of online and mobile customer applications, products and services.

While banks are building organizational agility into their business to achieve transformation, they will also need to consider modifying their definition of success as they operate in the digital era. For instance, appropriate success metrics would be the focus on creating Return on Relationships (RoR) for both existing and potential relationships, instead of return on equity or investment.

In 2014, a **Nordic bank** launched a program that will enable the bank to develop a more personalized and convenient digital experience for its

retail customers. Once the business goals were set, they decided to adopt an agile methodology and combined two existing delivery streams to create an agile team together with a short and iterative development cycle. They learned that empowerment is key to shift the mindset of people who were used to working with a waterfall methodology. Other key factors included cross-sectional collaboration for greater transparency and the strong support of the management team to work in the same ways as agile teams.

Transformation Cycle



6. Transition from manual and paper-based processes to digital processes

The current business world is undergoing a dramatic transformation: customers, products and distribution channels are now fundamentally digital, requiring processes to turn digital as well. Banks have mainly been focusing on providing better customer experience so far, neglecting the digitization of their processes and operations. Many banks are still supported by legacy back-end systems built several decades ago, and consuming a major part of the IT budget today. These legacy systems have resulted in inefficient manual and paper-based processes, significantly affecting the customer experience.

Taking loan origination as an example, the average industry processing time for a loan application is between 5 and 15 days. Moreover, the existing manual process is vulnerable to error (and rework costs) and contains operational risk, e.g., theft of the original documents, as well as costs relating to the storage for hard copies, e.g., renting space for paper archives. Digitizing the process would significantly reduce credit approval times by eliminating unnecessary handoffs and simplifying the customer experience. It will enable faster and more efficient processing with a consistent front-to-back experience that leads to higher customer acquisition and retention. Furthermore, modernized credit systems using digital technologies, with updated back-office systems, can provide a real-time view of the bank's capital and loan loss reserves at any given time, mitigating unnecessary credit risks.

Banks should consider the digitization of front-to-back office with technologies such as document and content management systems, business process management (BPM) and digital signature in the short and medium term, enabling an end-to-end digital experience to their customers. This will probably be a multi-year process as their legacy systems and IT platforms would need to be fully integrated to allow truly digital processes.

In 2013, a **Dutch multinational bank** launched a fully functional mobile bank with a comprehensive product range



and a major simplification of processes to make banking easier. New customer account opening processes via mobile were possible in just five steps and resulted in an 11 percent increase in new client acquisition. Moreover, consumer loans from application to funds were received in two minutes based on pre-approved limits for existing customers. The bank's Polish entity developed a similar mobile application that allowed customer to receive a consumer loan in minutes by leveraging advanced analytics.

7. Providing a seamless user experience across all digital channels

Changes in customer demographics and behaviors are increasing the importance of online, mobile and social media channels. In terms of channel preference, 75 percent of generation Y are using digital banking services while only 25 percent are using branches and the number is still decreasing. Financial organizations need to place greater importance on their end-to-end customer experience across all channels.

Among all of them, the mobile channel continues to be the greatest area for customer-focused innovation, and it is

expected that it will account for 80 percent of the market by 2020. Apple Inc. launched their new mobile payments system, Apple Pay, announcing partnerships with payment companies and several major US banks, including Mastercard, Visa, American Express and JP Morgan. While Apple's new release dominated mobile innovation news, other activity included mobile technology alliances between IBM and Monitise, as well as Westpac and Moven. Mobile technology continues to dominate innovation in the global banking industry. ➤



In September 2014, an **Indian Bank** launched four new mobile banking apps, to boost the adoption of digital channels and to expand their presence in India's rural areas. The new apps consist in a banking store, where customers can view and manage all their mobile banking apps; Insta Banking, which is used to cut the paperwork done in branch by letting the customer do it via their mobile in advance; video banking, which lets customers video chat with the bank at any time of the day or night; and mPassbook, which helps customers view their savings and credit cards on their mobile.

8. Transforming cyber security threats into opportunities

The traditional parameterized architecture was perfectly adequate for an organization that simply wanted to operate inside its own controlled environment, with email to the outside world. Today, this type of organization has almost ceased to exist because of the digital transformation: we now see wider connectivity to support sharing of sensitive information over the Internet (e.g., cloud computing) and IT consumerization (e.g., Bring Your Own Device). While developing digital strategy, and online partnerships with business partners, customers and suppliers, organizations must carefully consider the new threats and risks posed by the digital transformation and its related technology. Assets that were once physically protected are now accessible online; customer channels are vulnerable to disruption.

Although mobile is the primary channel of next-generation customers, banks need to deliver a consistent digital solution built across all channels (mobile, online, social, call center and branch). This would provide customers with an integrated view of their finances and a compelling user experience, using digital to increase customer engagement with the bank's services. By interacting with customers in locations and channels they prefer, customer satisfaction and retention can be increased and key customer interaction data can be collected. Banks must also keep track of customer interactions across the different channels to ensure that the next interaction starts where the last interaction ended, which is the essence of the omni-channel principle.

Personally identifiable information via mobile devices, facial recognition and biometric verification are the top strategies being tested by banks. A large British bank is implementing a heartbeat ID for online banking security. This revolutionary strategy in KYC is also being tested by several other global banks. By digitalizing their KYC and AML process, banks could vastly enhance security and trust, improve AML accuracy and transparency and also reduce the risk of errors in documentation and information storage.

Among examples of recent trends, biometric security adoption is increasing and diversifying in the banking industry.

For instance, Apple's fingerprint technology, enabled through its iPhones and iPads, has been adopted by an **Australian and a Turkish bank** as a method of verification when entering their banking apps. New and more innovative methods of identification have included Barclays and Robocoin, a Bitcoin ATM manufacturer, using finger vein technology to identify customers and MasterCard trialing facial recognition.

9. Leveraging FinTech via a win-win strategic alliance

Every hour, 3.3 million people use Alipay for transactions, US\$28.43 million is processed by PayPal and 9,000 P2P money transfers are executed via Venmo. FinTech companies are generally start-ups founded with the purpose of disrupting incumbent financial systems and corporations that rely less on software. This new industry is attracting more and more venture capitalists every year, from US\$4 billion in 2014 to US\$30 billion in 2015. They are serving several customer segments and banking products, especially payments for retail clients.

FinTechs are causing disruptions across the banking value chain, creating new opportunities for customer relationship development. Banks need to invest in and understand options to potentially respond to these disruptions with clear, in-kind, disruptive solutions of their own. Understanding where FinTech companies and technologies are going to disrupt their business model and the consequences will help banks define appropriate responses to be more agile and avoid losing market share.

Although FinTechs are competing with banks in some areas, banks should consider partnering with them, as banks and FinTechs have complementary needs. For both parties, a partnership should liberate them to focus on their core capacities and contribute these areas of expertise to the innovation process. On the one hand, FinTechs would be able to access banks' on-the-ground market, full line of banking products with specific financial knowledge and the existing customer base they have accumulated over time. Having been established far longer than FinTechs,

banks benefit from better customer loyalty and trust. Furthermore, they are also financially more stable and are more experienced with regard to being compliant with risk and regulatory requirements. On the other hand, banks would be able to leverage the absence of legacy systems, the innovation, flexibility and agility, speed to market and technology expertise provided by the FinTechs. They would also offset their constraints regarding the recruitment of profiles with the necessary technical know-how to deliver a seamless customer experience.

An American multinational bank has become the latest bank to launch an accelerator program, promising mentoring and financial support to selected FinTech start-ups. Start-ups working in areas such as payments, fraud and operations can apply for the first round. Up to 20 start-ups a year will be selected by a panel of bank representatives, venture banking and innovation executives. ➤

FinTechs are causing disruptions across the banking value chain, creating new opportunities for customer relationship development.



New technologies are enabling aggregation of customer information, allowing organizations to present the customer with a holistic picture of their wealth and financial needs.

10. Shifting from a “data-capturing” to a “data-leveraging” approach

The digital era is generating an enormous amount of data, from word-of-mouth tracking, to social influence, etc. Banks need to make this data meaningful by collecting and interpreting relevant statistics and convert it into a better customer experience, using data as the foundation for better decision-making and action.

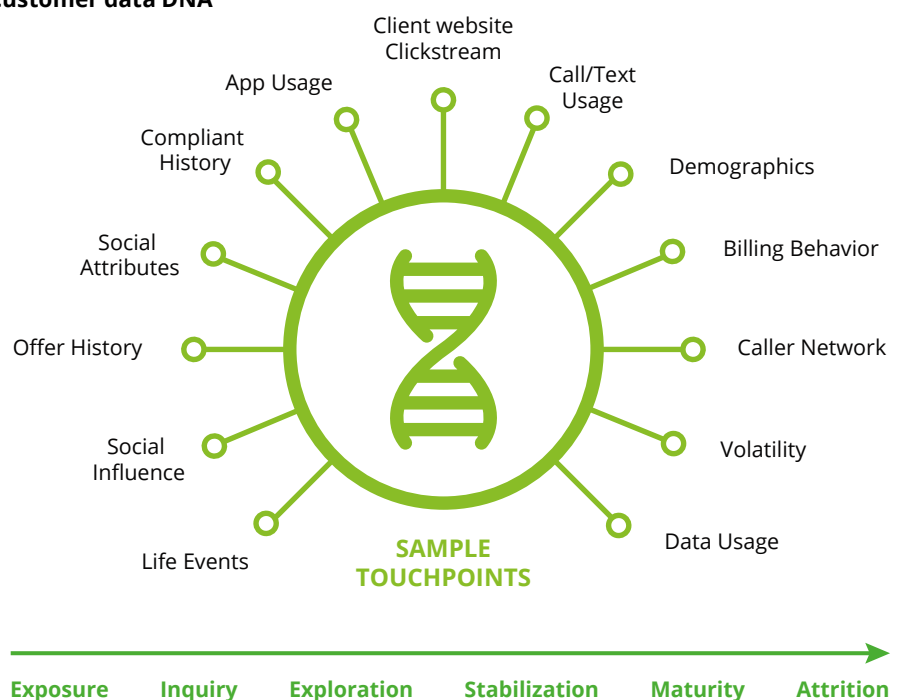
New technologies are enabling aggregation of customer information, allowing organizations to present the customer with a holistic picture of their wealth and financial needs. Meanwhile, banks are provided with new information on customers’ preferences, enabling further sales. The proliferation of big data and new analytical capabilities are resulting in new insights across multiple areas within banking and wealth management, such as client behavior and segmentation, product and investment strategies, and analyzing the effectiveness of advisors, intermediaries and channels.

However, most of the data stored still go unused. Banks need to shift from a “data-capturing” to a “data-leveraging” approach.

Through the use of analytics, banks would be able to identify growth opportunities by mapping a list of revenue growth opportunities for relevant products in each business area. Banks could also better define customer priorities by identifying and valuing their needs together with gaps in their portfolio of products held with the bank. Finally, they would make the most of their employees resources, as the time dedicated to dealing with clients could be spent on the customers with the highest potential for the bank.

Another use of the collected data that banks hold is to open them to the public (open data) and encourage crowdsourcing. The exposure of banking, payment and settlement capabilities to the wider business eco-system via Application Programming Interfaces (APIs) enables banks to leverage the APIs of third parties for verification, accounting, and modelling services. **An Australian bank** released a customer-facing API framework and portal to share access to real-time banking data with third-party developers. Developers are required to register themselves and their application on the portal in order to get an API “key” that unlocks access to the data and functionality provided.

Customer data DNA



Conclusion

- There is no one-size-fits-all digital transformation journey—the latter depends on the organization's business goals and its current degree of digital maturity. While some banks are starting to reap the benefits of their previous digital investments, others have only just embarked on their digital revolution.
- When driving their digital transformation, banks should not only focus on technology. Without a clear digital strategy, customer segmentation and appropriate data management capabilities, their digital business case could be put at high risk.
- Banks should start small to avoid big failures by adopting a “test-and-learn” approach together with an agile framework. In order to seize the benefits of the digital transformation, they also need to redefine the KPIs at brand and customer level.
- Besides building new or improved digital capabilities, banks should not forget to foster a risk-taking, innovative and collaborative digital culture across the organization, from employees to top management. Embarking on a digital transformation program is as much a people journey as it is a technological one.
- In order to become a leading digital organization, banks should focus on the following digital initiatives: become a data-driven enterprise, deliver a personalized and integrated customer experience, streamline and digitize their manual processes and adapt an appropriate digital operating model based on the chosen digital strategy.
- The main conclusion is that banks must constantly conform their digital offering to the market and adapt it continuously as needed. ●



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To what extent will a “robo adviser” replace your financial adviser?

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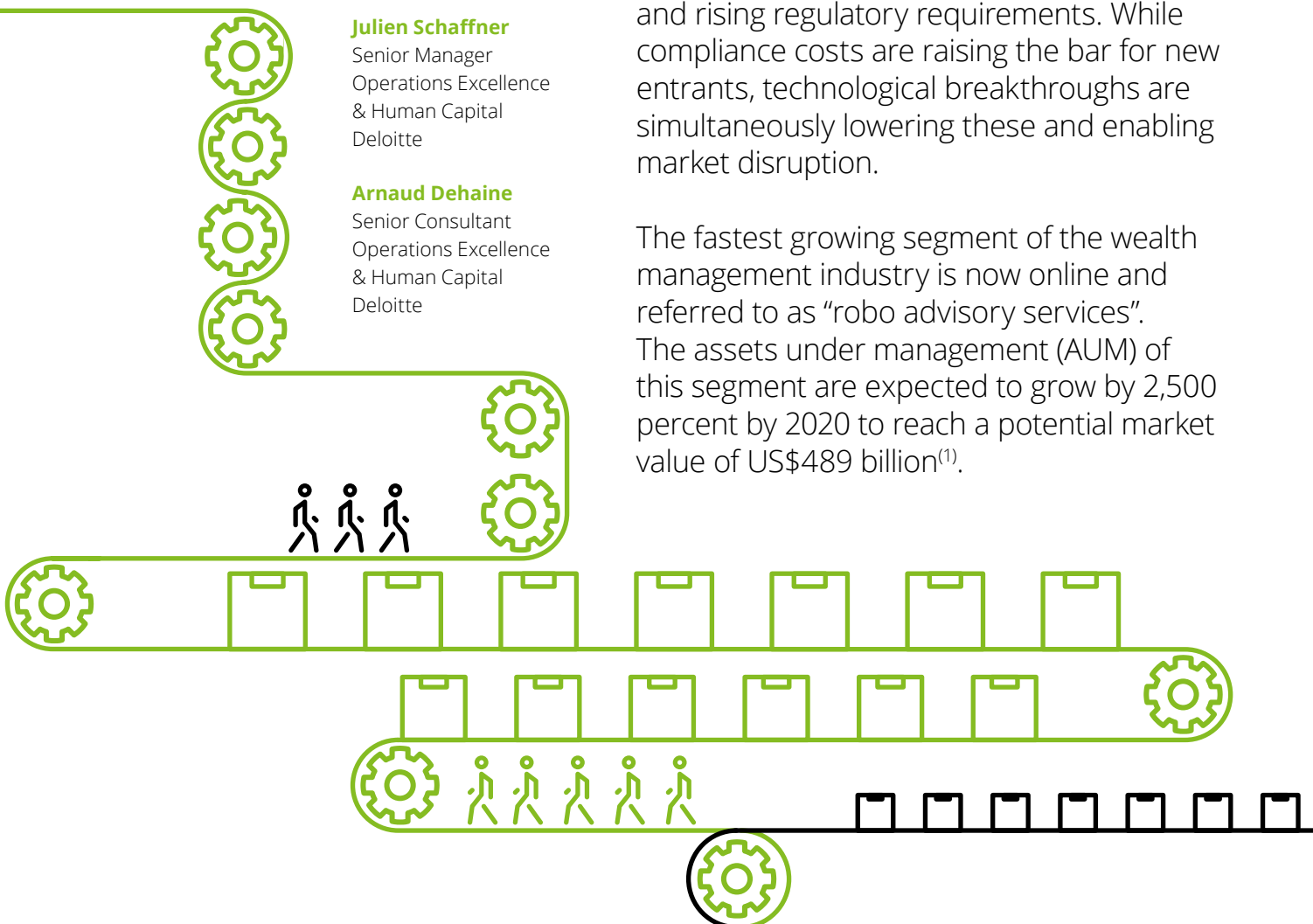
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The wealth management industry has been subject to increasing pressure over the past few years, with an uncertain economic outlook, low-rate environment, and rising regulatory requirements. While compliance costs are raising the bar for new entrants, technological breakthroughs are simultaneously lowering these and enabling market disruption.

The fastest growing segment of the wealth management industry is now online and referred to as “robo advisory services”. The assets under management (AUM) of this segment are expected to grow by 2,500 percent by 2020 to reach a potential market value of US\$489 billion⁽¹⁾.



The “robo adviser” buzzword is promising disruption in the wealth management industry, especially as the leading eleven pure robo advisers have seen explosive growth since market entry. They further increased their total AUM by 11 percent over the first six months of 2015 (to a total of US\$21 billion) after growth of around 65 percent during the previous eight months leading up to the end of 2014⁽²⁾. Even if these new market entrants are still nascent and represent a negligible amount relative to the US\$25+ trillion retail investable assets in the United States⁽³⁾, the top five robo advisory market actors in the United States already represent US\$34 billion AUM in early 2016⁽⁴⁾.

In order to understand the extent to which these new solutions may replace the traditional financial adviser, we will describe their various roles as imagined by their founders, and unveil the range of actors tagged as “robo advisers”. Details on the scope of their services will enable us to highlight their current range of coverage within the wealth management value chain. We will also provide an overview of both US and European robo advisory markets, so as to identify the reasons for success and main challenges in this fast-growing, disruptive market. We will conclude by outlining the impacts and opportunities of this trend for incumbent actors and the wealth management industry at large.

Robo advisers aim to independently replicate many of the activities performed by wealth managers through online access, and (supposedly) at lower cost.

To better understand what robo advisers are, it is necessary to bear in mind that the financial industry is still suffering from a great lack of trust on the part of individual investors. This is a fertile ground

for providers of new solutions claiming to empower the investor with the offer of full transparency and greater efficiency combined with significantly lower costs. Technology has made this possible through fast-growing, multi-channel online tools, and robo advisers are taking advantage of this situation to claim their place among the finance and investment professionals.

Wealth management services were usually reserved for high net worth individuals, sometimes extending to the mass affluent segment.

Robo advisers are targeting a broader customer base, including mass affluent and retail investors, and are continuously lowering the minimum amounts of funds required (some robo advisers are accessible with no minimum investment amount).

Private bankers were used to meeting clients in muted private rooms.

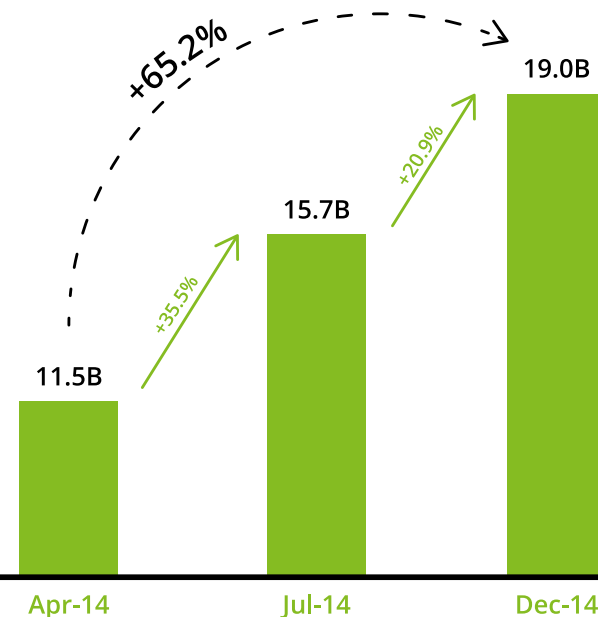
Robo advisory services are leveraging online and mobile channels to interact with customers 24/7, providing access to financial information on demand and delivering added-value services anytime and anywhere.

Financial investments used to lack transparency.

Robo advisers claim investor empowerment while making the tools used by incumbent actors available to mass investors, thus increasing the visibility of clients regarding how their money is invested.

Management fees were eating up clients’ financial gains.

Robo advisers are offering automated management services at low or no cost. Fees on AUM are reduced (but the spread remains significant, mostly between 0 percent and 0.85 percent) and Exchange-Traded Funds (ETFs) are widely used in order to reduce fees. ➔



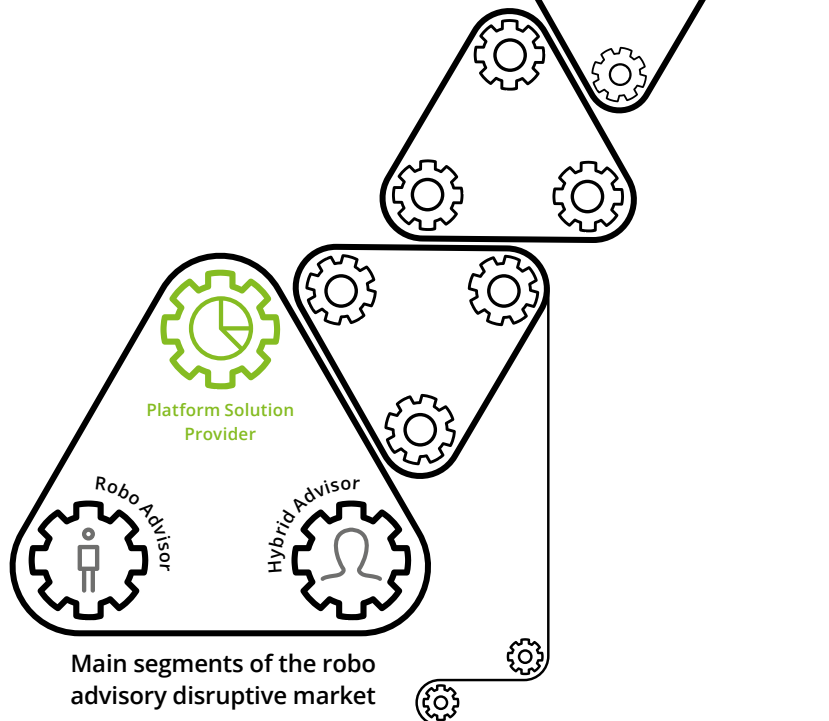
AUM Growth of eleven leading Robo-Advisors (USD Billion)⁽⁵⁾

The term “robo adviser” covers a wide range of financial FinTechs.

Whether in New York, London, Luxembourg or Amsterdam, FinTech events showcasing the trends and innovations of financial and banking technology give FinTech seeds the opportunity to broadcast themselves to investors and potential clients. Many of these are tagged as “robo advisers”, but their service offerings can be very different from one another, resulting in various business models.

The core model of the “robo adviser” galaxy is based on the use of algorithms rooted in traditional Modern Portfolio Theory (MPT), financial analysis and analytics to develop automated portfolio allocation and investment recommendations tailored to the individual client. This is the predominant form of robo advice in the United States. It may be extended to discretionary asset management services and include automated rebalancing. Users continue to benefit from online, multi-channel access to monitor the evolution of their portfolio and the performance achieved.

Another fast-growing B2C robo advisory segment in the US market is the “hybrid advisory”, which combines robo and human advisory services. Famous names such as Vanguard and Charles Schwab are market leaders in this segment. Personal Capital, funded by BBVA ventures and Blackrock among others, also offers the possibility to contact a human financial adviser in addition to the robo advice functionalities. The recipe for asset allocation remains the same: extensive use of ETFs to benefit from low fees and diversification. The scope of robo advisory tends to also encompass social trading platforms, algorithmic trading solutions and data analytics players, with a variety of brand-new solutions following the hype for automated forms of investment advice. B2B platform solution providers represent the third main segment of this new galaxy of FinTechs. Further developing their model, some actors have expanded their B2C solution of automated investment advice and discretionary asset management to also offer a B2B platform solution for professional actors, such as banking institutions and independent



Main segments of the robo advisory disruptive market

financial advisers. Other providers only offer white-labelled, automated advice and investment management solutions as a service for financial institutions. These toolkits enable professional players to easily and efficiently launch a digital wealth platform for their own end-user investors.

“Robo advisory” services are continuously evolving

In theory, robo advisers offer to leverage client information and algorithm-based portfolio management to develop automated portfolio allocation and investment recommendations tailored to the individual clients. This follows a clear, digitalized process:

- Prospects go online to define their profile: some financial planning elements are requested from investors to define an initial investment amount, regular payments and investment horizon. This is followed by an online questionnaire to collect the financial characteristics of the investors, as well as to assess their risk profile and field knowledge
- Based on this risk profile, a proprietary algorithm is run, based on MPT investment and diversification rules, to define the best-suited, personalized allocation (including diversification) to minimize risk and maximize performance
- The resulting investment recommendation is displayed online, on demand, for the future clients to visualize the potential gains and losses of the proposal, offering an on/off-track

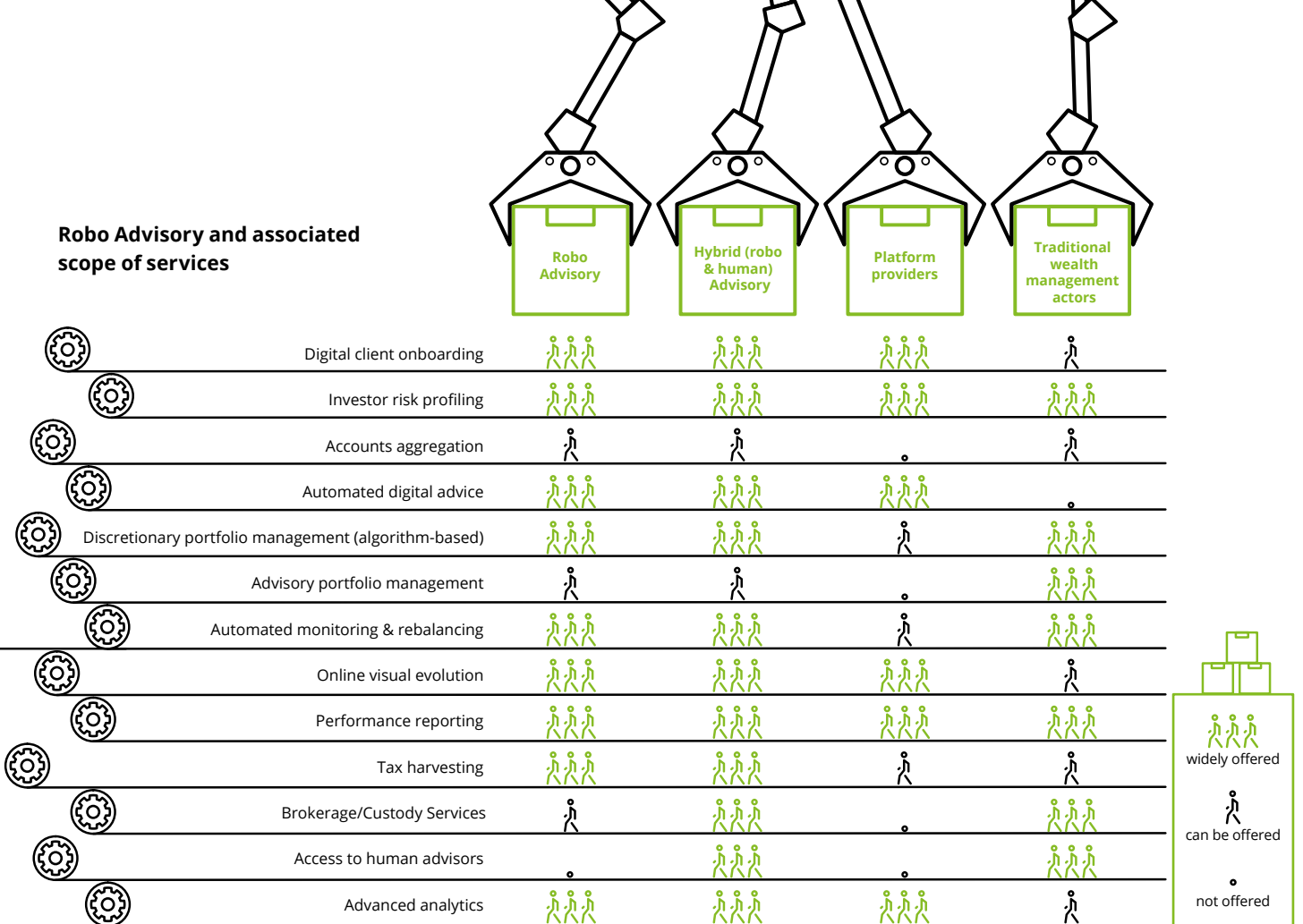
visual of their savings/investment objectives, as well as a more or less detailed composition of the proposed portfolio with exposure levels and target underlying securities.

The empowered investor can then accept and proceed with an online fund transfer/account opening. The robo adviser will provide discretionary management services steered by the risk profile/investment allocation selected. The majority of funds will be invested in low-expense ETFs also enabling diversification.

Robo advisers are extending their service offering in order to differentiate themselves from numerous competitors. In addition to the discretionary management services described above, additional paid investment advice can encompass an “active” advisory offering that provides more regular rebalancing proposals than “passive” quarterly reviews. Such services may also trigger additional fees. Several players are also offering financial account aggregation services, with the aim of providing a holistic view and therefore better tailored advice.

Innovation further came with tax-related functionalities that are now often a set catchphrase on many actors’ websites. Tax strategy is detailed for the investors, describing the options they have to select, as well as rules and priorities in selling their assets for generating gains or losses from existing positions, with the aim of optimizing tax payments. These

Robo Advisory and associated scope of services



Average coverage of services ⁽⁶⁾

tax harvesting features have now been replicated by a number of robo advisers and are integrated into the “common” service offering of these online financial actors. An additional set of services included in the offerings dedicated to individual customers is related to risk analysis and value-at-risk considerations, while investing in specific themes is another developing trend.

B2B platforms are providing integrated online wealth management plug-and-play solutions, enabling them to offer standard robo advisory features with automated digital workflows (e.g. four-eye checks), investment recommendations, and electronic signature features. Pattern configuration according to the own philosophy of the financial adviser may also be provided, or this may be done through module selection for the D2C interface.

Market overview in the United States and Europe

The United States currently rule the robo advisory market, with certain solutions dating back more than 10 years and two clear B2C leaders: Betterment and Wealthfront, created in 2010 and

2011, respectively. They each claim to have around US\$3 billion in AUM, with a slightly higher figure for Betterment. Their B2C offering is very similar and includes all the robo advisory basics: digital client onboarding and investor risk profiling, automated investment advice through algorithm-based allocation, discretionary management based on extensive use of ETFs and automated rebalancing. Their product offerings include individual retirement accounts (IRA), taxable accounts and trusts, and they both offer tax harvesting services as well, so as to minimize capital gains when withdrawing invested funds. While Wealthfront appears to be offering enhanced tax optimization services for accounts above US\$100,000, Betterment focuses on its financial planning and brand-new financial account aggregation services. The former offers a more beneficial fee structure for small-sized accounts with free services below US\$10,000 and a single 0.25 percent management fee above that figure, whereas the latter charges a similar scaled management fee that decreases as AUM increase, from 0.35 percent to 0.15 percent for accounts above US\$100,000. The only additional costs incurred are

associated with the ETF fees, declared to be 0.12 percent on average for the first solution, and ranging from 0.09 percent to 0.17 percent for the other. Numerous smaller players have entered the market with the support of venture capital, but none has currently reached a similar level of expansion and AUM. Many are charging fees on AUM, some are offering basic services completely free-of-charge (such as WiseBanyan) and charging for advanced services only, while others may charge additional setup and transfer fees, monthly flat fees, brokerage and custody fees.

Hybrid advisory solutions, which combine robo with human advisory services, are also expanding fast. By order of AUM volume, these are Vanguard Personal Advisor Services in the lead (about US\$21 billion), followed by Charles Schwab Intelligent Portfolios (about US\$5.3 billion) and Personal Capital (US\$2 billion), the latter being funded by BBVA ventures and Blackrock among others. These actors have a proven track record in asset management and differentiate themselves by offering investors a possible contact with human advisers. ➔

The investment threshold is significantly higher, starting at US\$5,000 at Charles Schwab and reaching US\$50,000 at Vanguard. The former charges no advisory fee, while Personal Capital charges 0.89 percent below US\$1,000,000. Less harmonized than the two pure robo advisory offerings, these players may not be targeting the exact same clientele.

On the B2B market, a growing number of platform solutions are designed for independent financial advisers, financial institutions and asset managers. Notably enough, two of the B2C actors mentioned above have launched B2B offerings: Betterment Institutional started in 2014, and Charles Schwab announced a new dedicated B2B solution in December 2015.

The European robo advisory markets are not yet saturated in comparison with the US maturing market, and have not reached the same level of maturity, especially as the service offerings appear to be very dependent on the country in question and local regulations.

The UK market is the fastest developing center for robo advisory in Europe, perhaps partly due to the local legislative evolution toward unrestricted access to pension schemes effective from 2015. Individuals can access advice for the management of their assets, but do not need to ask incumbent wealth management actors and engage related fees. As such, the same digital automated advice and discretionary management at lower cost applies, based on risk profiling and investments mostly directed to ETFs and funds. Nutmeg leads the UK market and now advertises on TV. Specialized in individual savings accounts and pensions, the service is accessible with just £1,000. No brokerage service is available, but bulk orders are placed during trading windows to keep costs down and pass savings on to the investor.

Other robo advisers are targeting the UK expanding market, such as the Italy-based firm MoneyFarm, which raised around €16 million in November 2015 to accelerate its entry into the UK market, scheduled for the spring of 2016. This solution also offers automated rebalancing based on

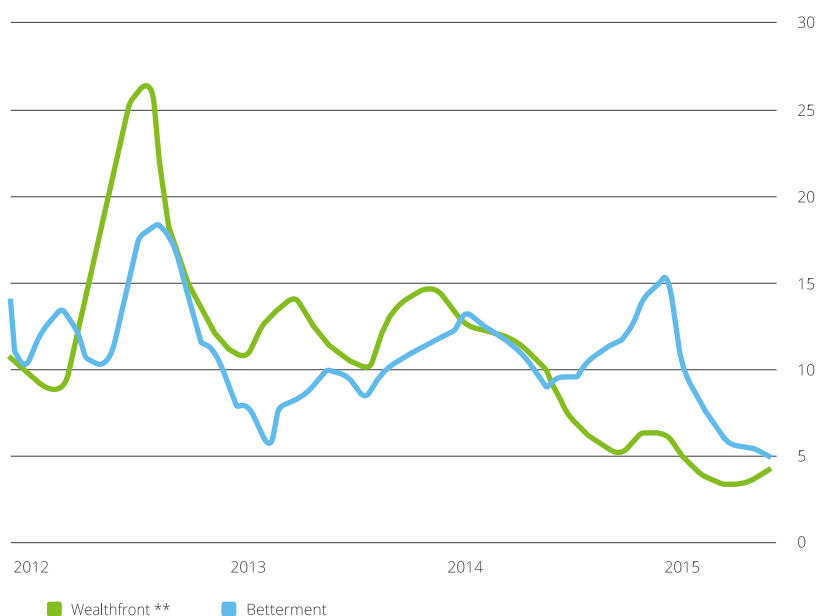
the decisions of its investment committee and brokerage services. With more than 50,000 active users in Italy, it speaks for the flourishing B2C robo advisory market in Europe. Several FinTechs have also been launched in France recently, mainly oriented toward individual investors. Some interesting seeds are offering aggregation of insurance contracts for global risk assessment and recommendations, or investment recommendations at securities level. The market is still too young to validate these expanding models, but most of the offerings are related to French life insurance investment products.

Belgium-based Gambit Financial Solutions, a provider of solutions in investment advisory, portfolio optimization and risk management, already servicing a number of major European actors in private banking and asset management, has extended its offering toward automated advice with Birdee Institutional. This

online and discretionary management solution, which includes visual portfolio management and robo advisory services is designed for private banks and retail banks targeting the mass affluent segment. Gambit also recently announced its willingness to market a dedicated robo advisory solution for individual investors in the near future, but the priority defined in launching their offering may underline the potential trend in the market: a growing interest in solutions offering a white-labelled platform to be tailored to incumbent actors' needs. And among European B2B/B2B2C platform solutions, many of which are still seeds at the moment, another UK-based FinTech called WealthObjects is targeting private banks and investment firms with a digital platform that provides modules for automated investment and financial planning supported by an omni-channel, automated workflow to handle client onboarding and enhance the digital D2C offering.



Bit disappointing Assets under management % increase on previous month*

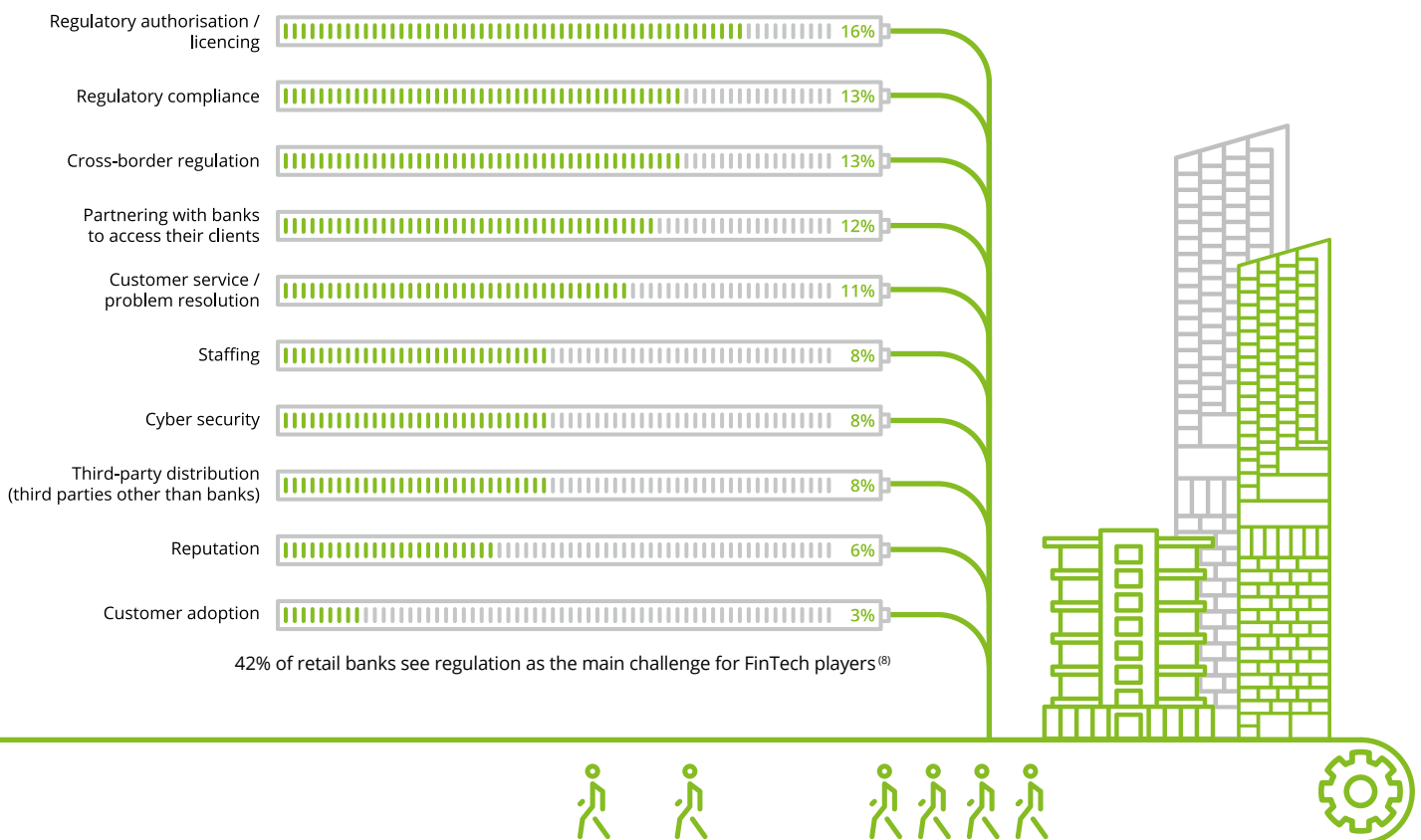


* 3-month moving average

** Based on latest estimate of \$2.9bn AUM

Slowdown in AUM growth rate for leading US robo advisory⁽⁷⁾

What is the biggest challenge faced by FinTech entrants? (% respondents)



Challenges and evolution of the robo advisory market

Key characteristics of the robo advisory market include accessibility, convenience, transparency and control, in addition to a personalized service at low cost, which implies having a large customer/ AUM base to generate profit. This may soon give rise to sustainability challenges currently looming over the horizon in the robo advisory market. Perhaps the hype has blown over or the market is simply maturing in the United States, and while growth in AUM continues, its pace is decreasing, as shown by recent figures published by The Economist⁽⁷⁾.

The flagships of pure robo advisory, Betterment and Wealthfront still have to increase in size to confirm sustainability. Each of them has raised over US\$100 million in venture capital over the past years to launch their offering and attract investors, but the increased share of players like Vanguard and Charles Schwab does indicate that it may be tough for them

to further expand to a profitable model. The client acquisition cost will be critical for all actors, in particular while targeting the mass affluent to retail segments with low-cost offerings. Fees on AUM will probably not be further reduced, as they represent the basis for revenues; therefore, it is more likely these players will charge fees to cover the additional services developed and offered as differentiators.

The consolidation occurring on the US market will probably intensify. The third pure robo advisory player by order of size is FutureAdvisor, with about a fifth of AUM in relation to the two leaders. It was acquired by Blackrock in August 2015 for an undisclosed amount rumored to be as high as US\$150 million. It was stated that the solution would "operate as a business unit within its BlackRock Solutions technology platform" and "continue to serve existing clients". On the B2B segment, the Jemstep platform solution was acquired by Invesco Ltd on 12 January 2016.

Robo advisers will also come under tougher regulatory scrutiny.

These digitally-enabled market entrants are very young on the market, and their role and scope is evolving very quickly. Nevertheless, they are obliged to comply with the existing regulations of the countries in which they provide their services, just as incumbent actors must comply with registration requirements, especially regarding the provision of financial advice. In the United States, individuals or firms who receive compensation for giving advice on investing in securities are deemed to be investment advisers and must be registered investment advisers (RIA) with the Securities and Exchange Commission or an individual US state's securities agency. Similar rules are in force in the United Kingdom (FCA authorization), France (AMF registration), Luxembourg (CSSF authorization and supervision), and other European locations where the MiFID obligations apply (in addition to compliance and internal audit provisions) ➤

requiring firms to act in the best interests of the customer and to assess investment suitability), as well as other **country-specific regulations depending on the investor's country of residence.**

The ESAs (European Securities and Markets Authority (ESMA); European Banking Authority (EBA); and European Insurance and Occupational Pensions Authority (EIOPA) provided a discussion paper on automation in financial advisory services in December 2015, and will probably issue further guidance on procedures to be applied within the robo advisory industry. While new players in Europe are mostly accepting Europe-based investors, some are restricting their offering to country-specific clients, but in all cases FATCA regulation constraints will also have to be checked. Further regulations governing the funds industry, such as the UCITS and AIFMD directives, will also have to be followed, in particular given that the automated advice and discretionary management model of robo advisory is generally based on the use of mutual funds and ETFs investments.

While recent news indicate that US agencies are looking at certain actors to confirm that appropriate controls are in place and advice is unbiased, it is noteworthy that the online investor risk profiling process requires just a few minutes and is completed by the individual alone, with no guidance from a qualified professional. Without discussing whether robo advisory solutions run the risk of making investment recommendations based on faulty information or wrong assumptions, this gap is nevertheless obvious given the reinforcement of investor protection set out by MiFID II for investment firms, and thus the fairness in the treatment of these actors can be put into question. Reporting duties, including loss reporting and execution venues, may also be challenging for new players. As for the nature of investment advice (whether independent or not), the algorithm-based solutions do not always detail the type of market analysis their recommendations are based on. As robo advisers claim transparency and independence, they may have to prove that their investment vehicle

selection process includes a sufficiently diverse scope of products. If the maturity of many actors and their offering is still very low, these questions will undoubtedly quickly rank as top priorities. Future partnerships or acquisitions could then appear as win-win solutions for traditional players and market entrants, reinforcing service offerings within a framework built to comply with increasing regulations.

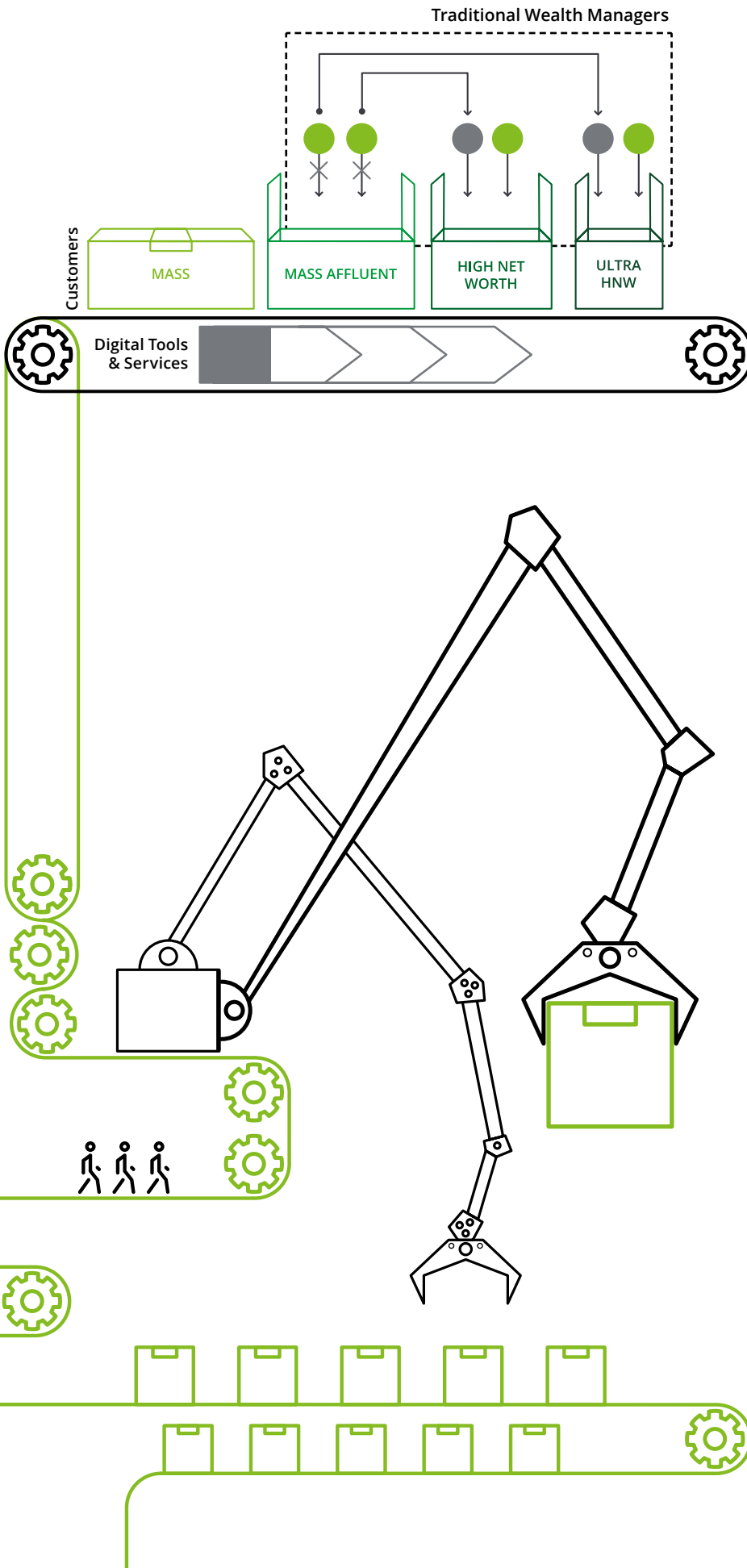
However, while transparency is at stake and **MiFID II regulation prohibits inducements**, the growth of robo advisory is putting into question the intrinsic value of financial advice. Market orientation will be key in reshaping the industry: a war on prices would further threaten revenues for both market entrants and incumbent actors. For this reason, an enlargement of the offering may well happen in the near future, and the perceived value of services delivered will be key in retaining clients and pricing services.

Lastly, B2B platform providers are not subject to the same regulatory requirements as financial advice providers and banks are looking for solutions that are compliant with an ever increasing regulatory framework in order to avoid costly developments on their legacy systems. Considering the B2B platform offerings launched recently or being launched as seeds, as well as the acquisitions that have already occurred over the last months, the B2B/B2B2C segment might be the most active in the near future.

As robo advisers claim transparency and independence, they may have to prove that their investment vehicle selection process includes a sufficiently diverse scope of products.



Erosion of the mass affluent market⁽⁹⁾



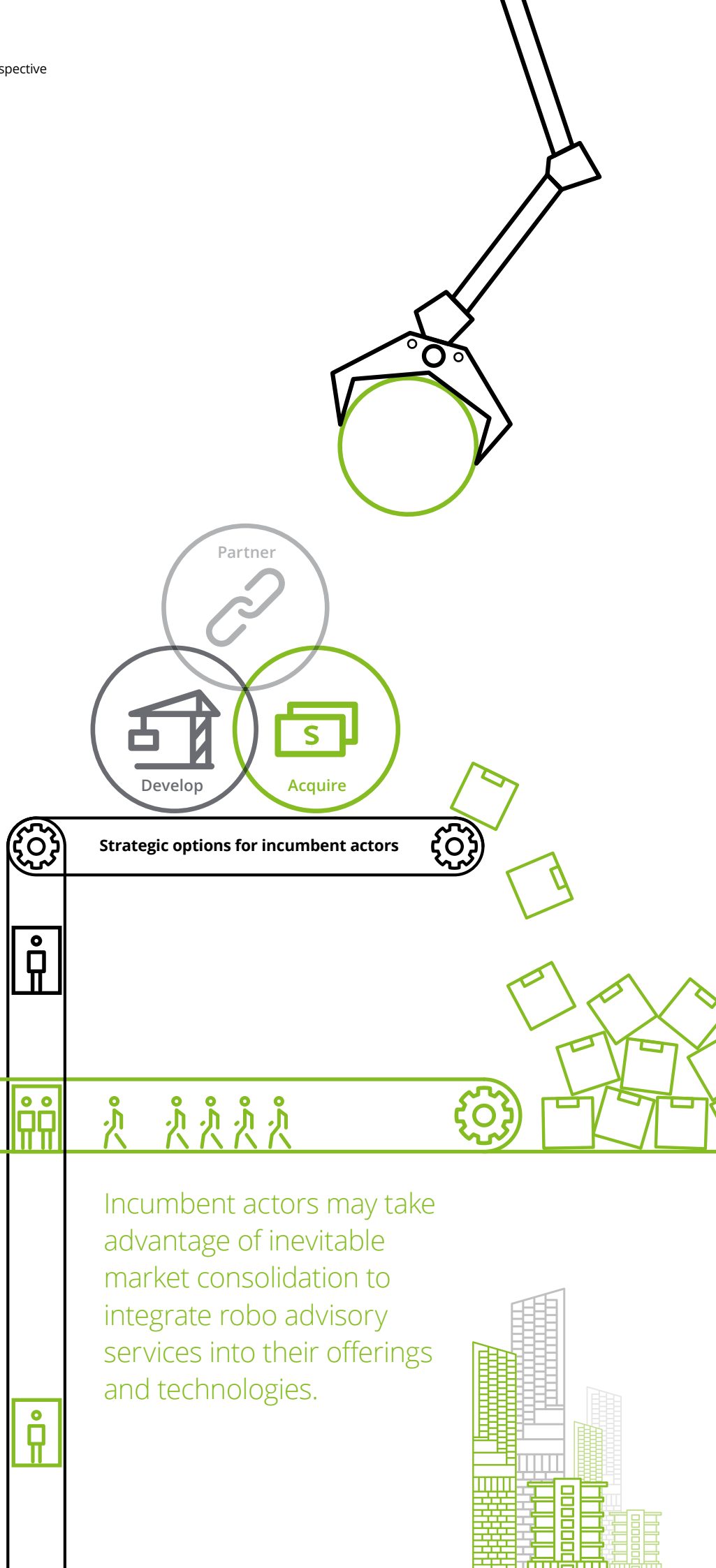
Key opportunities and challenges for wealth managers and investment advisory service providers

- **New market entrants:** agile, flexible and non-bank players are entering the wealth management and advisory services market without the need to maintain heavy banking infrastructure, as opposed to incumbent players. Independent financial advisers could see both opportunity and risk in the emergence of direct B2C competitors, but also in the issuance of alternative B2B solutions to support their activity
- **The mass affluent market,** which had become an expansion area of the wealth management industry in the past years, may be significantly attracted by online players and automated solutions through the commoditization of high value services (tax loss harvesting, financial accounts aggregation, etc.)
- **Business models are expected to evolve** due to intensified competition and a shift to lower cost asset management and financial advice, thus requiring industry players to focus on the most value-added services that require human expertise
- **Service offerings will be globally enhanced** as low-cost robo advisory services reshape customer expectations regarding their traditional wealth management and advisory services, leading aging banks to include similar digital features into their offering
- **The organizational impact** of service and relationship digitalization implies a review of the front office, both for multi-channel offerings and for the relationship manager role. The digitalization/ automation of operational processes will also impact the digital strategy of existing actors and their human capital
- **Investment management** companies may also reduce the need for intermediaries to distribute their products while including robo advisory services. Providers of **white-labeled platforms for automated advice and investment management solutions** therefore appear to be the most suitable targets for acquisition and integration in the short term. ➔

What are the next steps for incumbent market players?

They must choose their positioning and make their selection within a range of strategic options:

- Ignoring the opportunity at first and focusing on servicing UHNWI and HNWI who require higher added-value services tailored to specific needs, while the robo advisory market matures, taking into account the risk of positioning as a late-comer
- Developing an in-house robo advisory solution to leverage internal expertise, architecture and resources. This should reduce the existing cost base for providing discretionary services to the mass affluent segment
- Acquiring a robo adviser at a fair price; this offers growth potential in relation to the firm's strategy and digital IT roadmap. It could also enable it to serve a new fringe of customers at lower cost
- Partnering with an existing robo adviser to take advantage of this digital trend and its services in order to capture younger tech-savvy investors who may become the core clientele of tomorrow.



Incumbent actors may take advantage of inevitable market consolidation to integrate robo advisory services into their offerings and technologies.



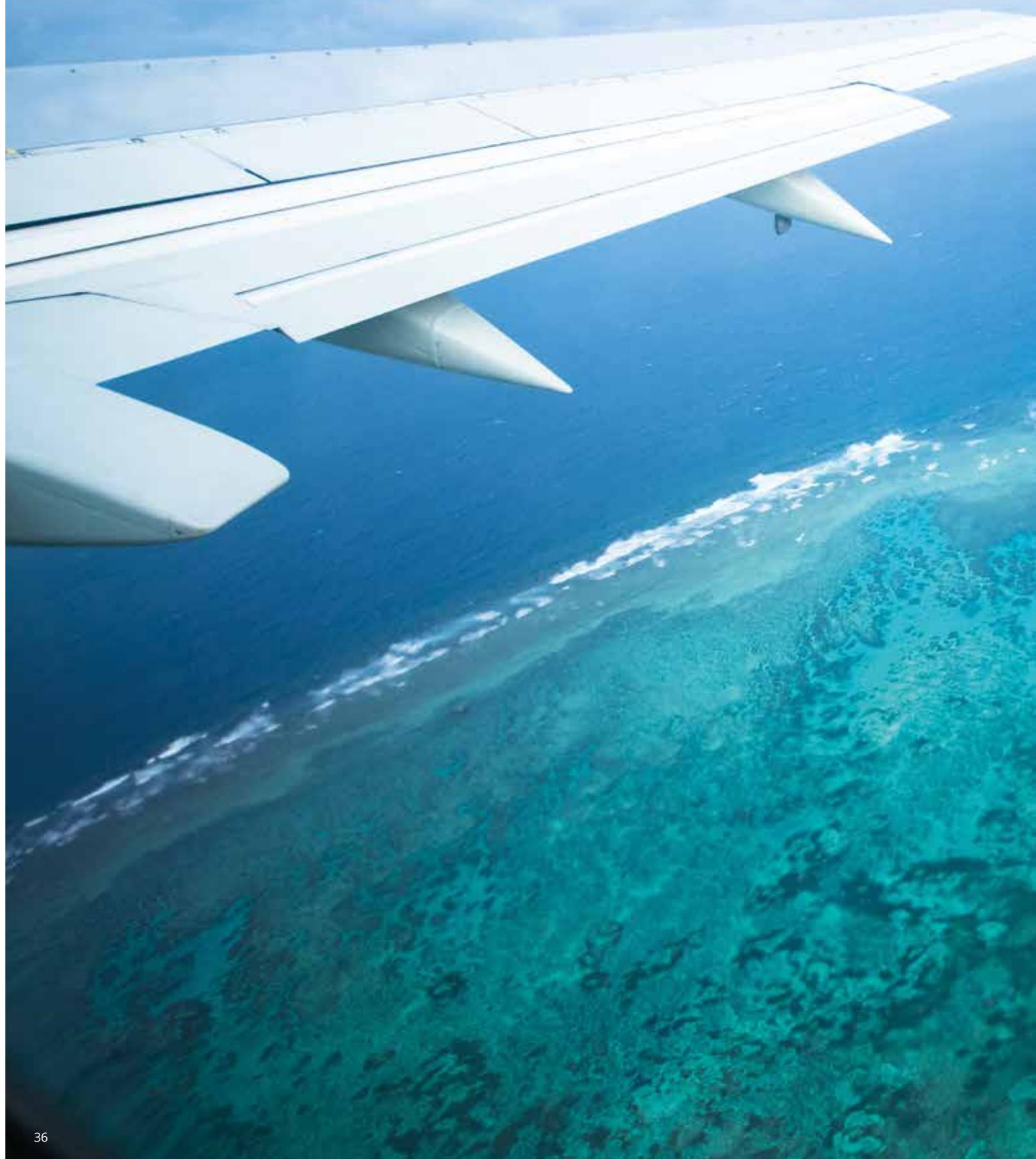
Conclusion

- Robo advisory solutions are digitalizing and automating client onboarding, investor risk profiling, and investment allocation through algorithm-based assessment, providing online investors with on-demand access to financial advice
- B2C solutions provide online discretionary ETF-based portfolio management at lower cost, including automated rebalancing and tax harvesting. B2B white-labeled platforms offer toolkits to quickly create bespoke D2C digital platforms for automated advice and investment management solutions
- Robo advisory services have been maturing in the United States, where pure B2C robo advisers are facing increased competition from hybrid advisory players within the asset management industry. Development on European markets appears very dependent on local country-specific legislation and many FinTechs are still at seed or validation level
- B2C robo advisers need to validate their business model to secure revenues and become profitable and sustainable, especially as the regulatory burden is expected to further increase, as highlighted by ESMA's recent discussion paper on automation in financial advisory services. B2B offerings are further expanding and triggering the interest of major actors from the industry, with several buyouts having been completed
- Incumbent actors may take advantage of inevitable market consolidation to integrate robo advisory services into their offerings and technologies. The perceived added value of service offerings is more than ever at stake, and offerings should be reshaped so as to highlight higher value services. Their pricing may evolve from an all-in fee to individual service selection in order to answer personalized needs and demands for transparency
- Finally, big data analytics providers may further disrupt the offering through ad hoc automated advice that answers specific investment needs or questions. Major players from both the finance and big data sectors are funding such B2B solutions designed for global banks and hedge funds that already serve institutional customers in the banking industry and state securities agencies, among others. The players combining their experience in the wealth management industry with new technology solutions supporting automated advice and the omni-channel experience could be the future market leaders if they are able to leverage the data available on the market.

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Digital cross-border Wealth management

**When crossing borders, do you know and comply
with all regulations, anytime and anywhere?**

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Given its size, its location at the heart of Europe and its multicultural workforce, Luxembourg's financial center naturally relies on and promotes cross-border business. This is particularly true for the wealth management and private banking industries, which should now focus on rethinking their approach to cross-border opportunities. ➤



Current context

It is no secret that financial institutions are facing a challenging environment. Compliance with new regulations is driving the CEO's agenda in the present and affecting the traditional way of doing business. As a result, banks and wealth managers need to reassess what they do and how they do it.

Institutions are adapting to industry challenges in a variety of ways, for example by cutting costs, changing their operating model, seeking access to cross-border markets, undertaking digital transformation or focusing on new customer segments. In this context, a key topic to be addressed is how institutions can benefit from cross-border opportunities to expand beyond their current business model (regions, clients, products and services, interaction channels and pricing approach) while minimizing their expenditure.

On the one hand, new tax transparency and regulatory constraints—especially in Europe—are leading individuals to transfer

their assets to their country of residence to avoid any potential conflict with their local government. This significant shift from offshore to onshore wealth has already forced Luxembourg banks and family offices to rethink the way they serve clients. On the other hand, new wealth is emerging outside of the traditional markets, leading banks and wealth managers to rethink their geographic coverage and expand toward other jurisdictions in Asia or Eastern Europe. Finally, UHNWIs themselves are increasingly mobile and expecting to be served around the world.

Interestingly, observed approaches to cross-border servicing can widely vary. Some financial institutions have, for example, made the daring choice to set up a branch abroad in order to follow their clients to their country of residence rather than losing them to the local competition. On the other hand, other companies have chosen to become as mobile as their clients and not to set up a permanent establishment, but rather to serve them wherever and whenever they need it.

In Europe, the “Free Provision of Services” (FPS) principle applies to wealth managers and private bankers crossing borders to serve their clients abroad. This principle allows Customer Relationship Managers (CRMs) of a European entity to meet or serve their client in another country, even when the financial institution does not have a permanent establishment locally.

However, European governments are increasingly imposing stricter rules to the general European FPS principle, and this right is itself limited to the European market. CRMs should therefore be permanently aware of the latest regulatory and tax developments not only in their home country, but also in their clients' country of residence. Therefore, private banks and wealth management firms should rethink their cross-border strategy and may now more than ever take advantage of digital and mobile solutions in order to avoid any non-compliance and reputational issues.

Increased regulatory requirements

In the aftermath of the financial crisis, the regulatory pressure on the wealth management and private banking industries has increased all over the world. Regulatory frameworks such as national regulations on consumer protection, the Foreign Account Tax Compliance Act (FATCA) and investor protection rules have an impact on the cross-border banking operating business model, affecting both its efficiency and profitability. In practice, however, observations show that the standard cross-border banking operating model remains unchanged despite the changes in the local and international regulatory frameworks. This approach can lead to significant non-compliance and reputational risks.

Partial harmonization within Europe

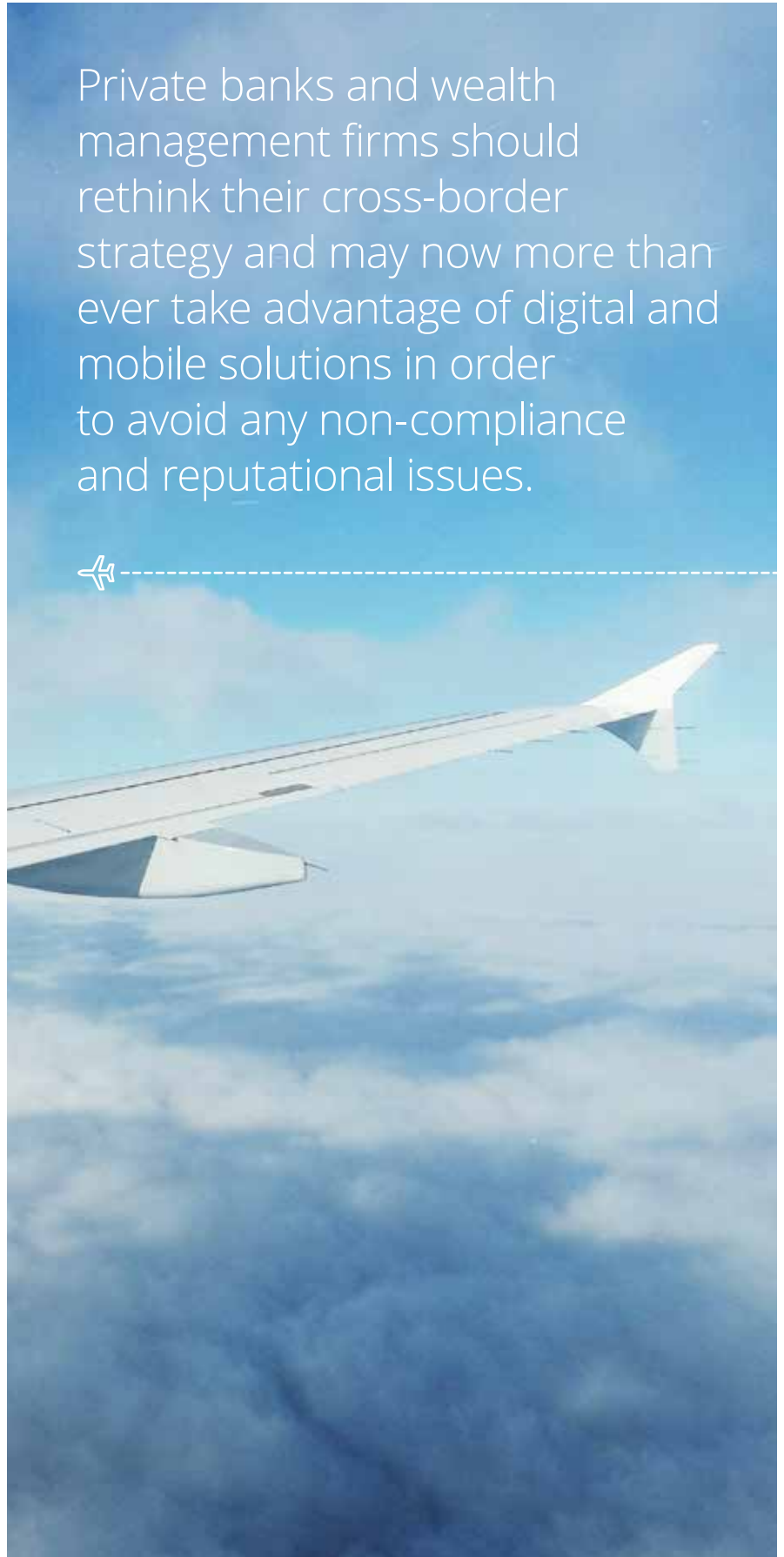
Article 56 TFEU prohibits Member States from restricting the provision of services within the EU. This right has been implemented through various pieces of secondary EU legislation, the most important in terms of financial services today being Directive 2004/39/EC and Directive 2013/36/EU, which respectively define access to the “EU passport” for investment firms and credit institutions.

This EU passport grants credit institutions and investment firms established in a Member State the right to provide services within the EU either with the establishment of a branch or through the direct "Free Provision of Services" (FPS). This passport and the relevant directives significantly ease cross-border provision of services through a partial harmonization of the relevant legislation (standards fixed at the EU level) and the application of the legal framework of the home Member State in key areas (for example in terms of authorization), with the exclusion of the legislation in the host Member State. The scope of this home Member State control will typically be wider in the case of FPS, as there is no establishment in the host Member State.

In case the relevant rules have not yet been harmonized and the home country control principle does not apply, the directives require Member States to guarantee access to service activities and the freedom to exercise such activity throughout the territory.

The treaty also generally forbids Member States from restricting free movement by imposing their national requirements on cross-border service providers unless the Member State can demonstrate that the measure is necessary to ensure the respect of one of the limited justifications allowed and that the measure is proportionate. In 2013, the ECJ stated that combating money laundering and terrorist financing constitutes a mandatory requirement justifying restrictions on free movement of services. ➔

Private banks and wealth management firms should rethink their cross-border strategy and may now more than ever take advantage of digital and mobile solutions in order to avoid any non-compliance and reputational issues.



Looking beyond traditional borders allows banks and wealth managers to have access to larger pools of clients as well as retain and serve existing clients better.



Outside of the EU—coping with disparate local rules

Such harmonization is even more limited, if not non-existent, when looking at markets abroad. The servicing of clients in Dubai, Sao Paulo or Shanghai therefore requires compliance with disparate regulatory and tax schemes, increasing the risk for daily business activities.

Risks and opportunities from cross-border business

Looking beyond traditional borders allows banks and wealth managers to have access to larger pools of clients as well as retain and serve existing clients better. They are, however, facing several challenges inhibiting the development of a real cross-border strategy:

and customer due diligence frameworks, which should take into account the specific regulatory requirements of the client's country of residence. These changes in operations are often quite burdensome as the regulatory information is spread over many directives, laws and regulations, which deal with many different subjects. This causes a further increase in operating costs, and has a direct impact on the industry's profitability.

Coping with the new challenges

Identifying the regulatory, compliance and tax risks associated with cross-border banking services is complex but essential for players to remain competitive. The complexity of cross-border business activities stems from the individual country requirements concerning investment

Digitization of such country-specific information appears to be the most appropriate solution, allowing both a quick access to and easy comparison of local rules applicable to a particular service or financial product. A regulatory-compliance tool reunites key features allowing financial institutions to cope with cross-border challenges. First, it allows for the gathering of a large quantity of information in a single database. Second, it returns only the necessary information in a user-friendly way resulting in increased flexibility. Finally, it allows clients to be followed to their residence country without taking the risk of missing regulatory or tax requirements.

The digitization of country-specific knowledge should summarize regulatory, compliance and tax information about permissible activities, products or services under national and international regulations. It should allow private bankers to challenge their strategy by comparing countries' local requirements, by identifying which country allows a particular service or activity or by ranking countries' openness to banking services or activities. The digital solution should be as flexible as possible covering every possible cross-border situation, independent of whether the client travels to the bank, the CRM flies to the client's location, or the service is provided remotely.

The complexity of cross-border business activities stems from the individual country requirements concerning investment suitability, cross-border regulation and tax transparency: a country-specific solution is therefore necessary.

- Difficulty of assessing and comparing the real cost of compliance when defining the firm's cross-border strategy
- Identification and mitigation of the potential risks arising from the client's location
- Monitoring of the increased regulatory (and reputational) risks associated with the dependence on Relationship Managers' knowledge of the cross-border rules while they increasingly travel within and outside of Europe
- Compliance with strengthened anti-money laundering (AML), investor protection and tax requirements in terms of information sharing and cooperation

This complex regulatory environment and the differences between countries mean that banks have to adapt their products

suitability, cross-border regulation and tax transparency: a country-specific solution is therefore necessary. Only then can a bank or a private wealth management firm decide how to structure their cross-border strategy, allowing them to identify which country to target and what level of compliance effort will be required.

Moving to the daily provision of daily business activities, customer-facing employees need to be properly equipped to ensure compliance with multiple local rules when servicing clients abroad. One solution is to increase the awareness of CRMs in this specific field, as they are the ones who cross the borders and who put their bank's image and reputation forward on a daily basis. However, as CRMs are highly mobile, the regulatory compliance should be as well.

In short, the cross-border business regulatory and tax awareness solution should ideally be digital and easily portable, as CRMs do not always have the opportunity to prepare for a client meeting from their office's desktop but rather prepare "on the go." While digital often refers to connectivity, the solution should allow databases to be used offline as CRMs may attend a meeting where no internet connection is possible. ●

The digitally-fit organization

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“There’s never been a worse time to be a worker with only ‘ordinary’ skills and abilities to offer, because computers, robots and other digital technologies are acquiring these skills and abilities at an extraordinary rate.”

Erik Brynjolfsson and Andrew McAfee, *The Second Machine Age*¹



Digital transformation isn't really about technology

Would you expect that the decision on which size of tables to choose for your employees' cafeteria affects your organization's productivity? Could this be part of your digital business transformation? At first glance, these may seem like random pieces that are difficult to fit within the same puzzle. But consider this: the tables in question were in the offices of a large, online travel company working with Humanyze, a people-analytics company headquartered in Boston. The latter works as an integrator of wearables, sensors, digital data and analytics to identify, for example, which employee talks to whom, where they spend time and how they interact with each other. The analysis identifies patterns of collaboration that correlate with high employee productivity. At the company in question, Humanyze found, on the one hand, that while eating together people shared more insights and thereby boosted their productivity and, on the other hand, that productivity increased in proportion to the number of people at the same table. In this case, integrating digital technology suggested that an increase in the table size would have a direct and measurable impact on employees' ability to work productively. The tale of the tables shows that digital transformation is not only about the technologies themselves—social, mobile, analytics and cloud—the real value comes instead from how companies integrate them and transform their business and their ways of working.²

With that story in mind, let's look around. Some might say that the fourth industrial revolution³ is happening right now! By 2020, more than seven billion people and businesses, and at least 35 billion devices, will be connected to the internet.⁴ With people, businesses and things communicating, transacting, and even negotiating with each other, a new world is emerging—the world of digital business, where the majority of revenues across different industries will be driven by digital.⁵

Is your organization ready to face the challenges triggered by the digital age? Do you have the right strategy in place? Do you have the requisite capabilities in your organization to successfully execute the business strategy? How will your governance processes support swift decision-making and respond to market trends?

Business agility is the new definition of success

In the new digital world, the definition of success is no longer linked primarily to efficiency, but to business agility. Organizations need to be able to seize opportunities in a rapidly changing business environment, while responding to the needs of their technology-empowered customers and acting quickly to successfully implement the digital strategy.

Presently, dwindling numbers of organizations operate using highly hierarchical models, in which decisions are taken in a traditional top-down manner. Instead, organizations operating in the digital business sphere have adopted loose hierarchies in which responsibility sits closer to where the impact of each decision is felt. Also, companies are shifting the focus toward outcomes and away from the processes performed to deliver those outcomes.

Mobility and flexibility will be crucial for people to stay relevant

It feels contradictory to note that the lifecycle of a piece of technology is measured in months, but leaders consider it acceptable for an employee to do the same job for 5 or 10 years. It is easy to stagnate in that environment, so professional mobility leading to the right life outcomes represents an important facet of successful organizations in the digital economy.

Planning the skills of a workforce in the digital environment is complicated. So is the simultaneous need to locate people

who will bring new skills into an evolving organizational context and to help existing employees gain relevant skills for the digital economy. In a world of accelerating change, building the organization's digital capability organically is not always feasible, so many organizations are acquiring other entities for their talent base, to narrow the digital skills gap.

The key imperatives for a digital organization

In 2016, organizational structure rocketed to the top of the agenda among senior executives and HR leaders worldwide, with 92 percent rating it a key priority.⁶ How you define and design your organization while identifying and developing talent and leadership is a key differentiator to the success of a new digital initiative; however, aligning your organization to respond to digital business objectives presents a unique set of challenges for the executive leadership team.

While 74 percent of organizations say that they already have a digital strategy, the level of readiness to execute such a strategy successfully is quite low, with only 15 percent believing that they are "equipped" with the right people and skills to succeed in a digital environment.⁷ ➔

In the new digital world, the definition of success is no longer linked primarily to efficiency, but to business agility.

When enabling your organization to successfully deliver on digital business objectives, the following key digital imperatives should be considered:

1. **DEFINE** what digital means for your organization
2. **DESIGN** the digital-fit operating model to support execution of the digital strategy
3. **DELIVER** the digital transformation

1. DEFINE digital

A. A digital organization must operate in a fluid and perpetually evolving environment, and this requires new definitions, objectives, and roles

"Digital" means different things to different people. Concepts like "digital operating model," "digital analytics," "digital optimization," "digital personalization" and "omnichannel," to name but a few, are very likely to be new and unfamiliar concepts for most employees.

Define what "digital" means for your business—the digital vision and business goals—decide how your vision translates into a digital strategy and identify the organizational design principles that will help you align your organization to the new digital business goals.

B. Digital organizations must be uniquely cross-functional, necessitating deliberate and formal alignment across functions

Digital organizations require the convergence of technology, customer data and analytics to enable disruptive product development. However, when adjacent enabling functions such as IT and marketing own the management of these required inputs, digital is likely to encounter friction. It is critical that a leader who can understand these enabling functions aligns their competing

business objectives. As a leader, you will be challenged to create shared goals and identify the right incentives for your new digital organization.

As companies strive to become more agile and customer-focused, organizations are shifting their structures from traditional, functional models toward interconnected, flexible teams. More than nine out of 10 executives surveyed (92 percent) rate organizational structure as a top priority, and nearly half (45 percent) report that their companies are either in the middle of a restructuring process (39 percent) or planning one (6 percent). A new organizational model is on the rise: a "network of teams" in which companies build and empower teams to work on specific business projects and challenges. These networks are aligned and coordinated with operations and information centers.

Challenges still remain: only 14 percent of executives believe their companies are ready to effectively redesign their organizations in order to enhance the roles of "networks of teams"; only 21 percent feel expert at building cross-functional teams; and only 12 percent understand the way their employees work together in networks.⁶

C. Digital organizations must operate with speed and precision while understanding when fast and nimble (rather than slow and consensus driven) decision-making is needed

Change is the new "normal." Digital organizations must be nimble, hyper-responsive to the market, and able to change track, essentially operating with the speed and decisiveness inherent to young start-up ventures. However, many large organizations are risk averse and pragmatic when it comes to decision-making.

Change is the new "normal." Digital organizations must be nimble, hyper-responsive to market and able to change track, reallocate resources, implement processes and continuously renew their digital culture. Embedding change capabilities in the business is one of the key success factors for digital implementation.

In light of these challenges, leaders of digital organizations must answer one central question:

"How do I redesign my organization to succeed in the new digital landscape?"

2. DESIGN the digital-fit operating model "One operating model does not fit all"

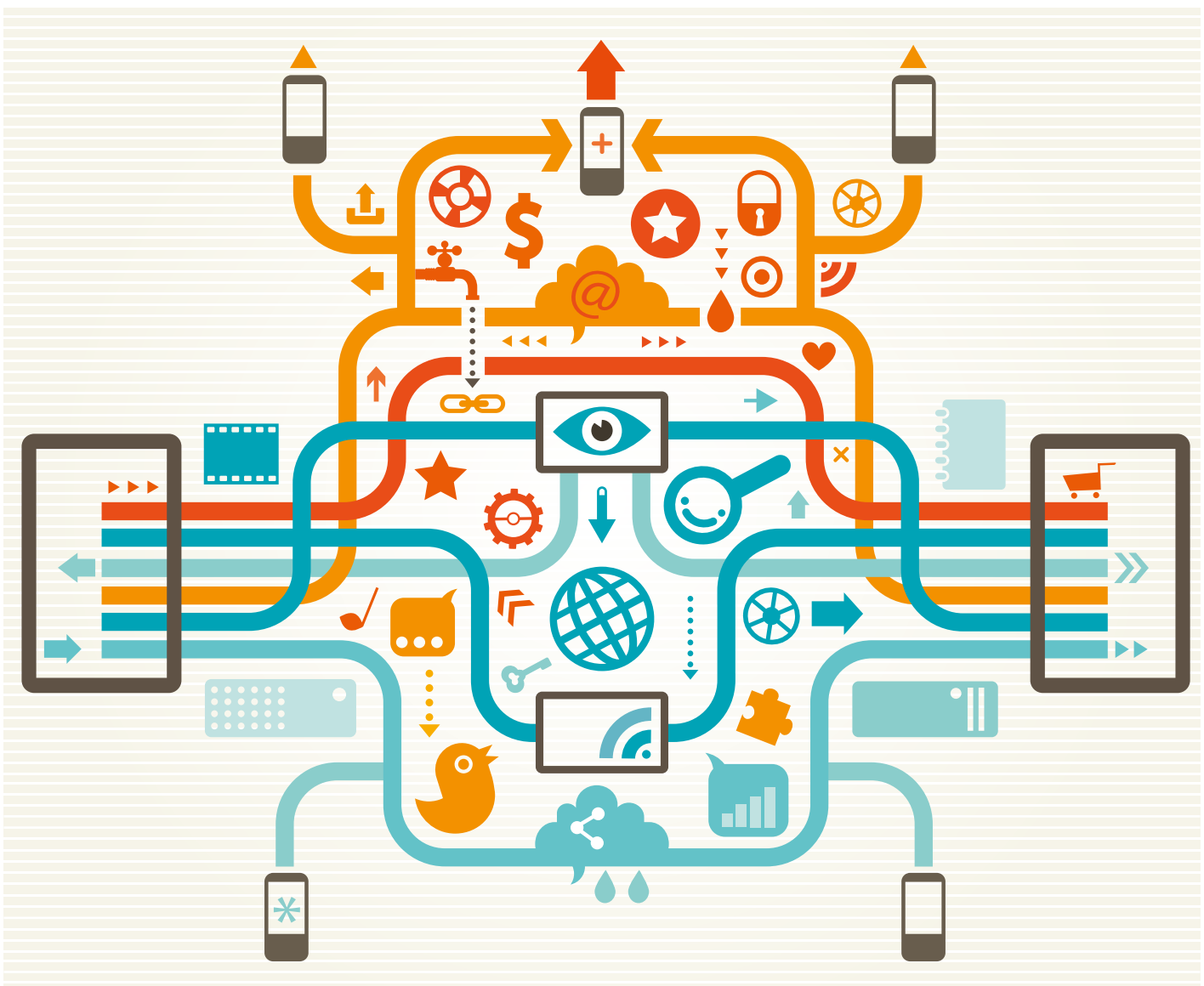
Culturally open, dynamic and flexible structures built on mutual trust are the basis of the information economy today and should be a long-term aspiration for many companies. Although radical structures such as those of Valve and Zappos are unlikely to work in many—or indeed any—other organizations today, they can't be dismissed as curiosities.

To become more agile, organizations must develop practices to deal with change events, to be able to adapt rapidly

Valve is a sizable and much-studied US software company that has no hierarchy, no defined strategy and is seemingly held together by the shared philosophy and sense of responsibility of its employees. Its 300 or so employees are encouraged to determine for themselves what the best projects are to undertake, convince their colleagues of their idea, then assemble teams to realize those projects. Valve was four times more productive than either Google or Apple in terms of market capitalisation per employee and as much as ten times more productive than peers in the video games industry.⁸

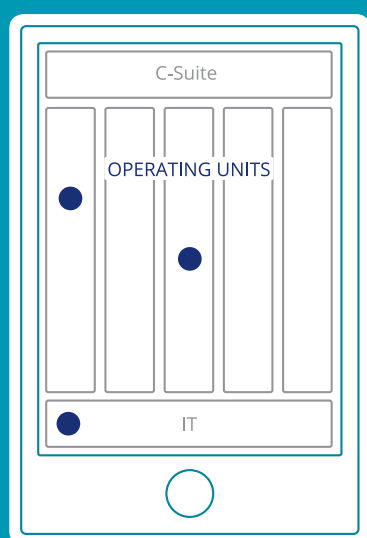
Zappos is a US-based shoe retailer with 1,500 employees, whose CEO Tony Hsieh recently announced the company's intention to move to a radical, self-governing, operating system called "Holacracy." In "holocratic" organizations, there are no job titles and no managers, and hierarchy is removed completely. In 2015, Zappos was ranked 86 on Fortune magazine's "Best companies to work for" list.

It would be a mistake for leaders of more longstanding organizations to attempt to jump to such structures. The culture shock would be too great. Instead, successful leaders must proactively consider what they can learn from organizational models being established by "digital natives" and, depending on their own level of maturity, see how they can apply new ideas and adapt their organizations to meet digital challenges. ➤



The four types of digital organization⁹

Possible solutions range from “Tactical” models, where digital technology and ways of working are used within business units to achieve existing objectives, to “Business As Usual” (BAU) models, which embed digital culture, processes, business models and technology across the organization until they become a way of life. There are, of course, many hybrid options in between.



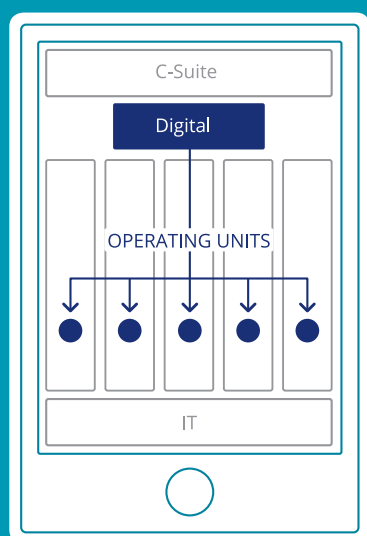
The Tactical model. **Characterized by: opportunism**

In the Tactical phase, digital technology and ways of working are used within business units to achieve existing objectives.

Techniques like digital marketing, processes such as online self-service and technologies like field force mobility all create value without the need to re-engineer the way the business works.

The challenge is that these investments are made in silos, without a view to changing the effectiveness of the entire businesses. Investments are large but not strategic. Digital remains at the edge of the business, its challenges and opportunities are restricted to the minds of a few, and the subject is treated as an exception to business as usual.

The Tactical model is extremely common in organizations that have expressed a desire to establish a digital market presence, but who have so far not articulated a coherent digital strategy.



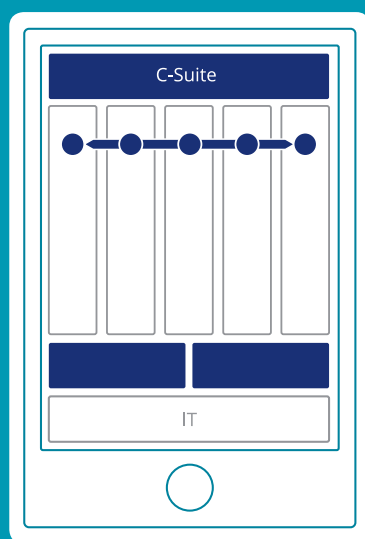
The Centralization model. **Characterized by: agenda setting**

To bring appropriate governance to expenditure in digital, digital initiatives and skills are consolidated into a central unit; this unit then translates corporate strategy into priorities for digital initiatives and works with the business units with regard to implementation. This enables appropriate governance of digital expenditure. It also creates a structure for turning corporate strategy into priorities for digital initiatives with the central team being able to work with the business units to implement them. This structure tends to be more efficient in enabling the organization to scan the market for digital opportunities, support the exchange of ideas on digital between business units and deliver digital processes and technologies on behalf of the business.

This centralization can also benefit organizations that are doing far too much

in digital. Phrases like “Skunk Works” and “Guerilla Units” are often used to describe the well-intentioned pet projects of managers that are meant to establish innovative technologies, products and ways of working, but rarely have much of an impact at a strategic level. Identifying and selecting these initiatives is one of the first tasks of a digital team. It can also identify strong talents and ideas to bring into the team.

In general, the central digital team is a transient feature of the organization that helps it gain control of investments, breaks down silos and teaches and empowers leaders to use digital techniques to transform the organization. This could become the optimum model in cases where, for example, the central team becomes a “Digital Expertise Center,” but in majority of cases, responsibility for digital should be broken up and passed to the business’s operational leaders.



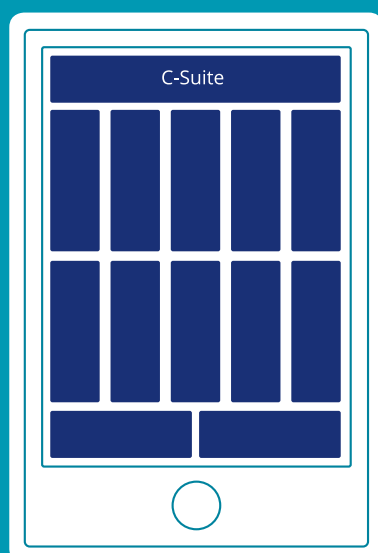
The Champion model.

Characterized by: transformation

A digital strategy is in place, and has been effectively communicated across the business.

A central digital team no longer holds all responsibility for digital, and emphasis is placed on sharing knowledge, educating and enabling others in the business.

Organizations operating on the basis of this model have sufficient openness and trust to effectively focus on performance rather than becoming embroiled in the decision-making process. The most significant enabler of this model is deep understanding between the leadership and employees of what digitally really means for their organization. Capabilities such as innovation, data analytics, and change are shared strengths that enable the organization to be self-sufficient.



The Business As Usual (BAU) model.

Characterized by: normality

Ultimately the objective of digitization is to create a business that is flexible and responsive to change at all levels. In the BAU model, using and working with digital is no longer unusual, and is a fully embedded part of daily working life.

There is no longer any need for a centralized team, and those working on initiatives and with specific digital skills rejoin business units. Everyone remains connected on an ongoing basis. Teams form and disband dynamically based on business needs. ➤

How to measure your digital readiness

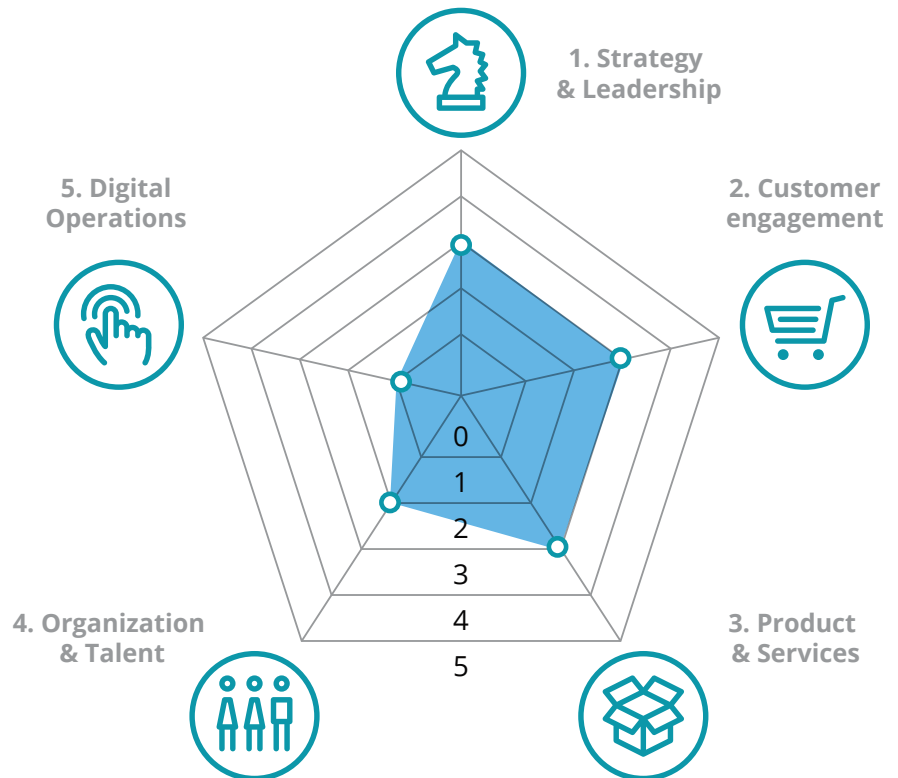
To choose the right operating model for their digital organization, leaders must understand the gap between the current and desired status quo in the context of the new digital ecosystem.

Organizations should not seek to be leaders in every aspect of digital business, but instead focus on those that are fundamental to their digital strategy.

To that end, leaders must answer five key questions:

- Do we have the right vision and strategy for digital, and the leadership, communication and focus required to support this vision?
- Do we have the right approach to understanding and communicating with our customers to succeed in a digital environment?
- Do we have the right products and strategy, and the ability to develop, manage and sell them effectively?
- Do we have the right organization, talent and culture to support my vision, products, and services?
- Do we have the right processes, controls and technologies to develop and sustain a profitable business?

Example of Digital readiness



The example organization shown above is typical in that it has succeeded in delivering some successful digital products and services to its customers in line with a defined digital strategy but it delivers them in a traditional hierarchical manner.

Although this is fine in the short term, in the majority of cases it will not be sustainable in the long term as the rate of innovation and change continues to increase and new digital competitors enter traditional marketplaces.



In the digital world, the most important capability gaps are not technology-related

The most critical capabilities organizations need to develop to meet the digital challenge are far from being technology-related.¹⁰ Instead, they include:

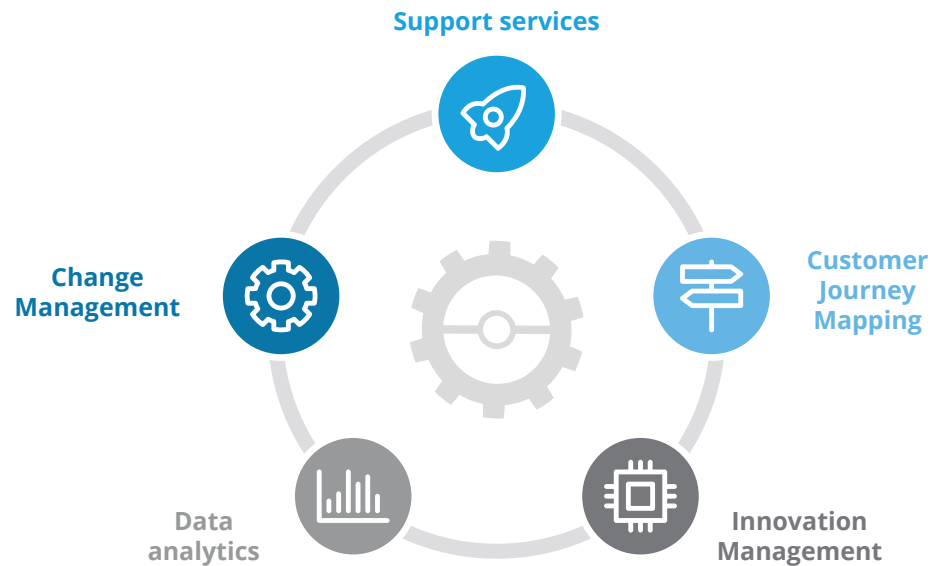
- **Digital leadership to build and support the business vision and strategy.**

Leadership is in fact more important than ever in times of change, but leadership styles may change to reflect the more collaborative nature of the digital workplace. There is no fixed definition of strong digital leadership in the digital world, but a few key leadership principles still remain critical to success:

- A. Set a vision. Above everything else, the leader must set a vision for the organization's digital future, be able to translate the strategic course of actions to the wider organization and get the buy-in
- B. Empower, don't dictate. The leader's role is to give the individuals and teams the ability, resources and freedom to accomplish a goal efficiently and accountably. Leaders must keep their teams focused on the outcomes, support and reinforce their people in taking ownership and be a role model that focuses attention on the business strategy
- C. Develop the "network of teams." The digital leader quickly develops a network within and beyond this area of expertise, successfully operating across silos and within functional teams
- D. Be smart and mobile. The digital leader is hyper-connected and always "on the go," ready to grasp any opportunities on the market. A digitally savvy professional capitalizes on opportunities new technologies bring to the business as well as to the team
- E. Provide real-time interactive feedback and use social and mobile platforms to engage with the team
- F. Foster a culture of knowledge and content e-sharing and role model values such as integrity, openness and transparency
- G. Drive decision-making based on analytics
- H. Supports team diversity to achieve the optimum balance between deep functional expertise and generalized skills to create a flexible, dynamic and highly effective team.

- **Change management to support the embedding of a culture of innovation, adaptability and entrepreneurship.**

Most organizations and business processes are not built for rapid change; rather, they are designed for consistency and efficiency. However, faced with a continuous change in relation to customer experiences and needs, organizations, processes, products and services must constantly evolve and adapt. Changing the mindset at the organizational level and foster a culture of change, innovation and entrepreneurship represents an imperative and a challenge at the same time.



- **Customer journey mapping to identify the pain points in the customer journey and improve customer satisfaction.**

Some organizations are redesigning the entire organization around the customer life cycle, while others empower their customer journey owners to create an enhanced customer experience. Whichever model they choose, organizations need to be digital customer savvy to be able to map the experiences within their customers' ecosystem of value and translate them into the right products and services to enhance their digital experience.

- **Innovation management** to enable a shift in thinking about and applying technology to create new sources of customer value. Digital businesses connect customers and employees to support "co-creation" of their products and services and ensure that they are properly tailored to meet customers' needs. Companies such as Procter & Gamble (P&G) use digital virtualization to test product packaging and shelf layouts with real customers in virtual stores before embarking upon the production phase.⁷

- **Data analytics** to help turn data into insight and improve customer experience to drive new sources of revenue. ➔



Key principles to effective digital governance

Siloed, rigid and random are just three characteristics of the ineffective governance processes of many organizations today, ultimately leading to an ineffective customer experience. As organizations move to more mature digital strategies, they will also need to shift their governance accordingly to ensure agility as they execute their strategies and provide effective and efficient responses to the needs of their customers.

3. DELIVER the digital transformation

Embed change management practices in the organization to enhance digital experience delivery

The digital age is characterized by constant change; no digital experience project is

completely finished and organizations are continuously challenged to adapt to new market dynamics and the needs of digital customers. In this ecosystem, change management is the key to helping your organization keep pace with the times.

Agile organizations develop practices to deal with change events impacting their businesses such as price wars or mergers. They must be able to rapidly identify challenges and opportunities, define an approach/response to deal with the issues, allocate resources, execute successfully and encourage positive behaviors and attitudes across the board. And they must handle all these changes as a routine without major disruption to the business.¹¹

The change management structured approach includes several key phases and key actions to be taken to enable

change management capability to be embedded at the organizational level and ensure a successful delivery of the digital transformation:¹²

- Creating a climate for change
- Engaging and enabling the organization
- Implementing and sustaining change ➔

Key principles to effective digital experience

Define your governance playbook, to help you define, prioritize and deliver customer experiences and enable your firm's digital experience success



Use governance to bridge digital experience strategy and delivery, either by creating unified governance bodies or by including digital in the existing committee meetings across the business



Focus on the business, not on controlling actions—set cross-functional objectives and metrics, and design clientcentric processes



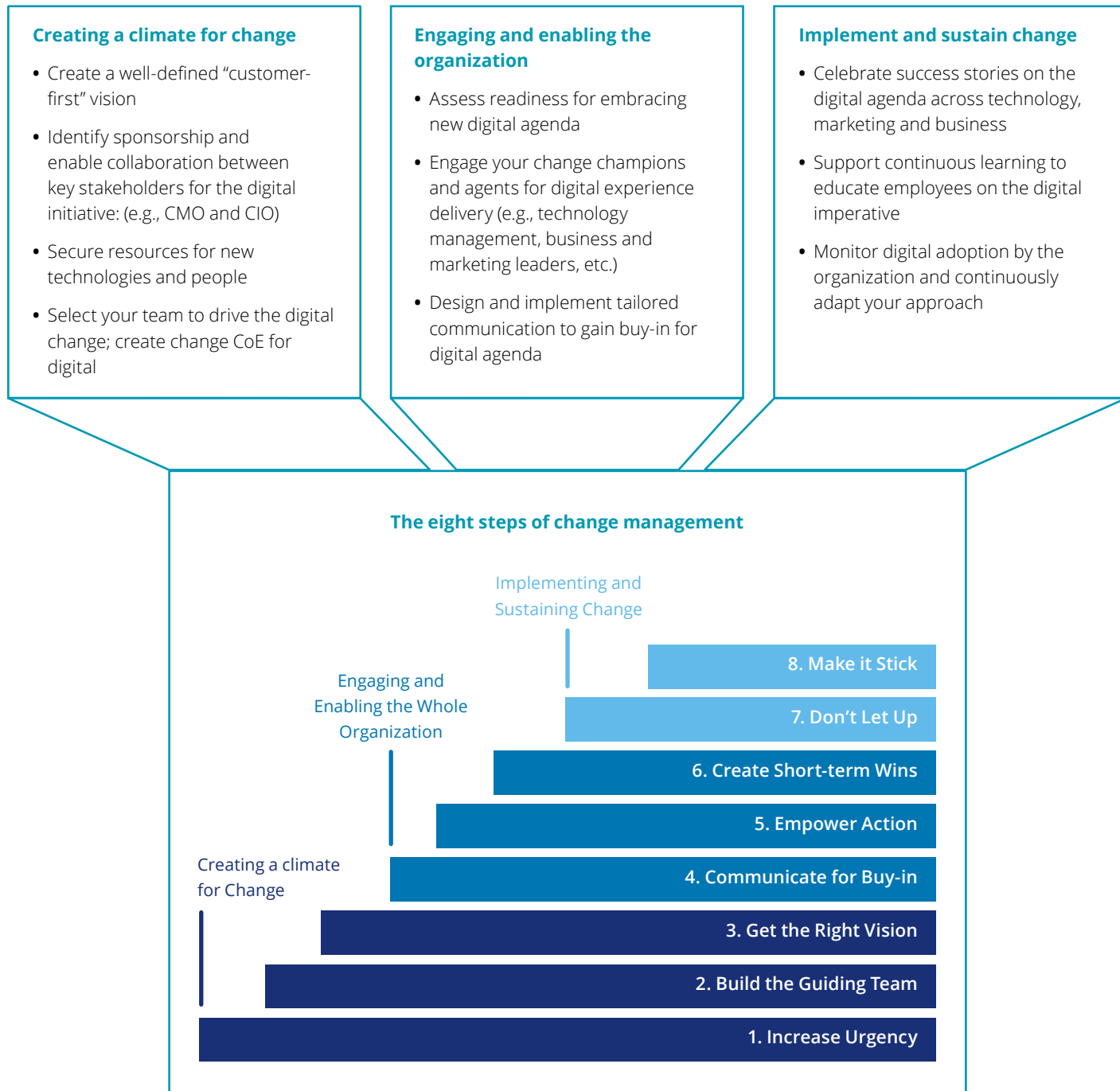
Develop an appetite for risk to enable innovation and drive customer experience excellence



Including digital agency partners (through transparency, integrated teams, PMO) is critical to maintaining digital experience delivery and enhancing the customer experience



Change Management — Key steps and actions



Source: Forrester, Implement essential change management practices to improve experience delivery, 2015

Conclusion

"The machine does not isolate man from the great problems of nature but plunges him more deeply into them."

Antoine de Saint-Exupéry

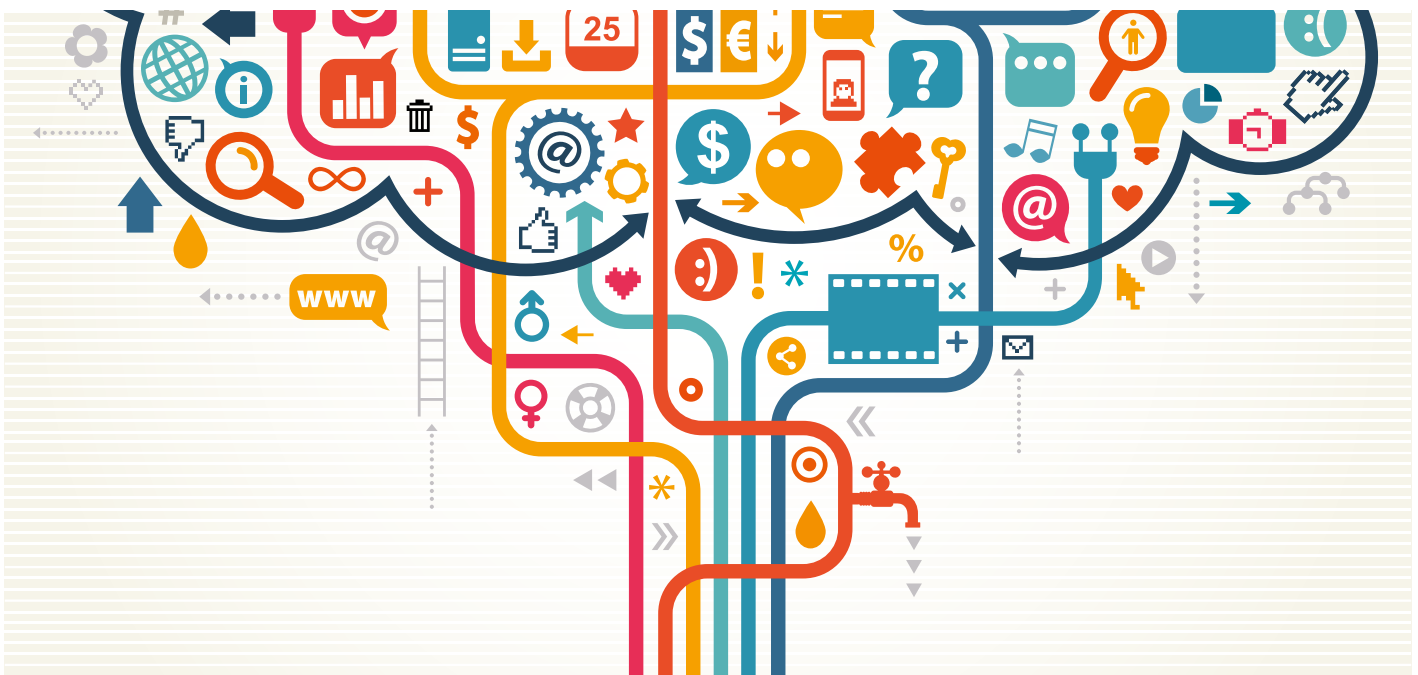
How many times have we heard about significant IT investments made in organizations to achieve a particular business objective and that “it didn’t work”? How many times do we

remember ourselves coming into the office one day to discover that we “were blessed” with a newly implemented system whose only aim was to “make our life easier” and which, in fact, just made things more complicated?

Undeniably complex, the ability to digitally reinvent a business goes beyond designing and implementing technologies, systems, social networks, tablets, etc. Instead, the focus is how we constantly evolve our organizations, how we develop our capabilities and our people, and how we prepare ourselves for and eventually change our ways of

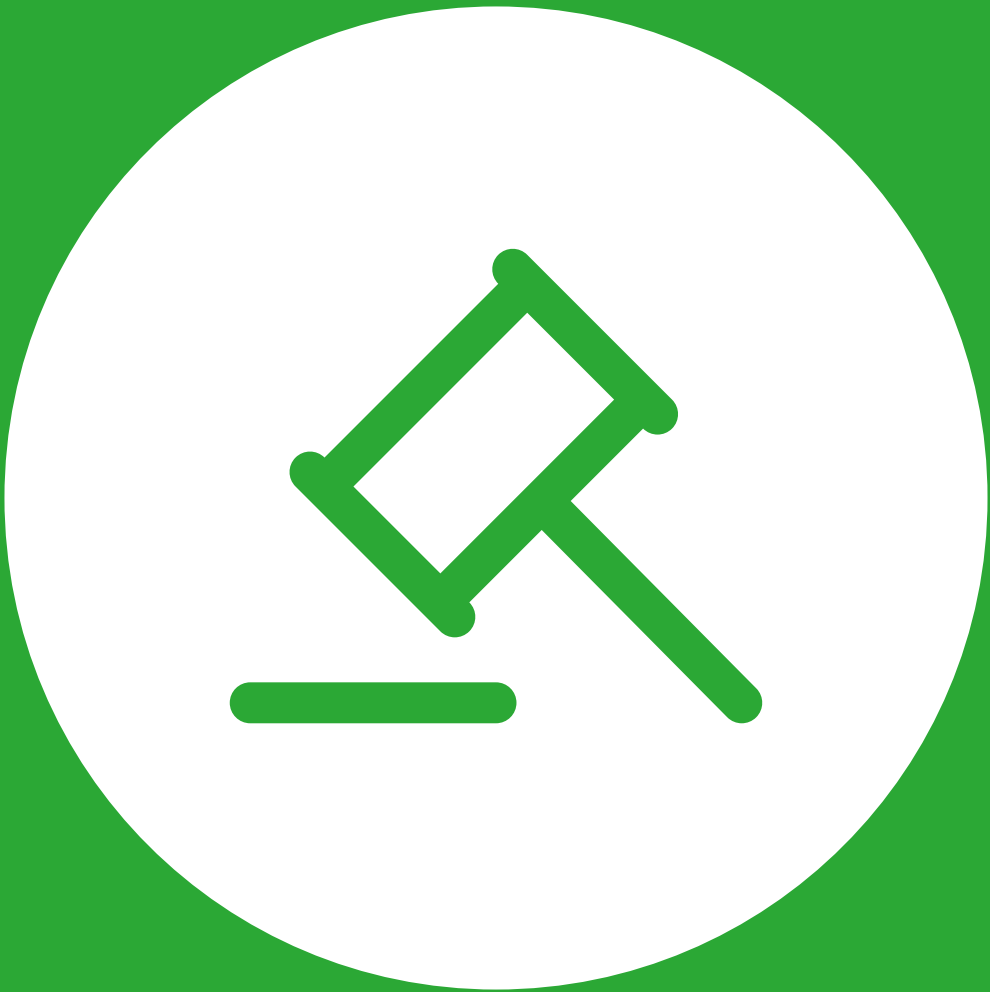
working to deliver a consistent customer experience across these touchpoints in a digitally driven world.

To achieve that, business leaders need a holistic new approach that integrates technology and people into a new organizational digital ecosystem and contributes to the creation of sustainable new ways of working that ultimately contribute to enhancing the business output.



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Part 02

From a regulatory
perspective ➤

Don't delay the MiFID II implementation phase

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On 10 February 2016, the College of Commissioners officially announced its final position concerning the delayed entry into force of the revised Markets in Financial Instrument Directive ("MiFID II/MiFIR"). As anticipated, the one-year delay will apply to the package in full, leaving a more realistic timeline to *"take account of the exceptional technical implementation challenges faced by regulators and market participants"* as stated by the European Commission.

In the course of April 2016, the European Commission has adopted the MiFID II Delegated Directive covering investor protection, and the MiFID II Delegated Regulation covering organisational requirements and operating conditions for investment firms. Generally, the published delegated acts confirmed the high regulatory maturity of several subjects but we are still waiting for the totality of level 2 measures and potential further clarifications. The Commission has notably taken its final position on some critical topics as costs & charges, target market definition and the independent advisory model. Therefore, given the regulatory maturity of most subjects, it is already possible to start the implementation process.

On that basis, we believe that the one-year delay should not lead investment firms to delay the MiFID II implementation project:

- For those which have already initiated the project, maintaining their momentum will allow them to leverage the project team and knowledge already acquired while planning the important IT developments over two years instead of one
- Additionally, delaying implementation would leave more time to take strategic decisions (instead of the tactical ones already undertaken to be compliant in a shorter timeframe). Such strategic decisions would likely imply an additional implementation workload. It is thus important to appropriately balance effort between long-term strategic analyses and the time required to take decisions vs. short-term tactical and mandatory implementation.

For CEOs: shining a spotlight on two key questions to address MiFID II challenges.

As part of their continuous efforts to increase investor protection and make financial markets more efficient, transparent and resilient, regulators have introduced measures that are likely to reshape the financial landscape. From the standpoint of a CEO in the banking industry, we want to address two key questions that need to be answered.



What products and services?

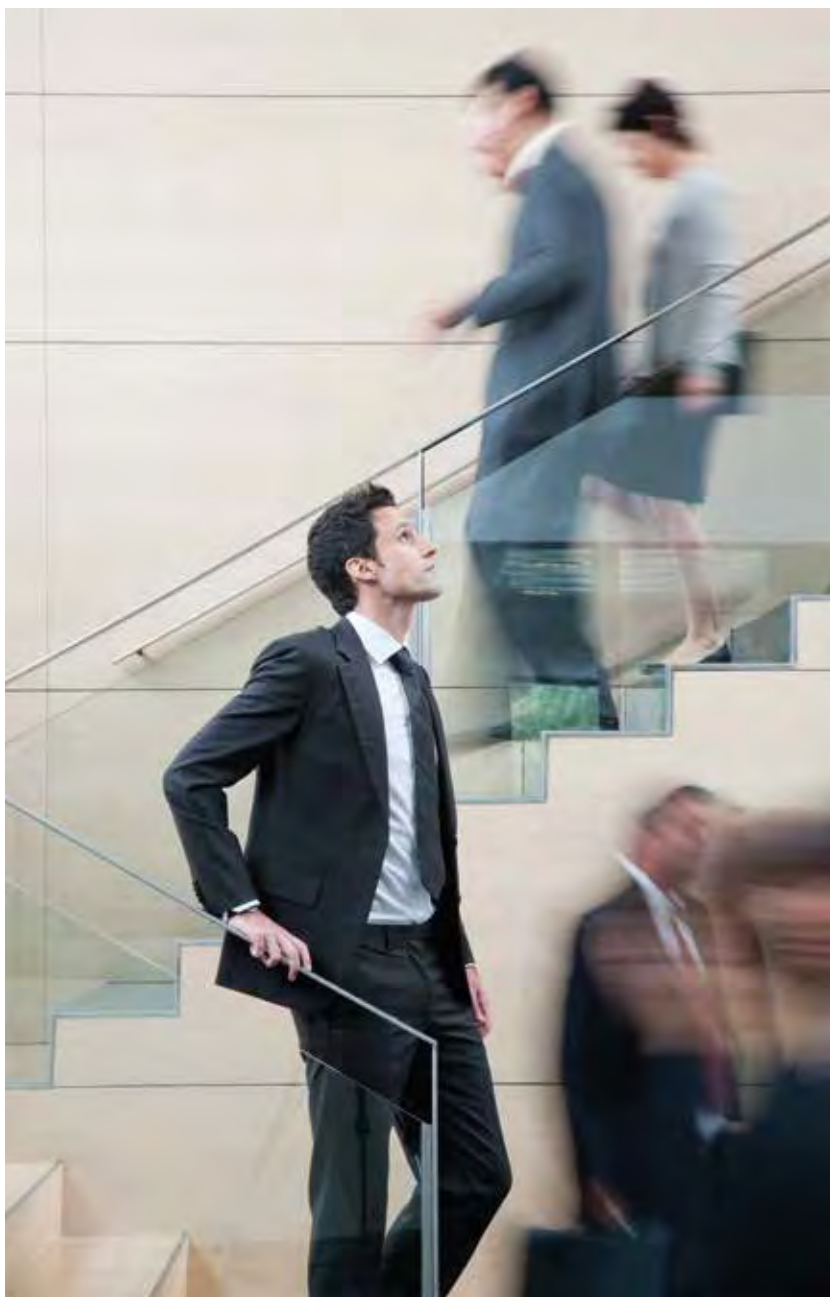
MiFID II introduces the obligation for investment advisors to categorize the investment advice delivered to their clients as either “independent” or “non-independent.” This leads to important strategic considerations: which advisory model should be chosen and what drivers should support this decision?

Firms wishing to provide independent advice will be required to set-up a selection process to assess and compare a sufficient range of financial instruments available on the market. With regard to in-house products, their amount should be proportionate to the total amount of product considered in the assessment. Therefore, the availability of in-house products represents a key criterion for the selection of the advisory model and could potentially lead to a decrease in current open architecture offerings.

Another major element to be considered is introduced by Article 24 of the MiFID directive: the future ban on perceived inducements for both independent advisory and discretionary portfolio management services. Inducements will be tolerated for non-independent advisory services if the remuneration flows are clearly disclosed to investors and the advisor’s offering enhances the quality of the service delivered to clients. As retrocessions may represent a significant part of firms’ revenues, completely removing them from business models could adversely affect the firm’s financial situation or at least reduce its profits.

Whereas an independent advisory model was almost inconceivable a few months ago, we see a growing number of actors reconsidering the opportunity to propose both services through hybrid offerings. In fact, such a “double-hatted” offering would allow firms to not restrict their horizon in term of market segment and potential

business development. However, from an operational perspective, structuring such an offer may not be easy as independent and non-independent advisory services must be performed by two different teams and be clearly traceable in IT systems. A hybrid model would also raise additional strategic concerns regarding the range of application of this duality and how to segment models between different group entities: should entities develop both independent and non-independent services or specialize their offering based on a single advisory model? What rationales should be considered for the offering: client segment, local market, in-house products? This raises the question on the branding and marketing of each investment firm: how will clients react to a non-independent or hybrid model? ➤



Which clients and relating distribution strategy?

Depending on the type of client serviced and the type of service provided, the distribution strategy could be adapted. For instance, it is likely that retail clients will not be willing to pay for an advisory service. Following this, maximizing automation of distribution processes in order to reduce the costs could be considered. As such, we could see a trend towards the use of robo-advisors for retail or mass-affluent clients.

Similarly, in the investment funds industry, we might observe an increasing number of fund distribution platforms (e.g., as observed with the enforcement of Retail Distribution Review in the UK) which target end-customers directly, bypassing the current distributors' network.

Generally speaking, investment firms will need to make sure that their distribution partners (e.g., private banks, IFAs, family offices, "apporteurs d'affaires," etc.) will still bring in business without inducement incentives. In other words, a strong partnership is needed between product manufacturers and distributors so as to efficiently address the challenges linked to the ban on inducements.

The pricing strategy between manufacturers and distributors, and also with the end client, will need to be carefully reviewed to reflect the business model evolution and avoid disruptions in ongoing business as well as a cannibalization effect induced by the proliferation of services.

Finally, MiFID II provisions relating to third country regimes could also raise questions as to the way in which non-EU entities will serve EU clients. Will non-EU entities be allowed to continue servicing EU clients in a proactive way (i.e., reverse solicitation)? If so, should they apply for a third country passport? Should they set up a branch?

For international companies, the third country regime might call into question the approach undertaken regarding the domicile of clients (EU vs. non-EU) serviced by non-EU entities, which might have some significant P&L consequences at local level.

Concerns for the COO: key objectives to achieve operational and organizational efficiency

Besides all strategic decisions to be taken, MiFID II requirements imply significant operational and documentation/contractual changes, as well as organizational adjustments.

Firstly, databases will need to be enriched. The quality and exhaustiveness of data will be even more crucial:

- The product databases will need to store information such as costs and charges, target market definition, product complexity and product performance-related information.
- The client databases will need to be enriched with KYC information such as the client's ability to bear losses, sensitivity to risk, etc.

onboarding packs, and product marketing materials is expected to require a significant amount of time.

It is also to be noted that there are overlaps between MiFID II provisions and other regulations such as the EU Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs) and the Insurance Distribution Directive

- Setting up internal hubs such as client data maintenance, product maintenance and governance, etc.
- Outsourcing activities to specialized actors and/or to offshore low-cost centers

From an organizational standpoint:

- Appropriate trainings will need to be delivered to the staff with a focus on client-facing employees who are the most impacted by MiFID II
- Any organizational change will need to be supported by a proper change in management processes so as to ensure smooth transition toward future business models
- Finally, a number of internal policies (i.e., conflicts of interest, compliance, remuneration, etc.) will require adequate review and update.

MiFID II provisions relating to third country regimes could also raise questions as to the way in which non-EU entities will serve EU clients

- The transactions databases will need to include all data requested for MiFIR reporting and post-trade transparency requirements (e.g., price, size, timing and venue).

Then, additional important IT developments will need to be performed, covering core banking systems, but also front office, reporting, data warehouse, MIS and finance systems:

- Implementation of additional controls required as per MiFID II: suitability and appropriateness tests being the most important
- Implementation of additional reports: transaction reporting, 10 percent depreciation of portfolio overall value from the beginning of reporting period, top five execution venues, pre- and post-trade transparency obligations, etc.
- Implementation of information monitoring process regarding instrument database for complex vs. non-complex products, target markets, risk level, etc.

Finally, the review of contracts with distributors, documents within client

(IDD). In that respect, it is critical to avoid duplicating the implementation workload that could be incurred by managing each project on a stand-alone basis. The same applies in investment firms with operations in Switzerland: a possible overlap with the LsFIN should be taken into account in the MiFID II programs.

Not only does the COO have to ensure that the project will be run efficiently, but he/she also has to make sure that post-implementation running costs will remain reasonable. Indeed, the incremental workload needed to perform the maintenance of databases and controls and the production of reports will generate additional costs that may negatively impact the profitability of the business.

In that respect, investment firms have started to investigate opportunities to reduce operational costs by:

- Launching efficiency projects such as increased process automation to minimize manual processing (e.g., robo-process automation)
- Setting up internal shared service centers between market participants

Conclusion

MiFID II requires investment firms to take a number of strategic decisions with regards to their service offering and distribution strategy. However, such decisions should not prevent firms from starting the implementation project, which will require significant effort. Firstly, to identify the gaps and design an efficient remediation plan, but also to implement the changes (in terms of the organization, operations and processes, documentation and IT) in a timely and efficient way. ●

“The early bird catches the worm”: anticipating the challenges and opportunities of PSD2

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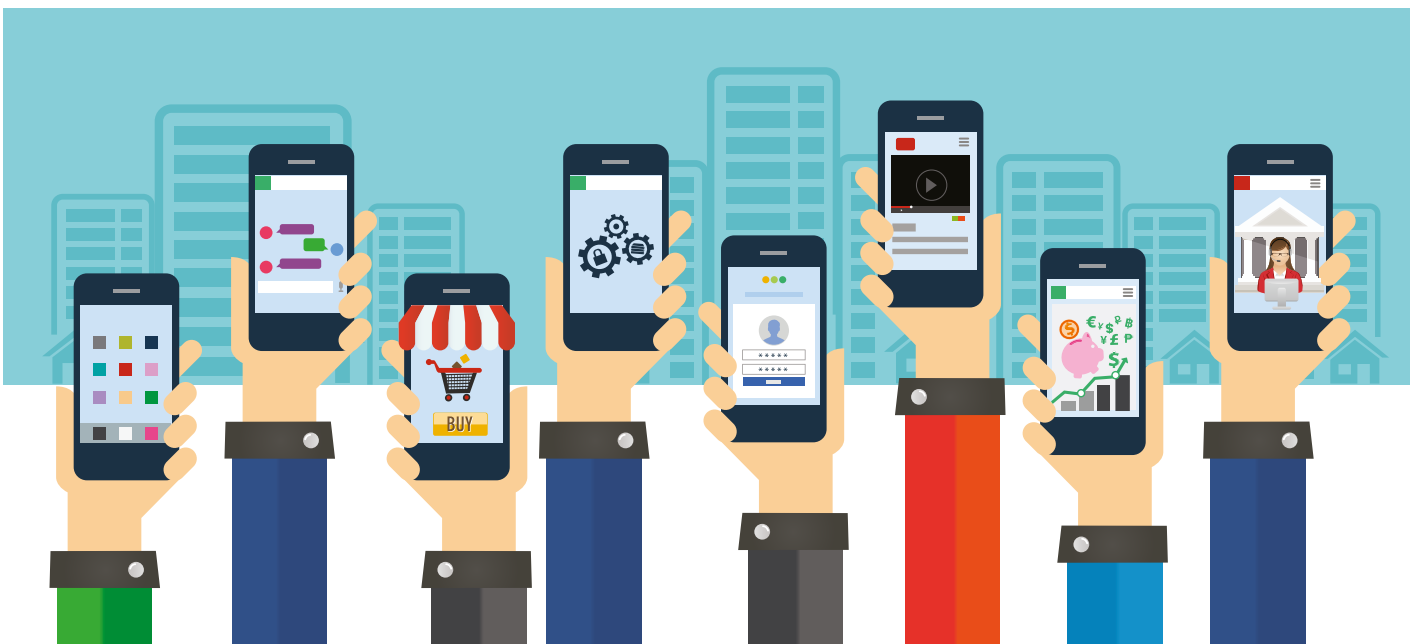
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The EU has taken an important step toward integrating the payments market. Broadening its regulatory scope to include both traditional and emerging payment systems actors, the Revised Payment Services Directive (PSD2) creates a level playing field for all. This reflects recent developments in consumer spending trends, and provides affected stakeholders with a clear wake-up call. The payments market has shifted, consumers expect different services, and authorities are aligning their regulations accordingly. The text of the Directive creates both significant challenges and a wealth of opportunities—and it is not advisable to turn a blind eye to either. Understanding changes and reacting early will be key to yielding the best results.



The changing relationship between consumers and payments

Now more than ever, consumers are dictating how operations should be run in a wide range of sectors, and the payments market is an excellent example of this. Reflecting the significant development of e-commerce and the deeper penetration of mobile devices in consumers' daily routines, the payments market has evolved into a space where payments can be executed without having to go through a bank. Instead, payers can pay directly via the merchant's platform using their smartphones, with transparent and easy access to their own finances. These consumer habits are predominantly led by the so-called "Generation Y": the cohort of individuals who came of age at the turn of the 21st century. This is a much more technologically savvy age group, increasingly open to new payment and purchase structures.¹

This development has not gone unnoticed in the FinTech sector. We are seeing a clear increase in entities that either allow consumers to view their entire financial situation or to initiate payments themselves in an extremely user-friendly, personalized and real-time way. These consumer habits, coupled with emerging FinTech technology, represent the drivers of today's era of innovation. In order to reap the greatest benefits, efforts should be made to ensure that the entire payments market works at its optimal level for all stakeholders—consumers, merchants and Payment Services Providers (PSPs).

In the context of a disrupted payments market and different consumer expectations, the EU has designed a new directive to regulate the actions of all active members of the payments value chain. Stakeholders are now finding themselves at an important stage in the evolution of the payments system, where inaction is not an option. Instead, it is essential that they recognize the most relevant challenges and opportunities, and react accordingly.

The EU aligns regulations to the changing landscape: PSD2

The EU plays an important role in designing regulations that are optimally tailored to changing payment trends. The payments market has been regulated since 2007 by the Payment Services Directive (PSD), which was formally replaced in December 2015 by PSD2.² This represents the EU's effort to align its regulatory framework with the reality of consumers' needs, habits and preferences as well as the rapidly evolving technologies involved.

PSD2 brings changes in four main areas:

- range of transactions
- scope of stakeholders
- liability
- access to information and security

As a whole, its provisions are designed to increase competition, and push for payments that are more innovative, efficient, swift and secure for consumers.

In light of the growth in cross-border transactions, and the fact that they often entail higher costs and longer processing times,³ the Directive extends the EU's regulatory scope to transactions in any currency where only one of the PSPs at either end is within the EU ("one-leg-out transactions"). PSD2 also creates a new category of PSP, Third-Party Service Providers (TPSPs), which includes Account Information Service Providers (AISPs) and Payment Information Service Providers (PISPs). The former offer a complete view of the payer's accounts across all relevant financial institutions, while the latter act as a bridge between the payer's and the payee's banking platforms. These players introduce significant benefits for payment users, including both consumers and merchants. On the one hand, TPSPs represent a tool for consumers and merchants to always have a full overview of their accounts, without accessing each banking platform separately. This is a significant enabler for informed payment and purchasing choices. On the other hand, payers and payees are in direct contact with each other, without having to go through their respective banking

platforms. To top it all off, all services are available virtually, without requiring payers to move any further than their mobile device (usually a mobile phone or tablet). Together, they provide consumers with a significantly improved payment and purchasing experience. In order for TPSPs to operate, banks are required to fulfil account information and payment initiation requests by providing TPSPs with the necessary information via Application Programming Interfaces (APIs)—where authorized by the payer.

Indeed, it is clear that the payer receives the most attention in the Directive: payers are provided with increased protection in case of incorrectly executed payments; payments always have to be processed on the basis of "strong customer authentication"; and any information on the payer exchanged via APIs cannot be retained beyond the purpose of completing the payment. ➤


We are seeing a clear increase in entities that either allow consumers to view their entire financial situation or to initiate payments themselves in an extremely user-friendly, personalized and real-time way.

1. Suren Ramasubbu, The Huffington Post, July 2015

2. Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC

3. European Central Bank, September 2010 and 1999

Table 1—The main PSD2 provisions by area

 <p>Range of transactions</p>	<ul style="list-style-type: none"> • In terms of transparency and information provisions, regulated transactions also include those in any currency where only one of the PSPs is within the EU (“one leg-out transactions”) • These provisions apply to those parts of the payment chain that are carried out within the EU
 <p>Scope of stakeholders</p>	<ul style="list-style-type: none"> • New category of PSP: TPSPs, including AISP and PISP • They both have to register as payment institutions with the local regulator • Banks have to provide AISP and PISP with access to information on the payer’s account whenever prompted to do so by a request supported by permission from payers themselves • The connection between banks and TPSPs is established via APIs
 <p>Liability</p>	<ul style="list-style-type: none"> • PSPs become fully responsible for proving that payments were (or were not) correctly executed • PSPs are required to cover the ensuing reimbursement of the payment account, as well as any related fees, charges or interest that the payer may incur • Payers are only fully liable if their behavior was fraudulent or grossly negligent • Except for these cases, the highest fee a payer can be liable for is reduced from €150 to €50 • PSPs should be protected against any liability with regard to the relevant bank and PSU. Both AISP and PISP are required to hold professional indemnity insurance that covers all territories in which they operate account information and payment initiation services
 <p>Access to information and security</p>	<ul style="list-style-type: none"> • TPSPs may only access and use information on payers and their accounts for the purposes of processing the payment. Information cannot be stored, and any personalized security credentials should always be communicated among PSPs securely • PSPs must implement strong customer authentication in order to validate the identity of the payer, i.e., the use of at least two of three independent features including “knowledge”, “possession” and “inherence” • PSPs must implement an incident reporting structure in case of major operational and security incidents • PSPs are required to implement an appropriate risk and control management framework, performing a comprehensive assessment of the operational and security risks, to be submitted to the relevant authority at least once per year

The impact on banks: key drivers for an amended business model

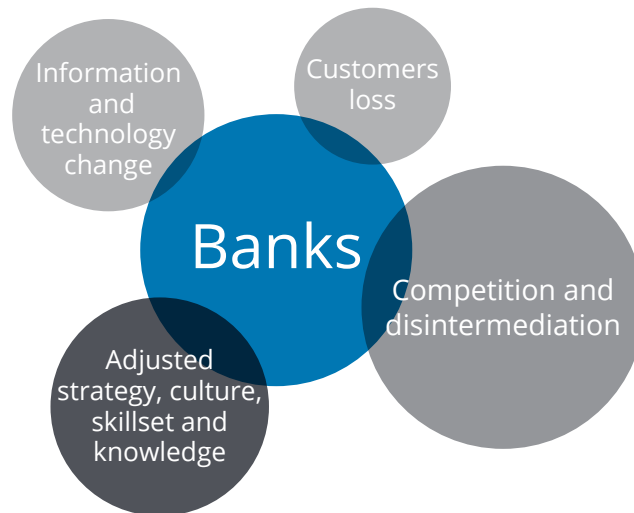
Challenges: once each Member State has transposed the Directive into national legislation, banks will have to comply with significant information and technology requirements—specifically with regard to setting up APIs and ensuring strong customer authentication. These obligations are at odds with the kind of infrastructure that most banks have inherited from the pre-digital era. For many, complying with PSD2 will require significant costs in relation to implementing the new IT structures. However, the severity of this may vary depending on whether a bank is already at an advanced stage with regard to strong customer authentication; such players will only need to implement an open API.

This IT cost could affect the operative costs related to the bank's payment activity, resulting in a loss of the direct relationship with those consumers and merchants, who will instead opt for TPSPs to initiate payments and gather information on their accounts. This growing preference for disintermediated/virtual payments is fueled by banks' inability to provide a customer experience that is as user-friendly and real-time as those offered by TPSPs. The personal, mobile, and swift nature of TPSP services is in conflict with how banks traditionally operate—i.e., one-size-fits-all products distributed on the basis of physical presence.

In complying with PSD2 requirements, banks will not only have to implement changes to IT infrastructure, but also—and just as importantly—ensure that their strategy, culture, skillset, and regulatory knowledge is properly aligned. This is particularly important given that banks will now be officially competing with other stakeholders on the same playing field, and these stakeholders are much more technologically advanced and aligned with consumer needs.

In general, banks are hindered by the lack of a clear and complete overview of national legislation. Indeed, several

Figure 1—Impact on banks: challenges



PSD2 requirements have to be read in conjunction with specific rules by the European Banking Authority (EBA), which is in charge of establishing Regulatory Technical Standards (RTS) for strong customer authentication, secure communication, cooperation and exchange of information for passporting, as well as Guidelines on implementing the appropriate risk and control management framework. This is an important issue because the RTS and Guidelines will not be published until January and July 2017 respectively, and only from then onwards will it be possible to fully understand the regulatory requirements in their entirety.

Opportunities: each challenge that banks face comes with an associated opportunity that, if leveraged in a timely manner, will ensure that “the early bird catches the worm.”

Banks will have to set up APIs for information to be available to AISP and PISP. Banks should consider developing APIs by differentiating between those services and functions that fulfil the basic requirements of PSD2, and those that go further—and which can be capitalized upon. Banks could offer these other services at a cost and based on a contract to be agreed between the bank and the

TPSP. This could compensate for the cost of the IT infrastructure change, and also become a source of profit. It should be noted that any such strategy would be dependent on the RTS that the EBA is scheduled to publish by the start of 2017: it is indeed possible that API requirements will only include the basic provisions and that no other developments will be allowed beyond basic compliance.

When considering the trend of consumers shifting from traditional payments through banks to the disintermediation offered by TPSPs, banks should account for the advantage they still hold and are not likely to dramatically and completely lose to TPSPs: banks are endowed with far stronger brands, they still have a far broader customer audience, and they benefit from a wealth of big data on their customers. This does not mean that banks should be content to stick with the status quo. On the contrary, the best way for banks to benefit is to ensure that they are not buried under an outdated infrastructure, and concerted efforts should be made to adapt to the market's needs and expectations, taking this opportunity to design and implement simplification and optimization strategies. ➤

Figure 2—Impact on banks: opportunities

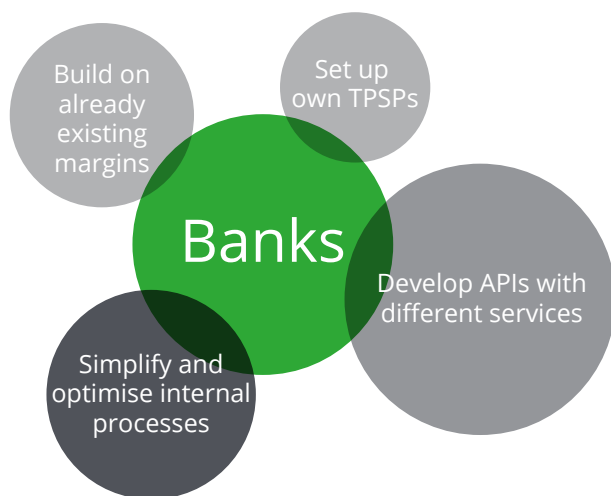


Figure 3—Impact on TPSPs: opportunities



It is important for banks to act on this opportunity now, while they are waiting for national regulators to implement PSD2. It is a precious two-year buffer zone, during which banks should prioritize designing and integrating strategies to secure their customer audience. By refining the services on offer and their operational and IT infrastructure, they can protect or even increase their share of customers before TPSPs get there first. Improvements could include, but are not limited to, the areas of big data, analytics and cross-border transactions.

Finally, while it is true that a growing number of TPSPs are increasing the level of competition, this does not rule out the possibility for banks to set up their own TPSPs.⁴ Under PSD2, banks are indeed eligible to provide account information and payment initiation services.⁵ Moreover, if banks recognize and properly invest in the opportunities that have already been identified (APIs with specific monetized services, existing margins, and simplified and optimized infrastructure), the account information and payment initiation services offered by banks could become even more appealing to both consumers and merchants.

The impact on TPSPs: ensuring the golden era is sustainable

Opportunities: TPSPs and the FinTech sector in general appear as the obvious “winners” from PSD2. And with good reason. They are presented with fertile ground for the services they offer, particularly as consumers increasingly prefer to initiate payments through TPSPs rather than directly through their banks. It is easy to see why TPSPs could escalate their profits by expanding their customer base. Moreover, their very nature and business model ties them to certain specific activities (either account information or payment initiation), meaning that they can pick and choose the segments of the audience they want to target. Unlike banks, TPSPs do not have the burden of meeting all of the needs and expectations of the entire consumer and merchant audience.

On top of this, TPSPs can improve their services by refining and better-targeting them on the basis of the information that they compile every time a customer initiates a payment or requests to view their accounts online.⁶ As consumers remain in the driving seat setting the agenda for the payments market, TPSPs can focus on understanding how payment

initiation and information request trends are evolving, to better anticipate or adjust accordingly.

Equipped with these healthy and solid capabilities and facilitated by these unique conditions, TPSPs are clearly leading the innovation race, positioning themselves way ahead of banks.

Challenges: in order to safeguard their advanced position in the payments market, TPSPs do however still have to ensure that they recognize, react to, and mitigate some noteworthy challenges.

While it is true that consumer preferences are shifting, TPSPs are undeniably the new kids on the block compared to the well-established banks. Banks may have suffered a significant blow with regard to consumer trust during and after the financial crisis, but they do maintain excellently marketed brands as well as a significant history. This is ultimately reflected by their reach and, as already mentioned, banks still have the majority of what TPSPs must heavily invest in building: a customer audience. TPSPs will have to approach this by identifying the right segments to target (e.g., millennials, merchants). Indeed, the fact that they

⁴ Chris Skinner, The Finanser, November 2015

⁵ Annex 1, Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC

⁶ Finextra, February 2016

Figure 4—Impact on TPSPs: challenges

specialize in either account information or payment initiation services may play to their advantage (see above) as well as disadvantage, ruling out a lot of potential consumers who may have difficulties in understanding the services offered by these new entities.

The risk of not connecting with as many consumers as a bank already can comes in addition to the boundaries set by PSD2 regarding access to accounts. PSD2 in fact prohibits TPSPs from keeping information on the payer after the execution of the payment.⁷ Without added, comprehensive, and detailed information on consumers, TPSPs are unable to develop any further services that would allow them to target untapped consumer segments.

Access to accounts is just one example of the overarching challenges that PSD2 presents to TPSPs: while already active in the payments market, they have only just become regulated now. The regulatory burden will mean that they must cover certain aspects for the first time: these include having to register as a payment institution with the local regulator, setting up risk and control frameworks, complying with all relevant reporting obligations, and performing AML and KYC controls.

Consequently, TPSPs will have to engage a significant amount of resources and time in liaising with new stakeholders, as well as in learning about, applying and complying with the regulatory framework. This is a context that until now they did not need—or know how—to operate within.

Finally, when evaluating their competitive and advanced position, TPSPs should maintain a comprehensive overview of all players on the field. Indeed, while TPSPs seem at first glance to be competing with banks, they are also competing with each other. And the natural question arises: how many AISP and PISP are too many? Given that they already risk being left out of certain segments of the customer audience, they should certainly consider the possibility of the market becoming saturated with fellow TPSPs. In this regard, monitoring how PSD2 is transposed into national laws will be crucial, specifically in terms of the requirements for the relationship between payment stakeholders. Indeed, the more standardized and harmonized the relationships, the simpler it will become for TPSPs to learn how to position themselves with regard to banks, and the easier it will be for new TPSPs to enter the market.

Making the relationship work: coopetition

In conclusion, the entry into force of PSD2 offers important opportunities. On the one hand, banks need to consider how to design their business model around payments as well as how to structure their relationship with new entrants. On the other hand, TPSPs need to come to terms with the loss of their unsupervised and unregulated status.

While these impacts are specific to the type of stakeholder, they cannot be tackled solely from the comfort of one's sofa.

Indeed, there is no escaping the fact that since PSD2 was published in the Official Journal of the European Union in December 2015, banks and TPSPs are officially operating in the same room, under common regulatory requirements, and ultimately serving the same customers. In order to make the cohabitation as mutually beneficial as possible, coopetition will be key. That is, a strategy to secure market-share through interaction rather than struggle, and recognizing that, at the end of the day, it is not likely to be a “winner takes all” situation, as both stakeholders are needed for the healthy functioning of the emerging payments ecosystem. ●

⁷ Articles 66-67, “Directive (EU) 2015/2366 of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC”

"T2S will consolidate settlement—the most fundamental part of the securities infrastructure value chain—across all countries in Europe. It will be a state-of-the-art settlement engine offering centralized delivery-versus-payment (DvP) settlement in central bank money to the whole European market. It will be operated by the Eurosystem¹ on a cost-recovery basis, to the benefit of all users. T2S will be neutral in respect to all countries and market infrastructures and with respect to the business models adopted by all CSDs and market participants."

European Central Bank

"Central bank money is the technical term used to refer to money that can only be created by a central bank. Central bank money comprises the coins and banknotes that the central bank brings into circulation as well as the sight deposits held by third parties at the central bank. The sight deposits that commercial banks hold at the central bank are used for the settlement of payment transactions."

Deutsche Bundesbank



TARGET 2 Securities

Time to settle

Laurent Collet

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Christian Westerholt

Director
Strategy, Regulatory
& Corporate Finance
Deloitte

Mayank Dalmia

Analyst
Strategy, Regulatory
& Corporate Finance
Deloitte

T2S (TARGET 2 Securities) will connect participating national Central Securities Depositories (CSD) to allow seamless and uniform securities settlement in central bank money.

What it is

T2S offers many benefits to not only its direct participants, i.e., the CSDs, but also to all the clients making use of the respective CSDs. The system, which is based on central-bank-money payments, is safer and more independent than other systems as the Eurosystem is responsible for running it. Indeed, due to the composition of the Eurosystem, it is neutral with respect to all countries and stakeholders. Additionally, the running of the T2S system is not incentivized by economic motives. Rather, its goal is to create a pan-European settlement system that is comparable in its simplicity to a domestic system, in terms of cost, technical processing and efficiency.

Furthermore, the present market infrastructure is highly complicated, requiring the interaction of multiple CSDs with their own sets of rules, rates and *modus operandi*; T2S aims to untangle this web of complexity and establish a set of universal rules and methods to apply to T2S and therefore, all participating CSDs. Not only would this lead to a significantly simpler system, but it would also lower the costs of cross-border transactions and fees.

The Eurosystem is a capable, trustworthy and proven manager of T2S as it has vast experience of successfully designing and implementing pan-European financial infrastructure and institutions. Moreover,

central bank money does not carry the same level of default risk as commercial bank money.

It is also worth noting that the T2S platform is solely a settlement platform that deals with the respective CSDs of participating nations. Hence, the CSDs remain responsible for any legal liabilities in dealing with their clients as well as services or management of client accounts, including custody, asset servicing, corporate action processing and reporting. ➔

1. The Eurosystem consists of the European Central Bank and the central banks of the member states within the Eurozone.

T2S 19 Principles

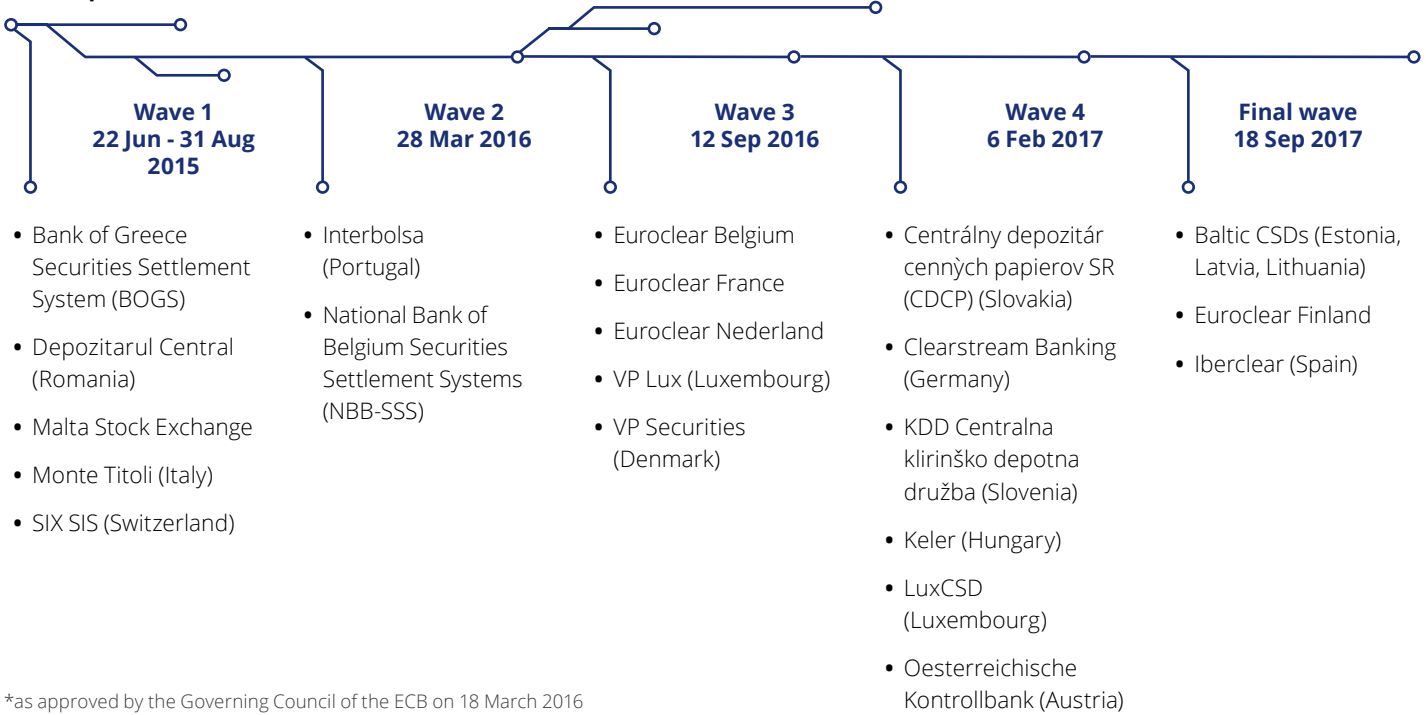
The concept of T2S is based on 19 General Principles formulated in conjunction with the market and designed to ensure the resilience, integrity and neutrality of the Eurosystem's settlement platform.

01. The Eurosystem shall take on the responsibility of developing and operating T2S by assuming full ownership
02. T2S shall be based on the TARGET2 platform and hence provide the same levels of availability, resilience, recovery time and security as TARGET2
03. T2S shall not involve the setting-up and operation of a CSD, but instead serve only as a technical solution for providing settlement services to CSDs
04. T2S shall support the participating CSDs in complying with oversight, regulatory and supervisory requirements
05. Each CSD's client securities accounts shall remain legally attributed to the CSD in question and each central bank's client cash accounts shall remain legally attributed to the central bank in question.
06. The T2S settlement service allows CSDs to offer their customers at least the same level of settlement functionality and coverage of assets in a harmonized way
07. Securities account balances shall only be changed in T2S
08. T2S shall settle exclusively in central bank money
09. The primary objective of T2S is to provide efficient settlement services in euro
10. T2S shall be technically capable of settling currencies other than the euro
11. T2S shall allow users to have direct connectivity
12. CSDs' participation in T2S shall not be mandatory
13. All CSDs settling in central bank money and fulfilling the access criteria shall be eligible to participate in T2S
14. All CSDs participating in T2S shall have equal access conditions
15. All CSDs participating in T2S shall do so under a harmonized contractual arrangement
16. All CSDs participating in T2S shall have a calendar of business days with harmonized opening and closing times for settlement
17. T2S settlement rules and procedures shall be common to all participating CSDs
18. T2S shall operate on a full cost-recovery and not-for-profit basis
19. T2S services shall be compatible with the principles of the European Code of Conduct for Clearing and Settlement

Source: European Central Bank

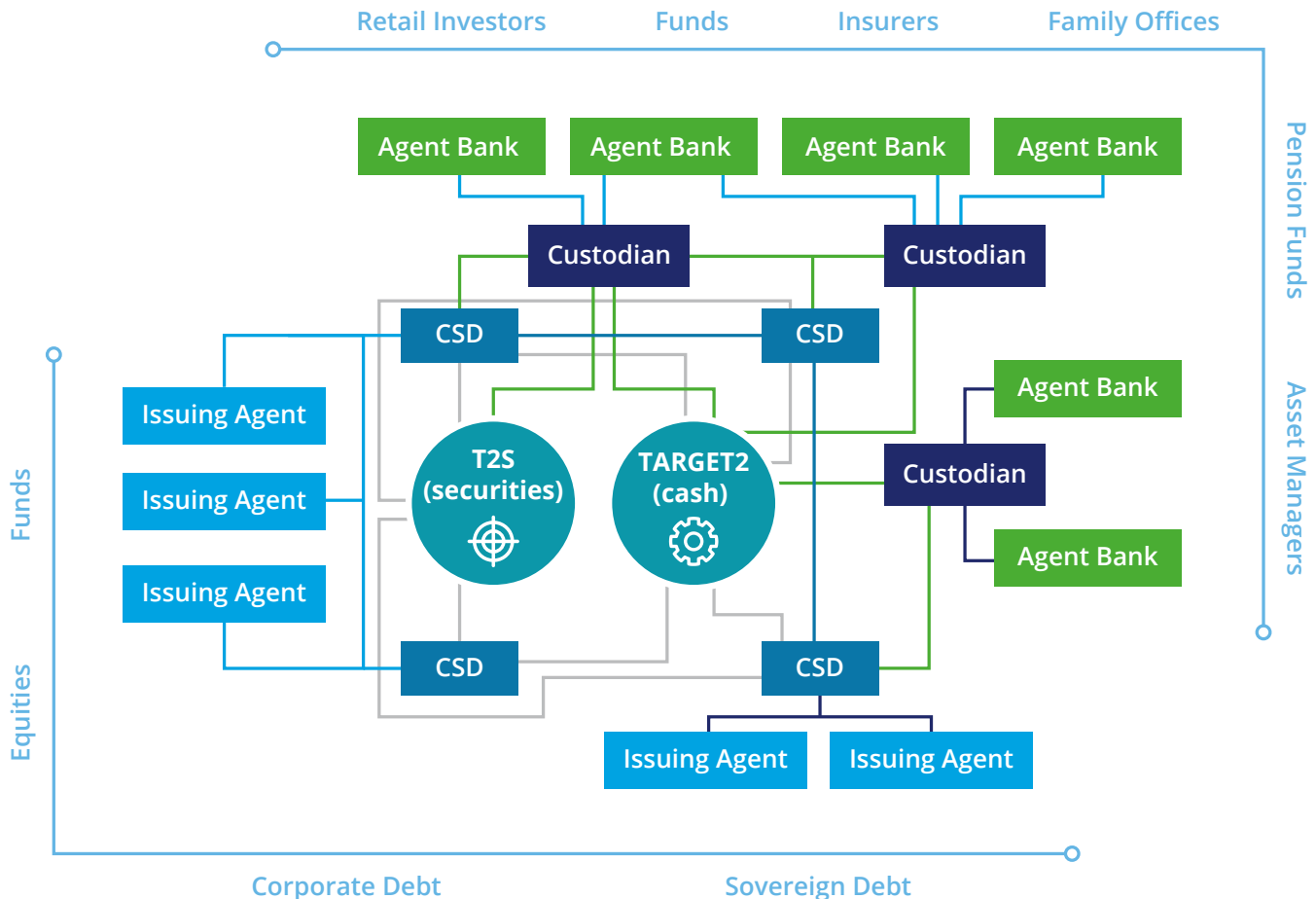
The Eurosystem is a capable, trustworthy and proven manager of T2S as it has vast experience of successfully designing and implementing pan-European financial infrastructure and institutions.

T2S Implementation*



How it works

Market players impacted by T2S





Roles of the players and interactions with T2S

T2S will be at the center of all settlement processing across Europe, working directly or indirectly with all market players. T2S operates via a platform known as the integrated model, which allows both cash accounts and securities accounts to be on the same platform. Thus, there will only be one interface between the CSDs and T2S.

This interface will connect participating CSDs to both the T2S settlement system for securities (T2S) and to the TARGET 2 System for cash (TARGET 2). Custodians are connected to the CSD of their choice ("investor CSD") and any participant may choose to connect to more than one CSD.

Custodians and participants must also maintain a connection to the TARGET 2 system through a central bank of their choice. As clients of the custodians, the agent banks hold their securities and cash accounts with their chosen provider.

The issuers select a CSD to issue their instruments to the market ("issuer CSD"). The issuers, when they issue several different instruments, may select different issuer CSDs for different instruments. Investor CSDs hold accounts in one or more issuer CSDs so that they can offer instruments for which they are not the issuer Investor themselves.

Key characteristics

T2S will be a state-of-the-art settlement engine with sophisticated technological features:

- Advanced optimization algorithms to enhance settlement efficiency
- Autocollateralization mechanisms leading to considerable liquidity savings
- A variety of liquidity management services through dedicated cash accounts
- Direct network connection to the platform for banks with large settlement volumes

Other note-worthy features of T2S are the following:

- T2S imposes a uniform set of rules across all markets, which will affect custodians/ CSD participants as well as clients of custodians
- The CSDs are obliged to comply with stringent operating rules and a connection to TARGET2 for settlement in central bank money is compulsory
- T2S creates a level playing field, ensuring that all CSDs compete with one another
- Custodians are now able to select a single CSD for all markets
- Custodians and other CSD participants must maintain a connection to the payment system in central bank money. They will be obliged to provide central bank money for clients that are only using commercial money at present

2. Investor CSD: An investor CSD opens an account in another CSD (the issuer CSD) so as to enable the cross-system settlement of securities transactions
3. Issuer CSD: A central securities depository (CSD) in which securities are issued (or immobilized). The issuer CSD opens accounts allowing investors (in a direct holding system) and/or intermediaries (including investor CSDs) to hold these securities

Impact on the wider market

Until now, the focus has been on system development, implementation and testing between the participating CSDs and the T2S platform. The participating CSDs have reached out to their clients to inform them about changes to interfaces and processes so that they are adequately prepared.

Now that T2S has become a reality and the wider European markets will migrate in 2016/2017, it is the right time for other market participants to assess the impact T2S will have on them.

While T2S will facilitate a more streamlined and efficient settlement system, there will also be a number of new system and processing requirements that will need to be carefully managed. On the one hand, T2S will create new opportunities, but on the other hand, there is a considerable risk of it threatening existing business. This impact is multi-faceted and driven by a number of factors.

New competition landscape

Custodians will be able to offer securities settlement services for all participating markets by using a single "investor CSD." Custodians will select one or more investor CSDs, a decision largely dependent on the level of services offered by the CSD in question.

This will result in agent banks having a considerably larger choice of custodians and gives them the opportunity to consolidate their custodian network. With the unprecedented level of market access resulting from this new network, agent banks would be able to compete for clients with asset portfolios that they were not able to serve until now.

In general, T2S facilitates and catalyzes the evolution of the current multiple market form into one more efficient and coherent market. In this new competitive landscape, technical access through systems and processes will become less important, while offering consolidated and value-added services will become the leading differentiator between different players in the market. ➔

New market rules and behavior



Settlement calendar and schedule

All CSDs will follow the same settlement calendar, with harmonized opening days as well as opening and closing times, and will observe the same daily schedule, e.g., instruction deadlines.



Settlement cycles

Participating markets have already migrated to T+2 as the standard settlement cycle.



Matching fields

T2S will introduce a set of matching fields for transactions. If the content of the matching fields from both sides of the transaction do not match, the transaction will not be settled.



Finality

CSD will introduce common rules defining when a transaction can no longer be revoked. Once a transaction is entered into T2S, unilateral cancellation (i.e., by one side only) is no longer possible. When the transaction is settled in T2S it is unconditional, irrevocable and enforceable.



Settlement discipline

All participating CSDs will introduce a settlement discipline regime. This will include penalties for late settlement and buy-in rules after a short period. The defaulting party will be charged with the buy-in costs.



Consequences

The rules and processes introduced by T2S will facilitate smoother settlement across all participating CSDs.

This will allow participants to rely much more heavily on the anticipated settlement results as a basis for connected transactions such as usage as collateral or on-delivery.

It does, however, require the stringent and efficient preparation of each settlement transaction. Counterparties will be much less able to accept settlement delays.

As the effort required moves from the reconciliation and repair function to the preparation function, a revised arrangement on the distribution of activities along the custody chain is necessary.

A very important component of this process is the requirement on both the custodian side and the client side to drive the change, as they both depend on each other.

Centralization of security and cash positions

T2S will allow the use of a centralized securities position (at a participating CSD) and a centralized cash position (at a national central bank) for settlements in any of the participating CSDs. The centralized securities position will facilitate the rapid transfer to any counterparty (e.g., for collateralization). The centralized cash position will reduce the need for realignment transactions and credit facilities to bridge misaligned cash positions.

Central bank money—the only cash that can be used for T2S—must however be available in an account at the national central bank. It cannot be “created” (e.g., by drawing on a credit line at a commercial bank).

An arrangement between the agent bank and the custodian is needed to determine the securities and cash services provided. An agent bank may decide to use multiple custodians and to decouple the cash function from the securities function.

Omnibus and segregated accounts

T2S will allow custodians to hold omnibus accounts at CSDs (for all or part of their business) as well as segregated accounts for individual clients. When the agent bank fulfils its requirements as a CSD participant, it may open its own account operated by the custodian.

As a result, each agent bank has to determine the best segregation approach to pursue, while also ensuring that the requirements of its clients are aligned. An operationally viable balance will need to be found between full segregation into separate accounts and full aggregation in an omnibus account.

An arrangement is needed between the agent bank and its custodian to determine the account segregation and the corresponding operational set-up.

Perceived benefits of implementing the T2S model

 Opportunities	 With T2S
High cross-border settlement costs <ul style="list-style-type: none">• Currently, the settlement process needs at least two CSDs and often several custodian banks• Little or no competition, i.e., monopoly conditions	Lower settlement costs, especially cross-border costs
Non-homogeneous settlement procedure across Europe <ul style="list-style-type: none">• No harmonization on legal, technical and fiscal levels• Unlike the US, no centralized clearing and settlement infrastructure	Harmonized processes and a single IT platform
	Optimized competition
	Risk sharing and diversification
	Safer financial markets
	Higher attractiveness for the euro area
High risk	Positive impact on financial stability

What happens now

Since the announcement of the T2S platform, CSDs and large global custodians have all installed programs and processes to connect to the platform. Moreover, they have also re-positioned themselves strategically by adapting their business model design and service offerings to reflect the incoming change to the T2S platform.

The next, but equally important, stage in the process of preparing for implementation is in the hands of the agent banks. A very important component of this process is the requirement on both the custodian side and the client side to drive the change, as they both depend on each other. There is no doubt that the implementation of the T2S platform will require preemptive thought and action in order to ensure seamless transition. These actions include:

- Custodians will need to carry out a self-assessment to identify the gaps present and hence, the necessary amendments required to adapt to the changes driven by T2S
- Related to this, the changed nature of securities settlement across the EU will require the re-development of old services to fit the new model and hence, successfully offer competitive and consolidated services
- Similarly, clients of the custodians must also adapt and comprehend the changes being brought in by the implementation of T2S to assess its effects. This will allow them to make the necessary changes ahead of time
- In lieu of the changed nature of service offerings, clients must also be able to readapt their strategies and demand for the new consolidated services

Rather than being reactive and waiting for various external influences to force a change, agent banks must take proactive actions and reposition themselves favorably ahead of time. These changes need careful curation to ensure effective implementation.



The changes include:

- The analysis of the impacts that will be caused by the implementation of T2S on legacy systems and processes, in terms of both scope and depth
- The reassessment of the current arrangements with their present custodian network to identify gaps and inefficiencies and as a result, create a plan of action to identify the required adaptations
- As for custodians and their clients, implementation will require a natural evolution in the nature of service offerings to reflect the new system
- In relation to the above points, agent banks may find that their old go-to-market strategy and position is made obsolete by the new system and requires a thorough review, not only to service existing clients but also to evaluate and search for new opportunities. ●

CRD IV remuneration requirements

A burden for financial institutions and HR

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Ever since the financial crisis, credit institutions within Europe have faced increasing regulatory pressures at almost every level of their operations. More than mere restrictions on operations, regulations affect the way remuneration is to be delivered to the workforce of financial institutions. With the introduction of CRD III (Directive 2010/76/EU) and now CRD IV (Directive 2013/36/EU), the European Union is attempting to reduce excessive and imprudent risk taking within financial institutions fueled by inappropriate remuneration practices. Regulators believe that poorly designed remuneration structures may have negative effects on the sound management of risk, the control of risk and above all the risk-taking behavior of given individuals. Today's evolving remuneration requirements have major implications for the cost structures of financial institutions as they

work to ensure full compliance. Indeed, remuneration requirements under CRD IV not only affect individuals themselves, but also have major consequences for the entire remuneration and benefits processes. This will also have an impact on talent and HR as a whole.

Understanding the major regulatory implications of CRD IV: "the eight commandments"

CRD IV, like all other directives affecting the financial industry, applies the same core principles regarding remuneration practices and procedures. However, the implementation and specific rules related to such practices differ in each directive. In light of this, we have identified the eight core principles that underpin the regulatory framework for remuneration practices, and these are illustrated below. ➔

Today's evolving remuneration requirements have major implications for the cost structures of financial institutions as they work to ensure full compliance.

The 8 core principles for remuneration practices



Proportionality Principle

The principle of proportionality allows institutions and national regulators to provide exemptions to certain requirements if their impact in particular cases would be disproportionate, both at institutional, as well as, individual level. The following factors should be considered together to assess the applicability of the proportionality principle:

1. Size
2. Nature, scope and complexity of activities
3. Internal organization

Institutional level

Individual level



Disapplication of Requirements

- Payment in instruments & Deferral requirements
- Retention periods
- Malus / clawback provisions
- Appointment of a remuneration committee



Institutions are obliged to set up a remuneration structure and practices that apply to all employees, with some specific requirements applicable only to identified staff.

Setting up a remuneration policy

The first key point to note from the above is that each institution must have a remuneration policy that is independently reviewed at least once per year. A major observation in market practices is that financial institutions often seem to think that having a standard drafted policy will be sufficient.

However, reality diverges from this point of view. Any remuneration policy should accurately reflect how remuneration is structured within the relevant institution and, most importantly, must provide sufficient evidence to prove that the given practices promote healthy risk management. It is important for institutions to realize that their remuneration practices are subject to independent annual review and will eventually be tested. Should the policy not reflect the reality on the ground, the report of the independent review will be submitted to the national regulator.

Understanding who affects the institution's risk profile

Another principle is the identification of staff. When referring to the so-called "identified staff" or "material risk takers," the regulator is targeting the people within the credit institution who might have a material impact on the company's risk profile as a result of their role and/or the nature of their activities.

But how can institutions identify material risk takers?

Under regulation (EU) 604/2014, credit institutions are given instructions regarding how to identify material risk takers. The regulations state that institutions shall identify their material risk takers through the use of qualitative and quantitative criteria, where the former might be linked to a persons' influence on the decision-making process or their power to use "veto" votes, and the latter is linked to the actual remuneration of that person. For example, if any employee is in the same remuneration bracket as senior management, such a person shall be considered as having a material impact on the institution's risk profile, regardless of his/her role and responsibilities.

Certain roles, such as the board of directors, senior management, and the control and risk functions, are officially listed as being in scope. However, the question then remains: who exactly in such roles is defined as "identified"? What common market practice currently tells us is that if people within the given functions/teams have the authority and power to act upon their decisions without any need for specific approvals, they are to be included in the list of material risk takers.

If the remuneration policy only applies to material risk takers, what's the big deal? This question reflects a common misconception. Experience has shown that many actors within the financial industry believe that the requirements (of CRR or other regulations) only apply to material risk takers. The reality, however, is that institutions are obliged to set up a remuneration structure and practices that apply to all employees, with some specific requirements applicable only to identified

staff. Yet, it is very important to understand that the general mindset of promoting a sound and effective remuneration policy needs to be reflected throughout the remuneration process with regard to every employee. All remuneration structures must be based upon specific evaluation criteria, and even aligned with the long-term strategy of the firm, as well as promoting its values and what it stands for.

Performance assessment

Regulators are of the opinion that, in the past, variable remuneration was too dependent on individual performance and did not reward respect for internal procedures and/or proper risk management in the decision-making process. In light of this, organizations in the financial industry need to ensure that the performance assessments used to determine variable remuneration reflect both quantitative and qualitative criteria. Moreover, one of the differences between the way that material risk takers and the wider workforce are evaluated is the length of the evaluation cycle used to set variable remuneration. Whereas the institution needs to link the variable remuneration for the overall workforce to performance over the given evaluation cycle, credit institutions assessing material risk takers must also account for performance across a multi-year framework.

The multi-year framework plays an important role within the entire concept behind the remuneration-related restrictions. It is important to understand that a good decision today might have negative future consequences. As such, risk takers with very bad evaluations two years ago and very good evaluations this year should not benefit from the maximum bonus amount, as their past decisions might still have a negative influence on future events.

Additionally, organizations must bear in mind that control functions are subject to other specifications, because the variable remuneration for such employees must be linked to the objectives of their function and their function only, independent of the performance of business activities they may oversee.

Ensuring a balance between fixed and variable remuneration

The notion of the balance between fixed and variable remuneration is quite vague. Fortunately, the CRD IV provides quite clear instructions as to what it means. The variable remuneration of any risk taker in a financial institution should not exceed 100 percent of his/her fixed remuneration, yet under specific circumstances this ceiling may be extended up to 200 percent. Such a ceiling can only be exceeded if the majority of shareholders agree. Should one of the shareholders fall within the scope of the exceeded 1:1 ratio, however, his/her vote shall not be taken into account. If a company believes that they may exceed the ceiling, there is a specific procedure it must follow. First, the institution must notify the regulator about its intention to exceed the 1:1 ratio. Then the organization needs to enter into a shareholder voting process and secure a majority of at least 66 percent (provided that at least 50 percent of the shares or equivalent ownership rights are represented or, failing that, a majority of 75 percent of the ownership

rights are represented). Once the vote has been validated, the institution should notify the regulator about the decision and provide a reasonable justification.

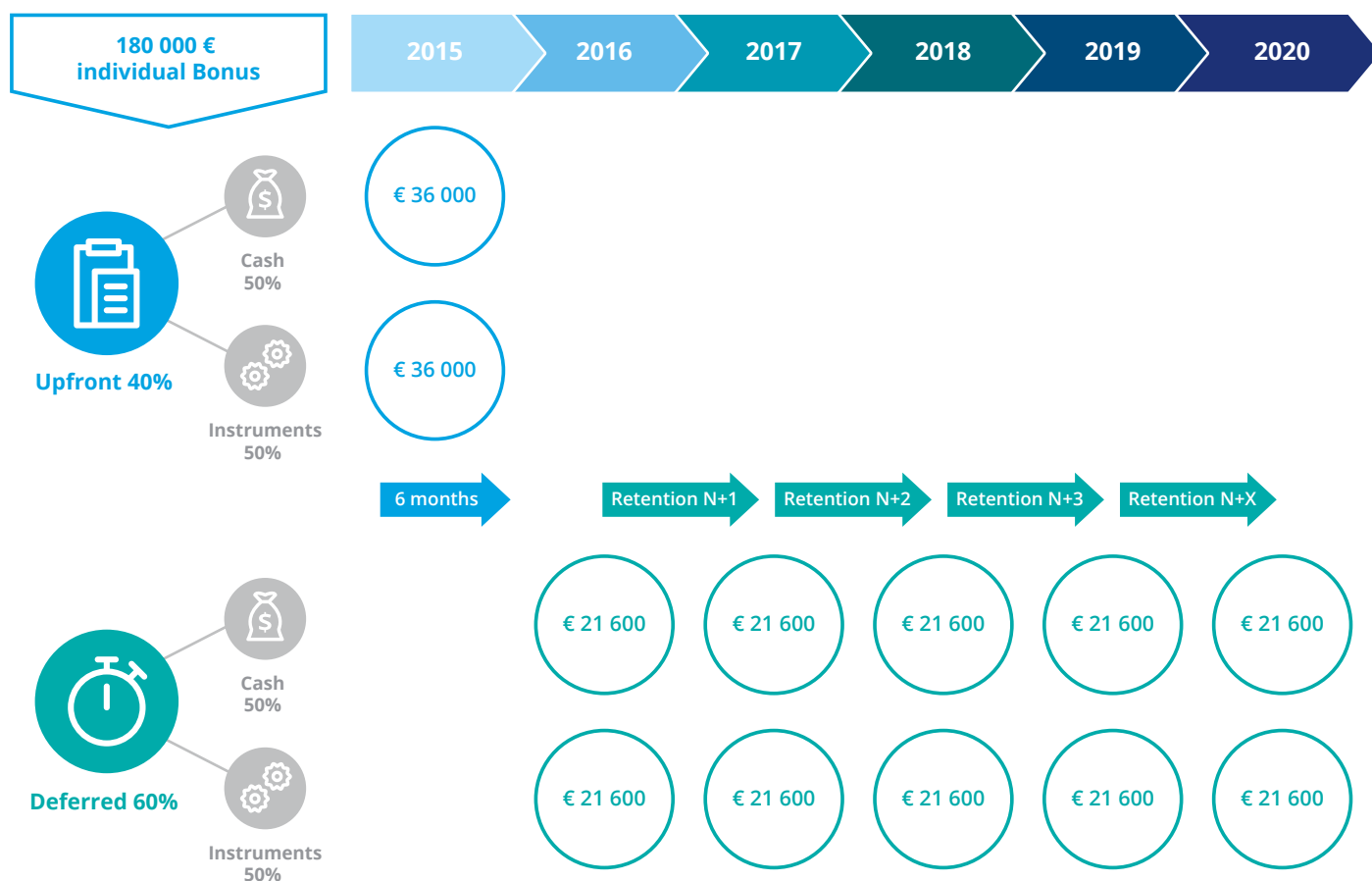
Pay-out process rules: deferral, payment in instruments and malus/clawback for identified staff

In order to ensure that variable remuneration links to the long-term strategy of the institution and reflects overall performance, regulators have imposed rules on how variable remuneration is to be paid out:

- At least 40 percent of the amount of variable remuneration in any event should be deferred
- The deferral period cannot be shorter than between three and five years
- For the remaining 60 percent of the variable remuneration, only 50 percent of the given amount is to be paid in cash, whereas the remaining 50 percent must be paid in shares, which are subject to a six-month retention period ➔



The illustration below gives a basic overview of some of the CRD IV requirements in terms of deferral and retention.



Given the above, the link between variable pay and payout in instruments enables institutions to align remuneration with risk-related exposure so that variable remuneration can also amount to zero. Indeed, financial institutions must ensure that variable remuneration under no circumstances rewards failure.

Governance

In order to avoid any type of conflict of interest, companies must devise an internal governance structure that proves that its remuneration processes are reasonable and independent. Organizations must understand the fact that the board members who define the remuneration principles and general guidelines within the firm are also considered to be "identified staff." As such, it would be easy to bias such practices and principles based on personal interests. Therefore, the regulators want credit institutions to set up remuneration

committees to ensure that an independent body reviews remuneration practices and principles and their proper implementation. Rather than simply setting up a remuneration committee, institutions should involve control and HR departments in the process and ask compliance to ensure that the legal requirements are met.

Proportionality

The proportionality principle is most probably the holy grail of every financial institution, whereby it may choose to disapply one or more of the specific provisions imposed by regulators. The concept behind proportionality states that it is not realistic to treat all institutions in the same way, which is why regulators deem it important that regulations should be implemented in a way that is appropriate to an organization's size, internal organization and the nature, scope and complexity of its activities.

The proportionality principle is most probably the holy grail of every financial institution, whereby it may choose to disapply one or more of the specific provisions imposed by regulators.

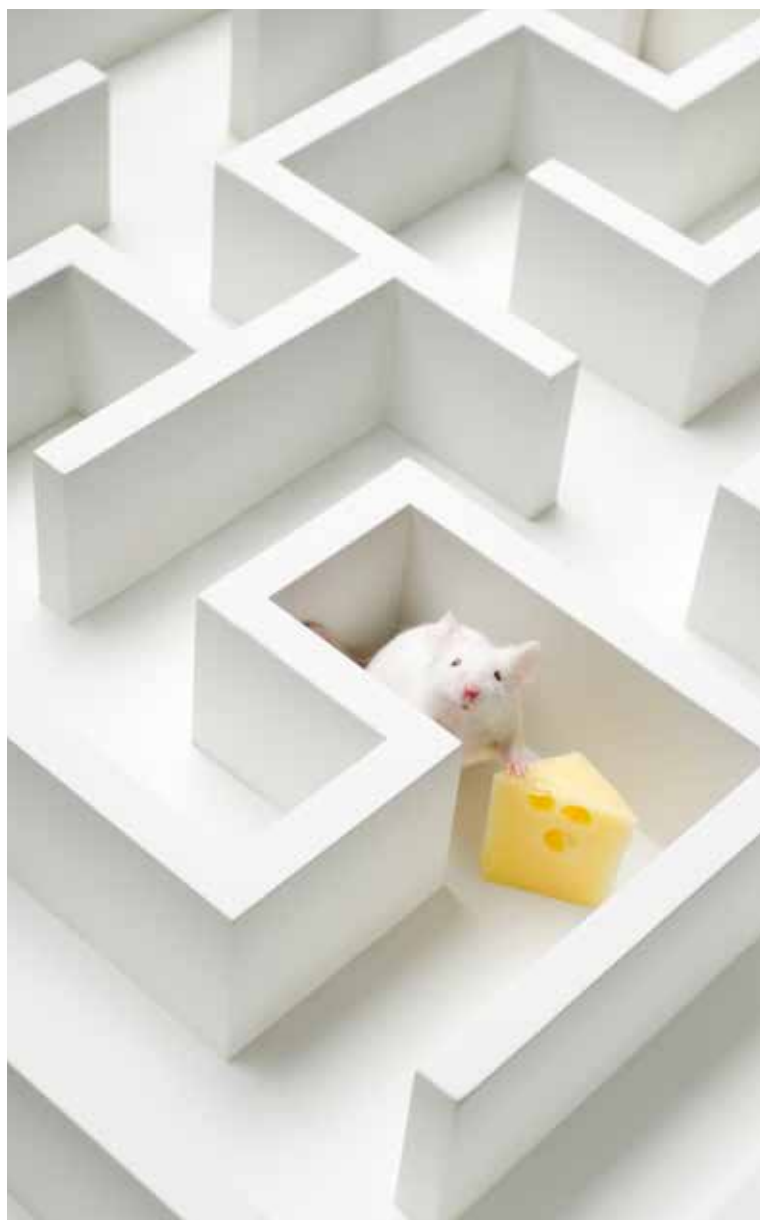
Applying proportionality allows an institution to disapply the following elements:

- Pay-out of part of the variable remuneration in instruments
- Retention period
- Deferral of part of the variable remuneration
- Ex post incorporation of risk
- Establishment of a remuneration committee

Indeed, this is pretty convenient for institutions and many seek to apply this principle. What many local institutions forget, however, is that when applying proportionality organizations need to provide a justification showing why they are eligible for it. Most entities just use the quantitative data as provided by CSSF 10/505, hence neglecting the fact that the regulator strongly recommends using the quantitative measure as a reference and also referring to an overall framework as stipulated by the Committee of European Banking Supervisors (CEBS) guidelines.

On the topic of CEBS, it is important to note that these guidelines still refer to CRD III requirements, whereas under CRD IV the European Banking Authority (EBA) is mandated to guide institutions as they interpret and implement CRD IV in terms of remuneration. As such, all eyes are currently on the new guidelines issued by EBA surrounding CRD IV, which will replace, from 1 January 2017, the existing guidelines on remuneration policies and practices published by the CEBS in December 2010. These will apply to companies that are subject to CRD IV on a solo and consolidated basis.

The most significant development to note is that the guidelines uphold, as expected, the EBA's position in relation to proportionality as the EBA outlined in the draft guidelines published in March 2015. It remains the EBA's position that, based on the current text of CRD IV, firms should not be permitted to "neutralize" or disapply entire provisions under CRD IV, either on account of their size and complexity or in relation to individuals who receive a lower level of variable pay.



It should be noted that the EBA has published a separate opinion alongside the guidelines pertaining to the application of the principle of proportionality, in which it states that small and non-complex institutions (other than subsidiaries of large firms) should be permitted to disapply the requirements relating to deferral, pay-out in instruments and discretionary pension benefits. It also states its view that it should be possible for these requirements to be disapplied by all firms, regardless of their size, in relation to staff who receive "low levels" of remuneration, though no indication has been given as to what would

constitute a low level of remuneration for these purposes (and whether such levels would be determined on a relative or on an absolute basis).

However, the EBA believes that, in order for there to be a legal basis for these exemptions, legislative changes will need to be made to CRD IV. It is therefore likely to take some time before any such exemptions will take effect and it is unclear whether it will be possible for such amendments to be made prior to the coming into force of the guidelines on 1 January 2017. ➔



As of today, major HR trends show the desire to shift towards simpler performance management processes.

So what does this mean for HR?

HR is handling the constant application of regulatory requirements, and it shoulders a considerable burden as a result. HR must be heavily involved in implementing changes because of the constant shift in evolving regulations. Rather than simply implementing regulatory requirements, HR must constantly evolve and develop the right knowledge about regulatory requirements so that the right processes are implemented.

Such regulatory requirements have a significant impact on three major HR domains: payroll, performance management and talent-related subjects such as talent attraction and retention.

The first two points are very closely linked in the context of a regulatory framework that insists upon a link between variable pay and performance. As such, one would think, "Well, HR has dealt with this all along... why is this changing now?"

Complex performance management process

The challenge is the fact that HR must now integrate the notion of a multi-year evaluation framework, where employees will receive variable pay not only relating to their performance for the given evaluation year, but in relation to prior evaluation cycles as well. HR needs to understand the different structure variable remuneration will adopt and even needs to monitor the deferral of such pay and the possible shifts in its value, knowing that each year a new level of variable pay will be entered into the system for the employee in question. Moreover, when monitoring the remuneration of the workforce, HR needs to clearly understand the parameters applied to identified staff. Moreover, HR must constantly be aware of shifts in the status of the different people within different departments so that the relevant criteria can be applied.

As of today, major HR trends show the desire to shift towards simpler performance management processes, with an emphasis on development rather than evaluation. Yet the increasing requirements regarding remuneration and the respective link to performance intensifies the need to maintain complex evaluation systems.

Remaining an employer of choice

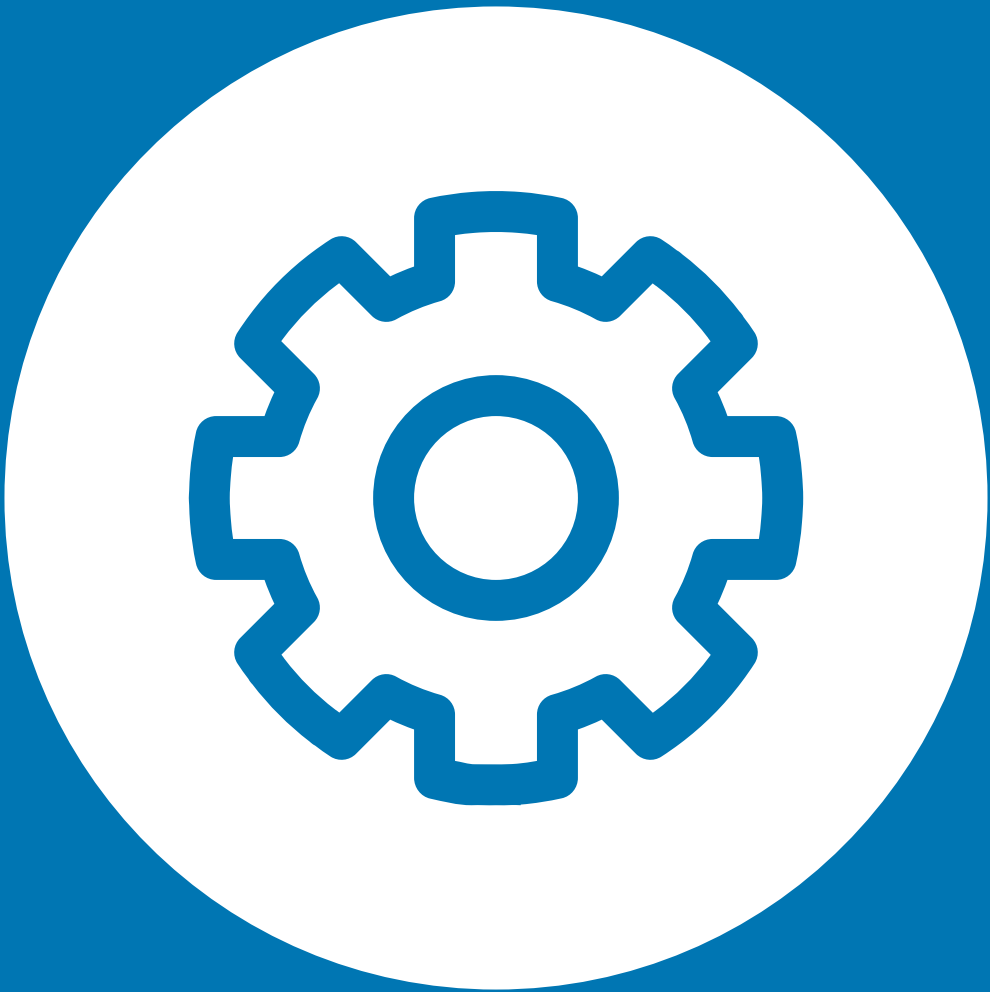
Restrictions imposed on remuneration in the European Union have a wider effect than initially intended by the regulators. The many regulations imposed on financial institutions, especially in terms of remuneration, will mean that new talent increasingly turns to new markets, far away from Europe.

The question we must ask ourselves is: "what is the incentive for bankers, financial analysts and others to choose a European employer over any other?" Under such circumstances, it is becoming difficult for HR to recruit the necessary talent to respond to the organizational talent demand. In addition to attracting talent, retaining talent is also becoming challenging, as many choose to find refuge either in emerging economies or well-established environments such as the USA, Singapore, Hong Kong and others.

Conclusion

- There are eight major pillars of remuneration requirements:
 - Remuneration policy
 - Identification of staff
 - Performance assessment
 - Governance
 - Remuneration Cap—1:1 ratio
 - Pay-out process—deferral and payment in instruments
 - Malus/clawback
 - Proportionality principle
- It is becoming difficult to shift toward simple and less complex performance management
- Talent attraction and retention is becoming more challenging. ●





Part 03

From a corporate
perspective ➤

Product profitability in Wealth management and Private Banking

Unlocking profit opportunities with enhanced reporting capacity

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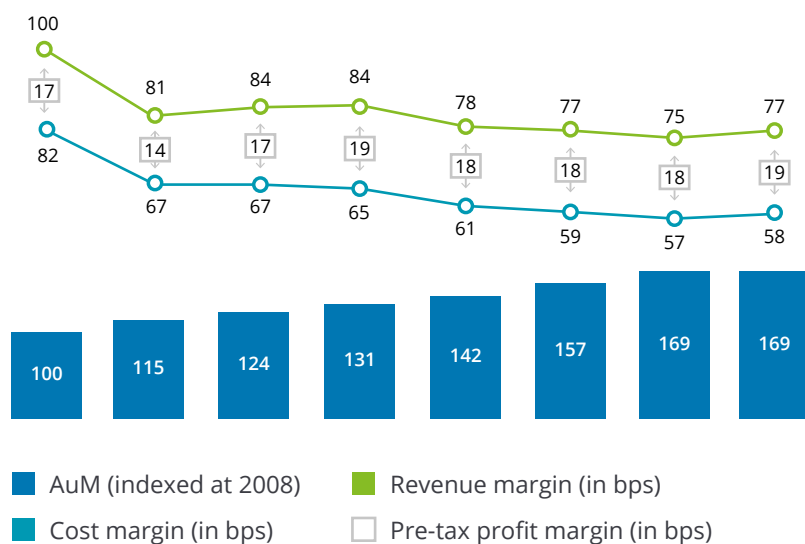
In light of ongoing industry challenges, managing profitability remains a priority for wealth managers. Product mix optimization stands out as a key enabler for top and bottom-line improvement. To unlock its potential, best-in-class wealth managers are developing methodologies for monitoring and steering profitability across the product portfolio. In our view, given shift driven by MiFID II and evolution in clients' expectations, Product Profitability should be top priority on the agenda of Wealth Management CFOs.



Profit in the wealth management industry remains under pressure

Client wealth levels suffered significant decreases following the recession in 2007-2008 that led to significant declines in wealth managers' Assets under Management (AuM) and profitability. However, despite notable recovery in AuM since then, wealth managers are struggling to recapture the high profit margins they experienced in the past. Indeed, as illustrated in Figure 1, pre-tax profit margins remained between 17bps and 19bps while AuM grew by approximately 70 percent between 2008 and 2015. ➔

Figure 1: AuM and pre-tax margin evolution



There are many reasons why wealth managers' profitability remains under pressure:

- **Clients have grown increasingly conservative and price sensitive.**

Indeed, following the financial crisis, many investors have downgraded the risk profile of their portfolio and moved into low-cost, index-based products, being reluctant to move back into the types of high-risk asset classes, such as equities, that tend to carry high operating revenue and margins.

- **Additional regulatory pressure has constrained industry development.**

In recent years, a number of new regulations have been introduced and had a multitude of consequences for wealth managers, such as:

- Reduced financial resources (lending capacity, deposit-taking capacity) to comply with new capital requirements
- Reduced product scalability due to additional administrative burdens
- Increased transparency on the types of services provided and the associated pricing

- **Intensified competition has pushed wealth managers to add even greater value.**

The removal of banking secrecy in offshore centers such as Luxembourg and Switzerland, the automatic exchange of information and the recent developments in the FinTech space resulted in: (1) a reduction in the competitive advantages of established players, and (2) lower industry barriers to entry. Intense competition and more transparent product offerings (particularly on prices) have empowered customers to compare offers from different firms. These developments have sparked greater competition and created a need for wealth managers to clearly demonstrate how they add value.

Industry forces induce a shift in product offering and pricing model

As the likelihood of returning to pre-crisis margins is remote, wealth managers need to reinvent and rationalize their advisory product shelf. Moreover, the greater transparency required under MiFID II will push the wealth management

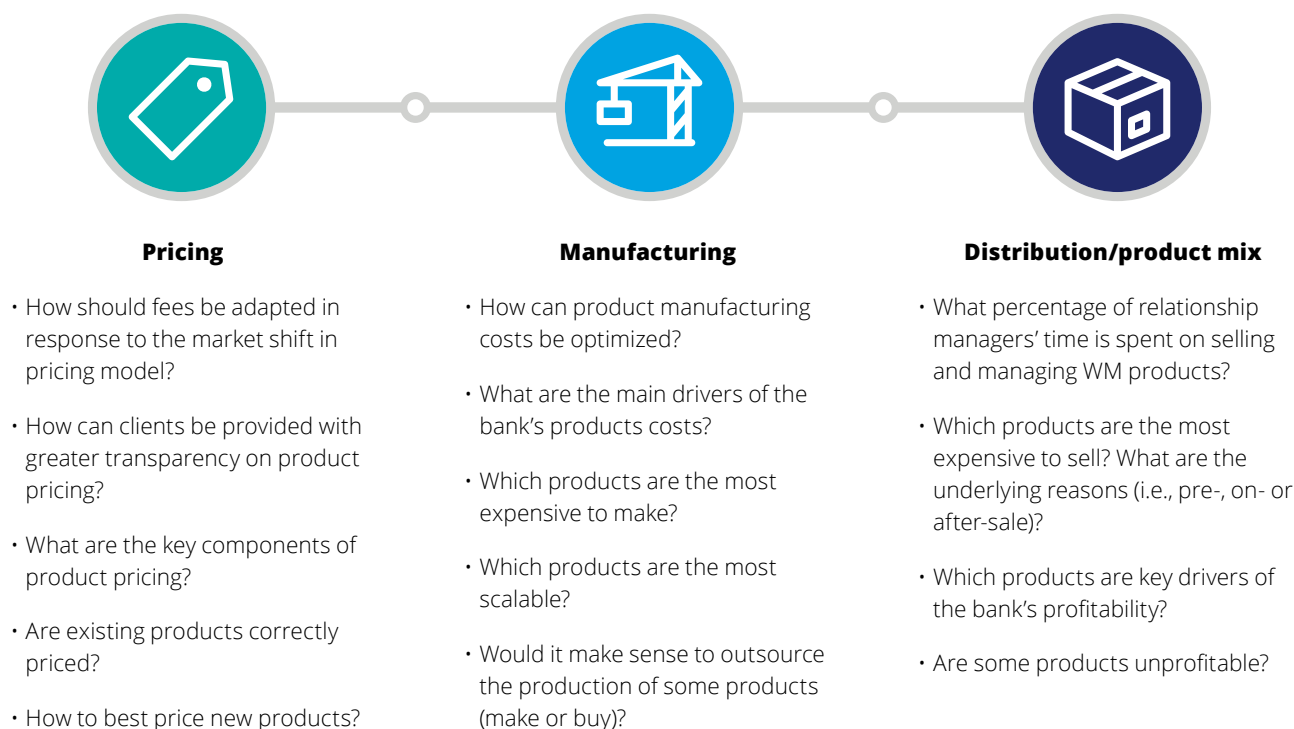
industry product offering and pricing model to change toward "under contract arrangements" with separate and explicit charges for advice requiring banks to distinguish the product manufacturing costs from distribution, sales, and advisory costs.

This shift raises a number of questions, which can be broadly broken down into three main categories: (1) pricing-related questions, (2) manufacturing-related questions, and (3) distribution and product mix-related questions. Figure 2 presents some examples of questions on the agenda of decision makers in each category.

To optimally manage their product mix, decision makers need financial reporting at product level

To answer the questions raised by the ongoing shift in the product offering and pricing model, wealth managers are increasingly looking to understand the factors that contribute to greater profitability. With a view to clarifying which products add to profit margins and

Figure 2: Examples of questions on the agenda of decision makers



the underlying drivers, **best-in-class wealth managers are developing methodologies for reporting profitability across the spectrum of products.**

The challenge, however, is that it can often be difficult to obtain a clear picture of product profitability:

- Tying back revenues to the underlying products is constrained by complex aggregation methods across various income streams from fees, interest income, trading and other sources.
- On the other hand, 50 percent to 70 percent of wealth manager costs are typically not directly product-related (e.g., client acquisition costs, relationship

management costs, overheads and other costs) and need to be allocated based on ad hoc methodologies.

- Moreover, the cost and revenue data relating to services provided to individual clients is often difficult to consolidate from the various accounting and management information systems that cross different businesses and functions. Thus, the true operating earnings for various profit centers are often hard to ascertain given complex, incomplete, or sometimes inaccurate cost and revenue allocations.

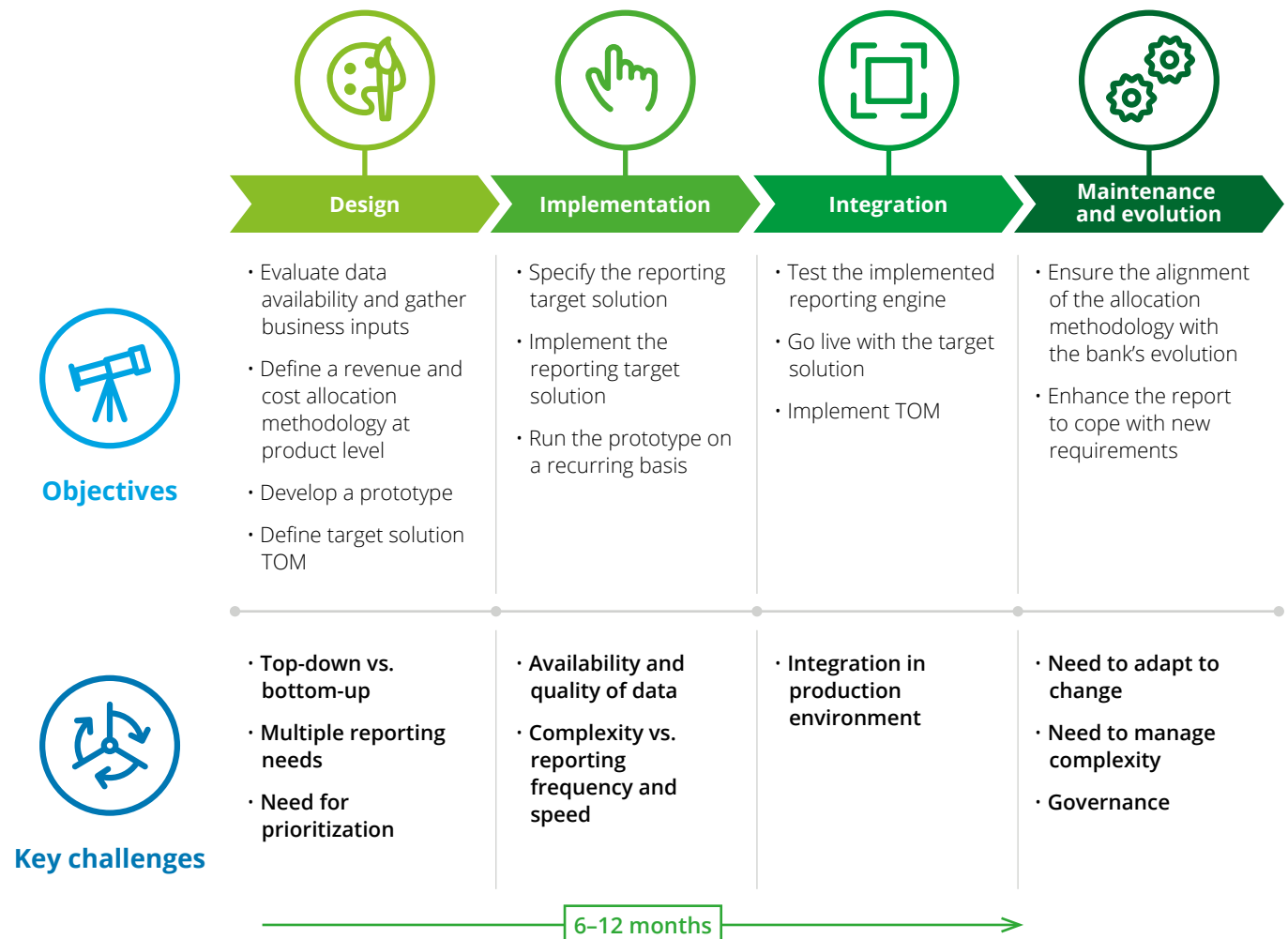
In light of these challenges, wealth managers often have to arbitrate between sophisticated models (based on bottom-up

allocation methodologies), which are more insightful but require higher investments upfront, and tactical solutions (based on top-down allocation methodologies), which are less insightful but are easier to establish and maintain.

Developing a product profitability reporting capability means following a process

Regardless of the type of model chosen by the wealth manager (sophisticated vs. tactical), developing a product profitability reporting capability usually means following a three-step process typically lasting between 6 and 12 months (see Figure 3): ➔

Figure 3: Product profitability reporting capability development process



1. Design phase: The key objectives of the design phase will be (i) the definition of a methodology for allocating revenue and costs at product level, and (ii) the implementation of a prototype for the purposes of producing a pilot product profitability report. The main purpose of the pilot report is as the creation of a communication tool that can be used to validate the overall framework (e.g., product structure used, P&L structure used, etc.) and the proposed methodology with key project stakeholders. Once the pilot report has been formally approved, the project team in charge can proceed with the implementation phase.

2. Implementation phase: The main objectives of the implementation phase are to (i) specify the reporting capability target solution from a business, functional and technical point of view, and (ii) implement the specified target solution. This second phase is considered complete when the implemented solution is ready to be tested and released in a dedicated environment.

3. Integration phase: The key objectives of the integration phase are (i) to test the implemented reporting solution to ensure that it is consistent with the specification, and (ii) to integrate the solution into the wealth manager's production environment.

It is important to note that the prototype developed during the design phase will typically be used to generate product profitability reports on a recurring basis throughout the subsequent phases. In this way, wealth managers can start sharing product profitability results after only a few months and thereby improve the extent to which the ultimate report may be used as a basis for action.

Steering product profitability and laying the foundations for future strategic decisions at management level

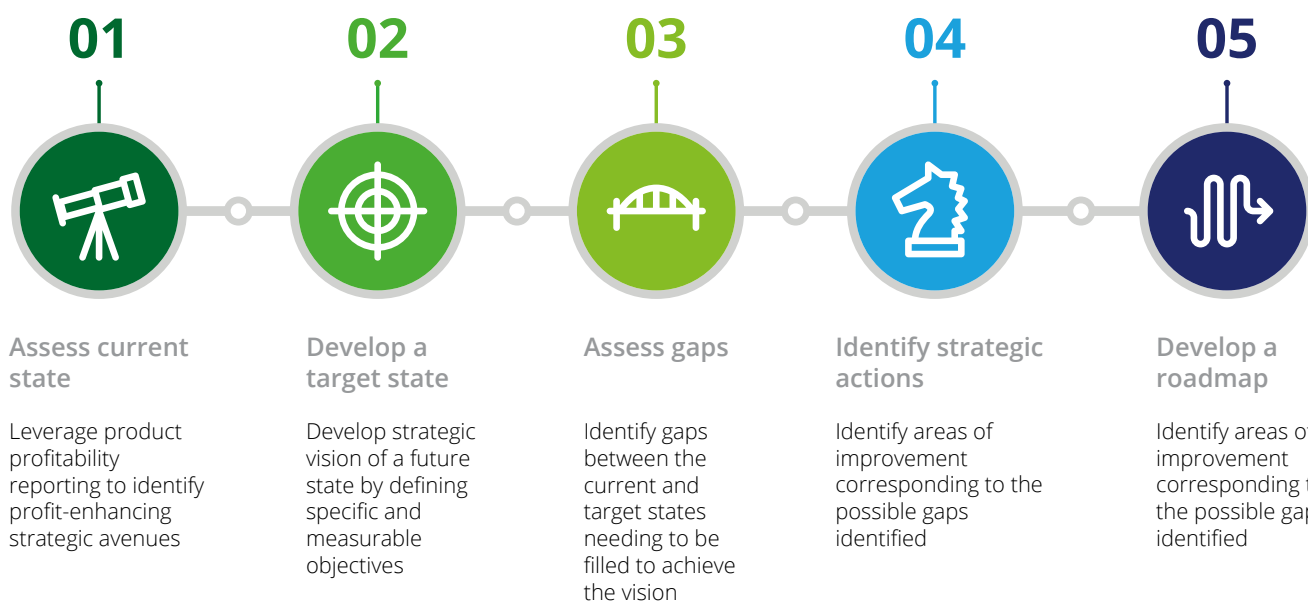
The ultimate purpose of developing a reporting capability to track profitability at product level is to identify high-impact opportunities to invest, divest, and reduce costs where appropriate. Product profitability reports may uncover a broad range of opportunities that could be seized to increase profitability.

As shown in Figure 4, wealth managers may wish to follow a five-step approach as they identify and implement profit-enhancing strategic actions.

1. The first step is to leverage profitability reporting to identify areas of the business where there is room for improvement. This starts with a set of qualitative and quantitative observations listed and grouped into major functional segments that provide an assessment of the current state of the business. Typically, a product profitability report will be assessed with reference to two main dimensions:

- **Product mix:** Analysis of overall profitability through an assessment of resource allocation across products.
- **Individual product P&L:** Analysis of individual product profitability through an assessment of resource allocation along the value chain.

Figure 4: Recommended approach to identify and implement profit-enhancing strategic actions



2. The second step focuses on developing a strategic vision of the future state of the business. This phase often involves multiple functional departments across the organization (e.g., front office, operations, risk, compliance, and legal) so that diverse, often conflicting, perspectives are taken into account and significant stakeholders are engaged. Setting specific and measurable objectives during this phase is of particular importance because it may establish clear points of reference and guidelines throughout the following steps of the process.
3. The third step consists of comparing the analysis of the current state of the business with the target state vision and determining gaps that need to be addressed to reach the target state. This step is crucial because it links the observations identified in previous steps to strategic actions in the following steps. Gap definitions need to be very specific and broken down by functional areas as much as possible to help involved parties identify the root cause of the issues.
4. The fourth step focuses on the identification of possible strategic actions that may be executed to close the gaps and achieve the target state. Strategic action selection is based on specific objectives, potential scope, timing, and required return on investment. Examples of high-level profit-enhancing strategic actions identified by wealth managers based on observations made regarding product profitability reports are presented hereunder:
 - Product rationalization and harmonization across markets and segments
 - Product standardization (e.g., decreased number of options/ flexibility)
 - Automatization/rationalization of middle and back office processes
 - Alignment of product distribution channels with customer behaviors
 - Frontline staff efficiency optimization through advanced analytics
5. Lastly, the fifth step consists of developing a set of practical activities to be performed and milestones to be reached to effectively implement the initiatives previously identified. The focus should be on both quick wins as well as on long-term sustainable initiatives to make profitability an ongoing process. The roadmap should strike a balance between complexity and risks versus the magnitude of the transformation, and evaluate improvements against the transformation timeline. Clear owners and accountable parties should be identified and empowered to enable effective delivery in line with expectations. During this phase, the creation of a "transformation summary dashboard" that tracks accomplishments against objectives on a quarterly or monthly basis can help monitor progress and prioritize remediation actions as needed.

In our view, given shift driven by MiFID II and evolution in clients' expectations, Product Profitability should be a top priority on the agenda of Wealth Management CFOs.

Key takeaways

- Profit in the Wealth Management industry remains under pressure
- Product mix optimization stands out as a key enabler for top and bottom-line improvement
- Best-in-class wealth managers are developing methodologies for monitoring and steering profitability across the product portfolio
- In our view, given shift driven by MiFID II and evolution in clients' expectations, Product Profitability should be a top priority on the agenda of Wealth Management CFOs ●



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1. Beyond outsourcing

One of the responses financial services firms gave to the financial crisis is an increased level of Business Process Outsourcing (BPO). While this seems at first glance contradictory, BPO can represent substantial value to service providers by reducing risk and increasing value delivered to clients — whether through lower service cost, increased service quality or extension of service offering.

Reduction of risk—many industry players have chosen to focus on core and strategic activities in light of ever-increasing regulatory burdens, risk-averse shareholders and operational complexity. As an illustration, private banks are increasingly outsourcing the production of tax reports for their high net worth and global clientele. This allows them to acquire capacity and mitigate the risks associated with the various fiscal regulations across the globe whilst centralizing production to align service levels and controls.

Lower service cost—stronger transparency requirements and increased competition from low-cost and alternative service providers put industry players under fee pressure. Outsourcing non-core business activities allows financial service providers to benefit from economies of scale that they would not be able to achieve if these activities were kept in-house. Moreover, it transforms a fixed cost into a variable cost through the application of the “pay-as-you-go model”.

Increased service quality—transparency, “bank shopping” attitudes and standardization/ring-fencing of service offerings through tighter regulatory constraints can make it difficult for financial service providers to differentiate through their core activities. Differentiation can, however, still be achieved through an outstanding service quality. For instance, fund factsheet production may be seen as a commodity. This said, in this field,



Outsourcing outside the box

BPO providers not only apply but also define industry best practices. Leveraging their expertise can give financial service providers that competitive edge in service quality, further reducing operational risk (see above).

Extension of services offering—fighting against an image of an industry that is non-innovative and facing competition from non-traditional service providers, the financial industry is increasingly urged by its customers to reinvent itself. This can, for instance, happen through the integration of innovative digital solutions. BPO is typically seen as covering existing processes only. However, BPO service providers act as business integrators, allowing financial service firms to access a whole range of new, non-core services and solutions, and this off-the-shelf without substantial implementation effort. They can also

bridge the capability and knowledge gap when it comes, for instance, to the integration of disruptive digital solutions within traditional banking environments. The perfect scalability of BPO services allows BPO clients to benefit from higher operational flexibility and the availability of resources “on demand”.

Actually, outsourcing is nothing new to the world as the first evidence of BPO can be traced back to traditional manufacturing industries such as Coca-Cola, which outsources large segments of its supply chain to be more cost-effective and efficient. Despite the significant benefits of BPO for the industry, the financial service providers, however, still lack the degree of outsourcing leverage applied in other industries. ➤

As an illustration, private banks are increasingly outsourcing the production of tax reports for their high net worth and global clientele.

1 Source: Plunkett Research, <https://www.plunkettresearch.com/industries/outsourcing-offshoring-bpo-market-research/>

2 Source: Elixirr Research, <https://www.elixirr.com/2014/06/trends-in-outsourcing-in-the-financial-services-industry-2009-2013/#sec1>

It is estimated¹ that outsourcing represented an approximately US\$ 524.4 billion global industry in 2015, with significant emphasis on three broad areas:

1. Logistics, sourcing, and distribution services;
2. IT services, including the creation of software and the management of computer centers;
3. BPO areas such as call centers, financial transaction processing and human resources management.

In the Financial Services Industry, BPO was a known quantity even before the crisis, but has become prominent, growing² by 3.2 percent CAGR from 2009 to 2012, reaching US\$ 143 billion. In the face of increased enforcement of regulations, this is projected to increase to 5.2 percent CAGR between 2013 and 2017. However, this figure still lags behind when compared with other industries such as the manufacturing industry, which often outsources up to 70-80 percent of its finished product³.

To break with this image, let us therefore take BPO to the next level by introducing the concept of "Smart-Sourcing".

So why does the financial industry still shy away from the BPO business management practice?

We suspect the reason for this is two-fold:

1. On the one hand, BPO has a bad image and is burdened by substantial misconceptions:
 - a. It necessarily results in staff lay-offs
 - b. It is a complex to manage process that often fails in the details
 - c. It is a statement of the firm "against" a defined, low-value activity
 - d. All the math done, it is often not cheaper than in-house processing
 - e. It increases vendor dependency
2. On the other hand, many players have bad experiences with BPO or failed in making it a success story for their firm as they did not take full value of BPO projects in the past:
 - a. It did not consider all the potential processes in scope and only covered low value-added back-office activities
 - b. It did not take value from vendor centralization and resulted in a fragmented vendor landscape
 - c. It only copy-pasted existing processes and did not trigger a review of the business process and service offering in itself
 - d. The project was not managed with sufficient management focus and lacked resources for implementation
 - e. It failed to produce the expected financial benefits through higher-than-expected implementation cost and non-adapted pricing models
- f. The financial business case did not compare to the fully loaded in-house production cost
- g. The contractual set-up and vendor management approach was risk-driven and did not allow for enough flexibility to adapt to changing servicing needs

We believe that when smartly managed, a BPO project does not necessarily have to entail these consequences. It can be of substantial value to a financial services firm by increasing margins, reducing risks, propelling innovation and enhancing value delivered to clients (whether internal or external clients).

To break with this image, let us therefore take BPO to the next level by introducing the concept of "Smart-Sourcing". In this sense, the essential business question becomes:
"Do you still outsource or are you smart-sourcing already?"

2. What is smart-sourcing?

Smart-sourcing can roughly be understood as outsourcing business processes under the considerations that:

- The processes to be outsourced are reviewed and redesigned
- The quality of the services is significantly increased through the application of best practices
- The project entails a review (and upgrade) of the service offering
- Vendors are centralized but smartly managed to grasp additional economies of scale and provide higher processing transparency

³ Source: The Economist, https://www.economist.com/media/globalexecutive/outsourcing_revolution_e_02.pdf

Engaging in smart-sourcing instead of simple BPO entails (and even requires) a mindset change for many financial institutions:

From outsourcing... to smart-sourcing

Focus on cost reduction

Streamline back office tasks

Works well with predictable processes

Commoditised process

Efficiency

Vendor Management

Tight monitoring of operational risk

Focus on creating value and seeking innovative solutions

Enhance the value proposition

Help you manage the unknown

Service Differentiator

Excellence

Trusted advisor

Lower risk through better processing

Smart-sourcing for inspiration: defying conventional wisdom, 7 large start-ups have relied on smart-sourcing for their IT development to successfully power their business

Start-up companies have very well understood the value of smart-sourcing and have relied on it to fuel their expansion plans. In the examples below, those companies have challenged traditional strategies by outsourcing what could be seen as a key asset: their IT development process.

- 1. Slack:** Now valued at nearly US\$ 3 billion, this company used outsourcing to develop its team communication solution in its earliest days.
- 2. Skype:** They used a team of developers in Estonia to help them build out their business.
- 3. Staff.com:** Serving as a company that offers outsourced talent and freelancers for other

organizations; Staff.com utilized the same model to grow from a start-up into a globally successful business.

- 4. Basecamp:** The same practice of outsourcing worked for Basecamp as it developed itself into a technology leader.
- 5. MYSQL:** From the start, the company believed and proved the success of a growth strategy that included using a mostly outsourced staff in various countries to ramp up operations in each location.
- 6. Opera:** This web browser company relied on developers in other countries to create and implement its platform.
- 7. Pingar:** The company helps organizations with data analytics. While establishing itself in its industry it called on outsourced talent to develop its business.

2.1. Characteristics of the ideal process to smart-source

One of the main root causes for a disappointing BPO process is wrong casting for the smart-sourced process. A critical step on the path to smart-sourcing is indeed understanding what characteristics make a process ideally suited to be outsourced. A good casting of the process to be smart-sourced can be achieved as outlined in the following points:

Core process for the smart-sourcer, but not for you—first, the outsourced process must not be a core activity of yours but it should be a core activity of the outsourcing service provider (the “smart-sourcer”). Indeed, the smart-sourcer will have developed best practice formulas and specialized systems that are proven and optimized.

Other criteria of processes prone to smart-sourcing are:

- **Large scale/Cyclical**—this is to allow a constant flow of work to the service provider, which is important to benefit from economies of scale and to allow the vendor’s performance to be measured in a deadline constrained framework. ➤



Maybe the greatest benefit of smart-sourcing fund factsheets is that it allows innovation to be captured much faster than if it were insourced

Smart-sourcing solution: traditional and future fund factsheets

A fund factsheet is the essential marketing tool to promote fund products. Yet, today, too many fund factsheets are still produced with a rigid content and are not refreshed as often as one would want. In addition, classic factsheets today are designed to be printed and fail to satisfy the requirements of the upcoming generation of global “digital native” clients.

By smart-sourcing fund factsheet production, fund houses can differentiate themselves in many ways:

- By being assured that local compliance obligations will be met (and avoid pricy fines and public sanctions)
- By allowing rapid development and launch process for products to “go to market”
- By strengthening the data management process (this can

actually benefit many other fund document productions, KIIDs, prospectus, etc.)

- By getting a faster, more cost-effective, more flexible, more scalable production solution that even large players could not afford

Maybe the greatest benefit of smart-sourcing fund factsheets is that it allows innovation to be captured much faster than if it were insourced. Current systems are indeed most often outdated and undersized. What would be the rationale of trying to replicate third-party solutions with less investment and focus than “smart-sourcers”? To illustrate this point, fund factsheet smart-sourcers are now proposing solutions that many asset managers have not yet started to dream of: factsheets can now come to life, i.e. be dynamic, generated on a real-time basis, reworked online by clients as they wish, mixing all media available today: static and daily data (like NAV per share, risk measures, news, links to other documents), video, news feeds and even social media.

- **Complexity is not an issue/high value tasks**—a popular misconception surrounding BPO is that the services being outsourced should usually be of low value and should be simple in nature. However, quite on the contrary, complex tasks, especially those requiring a vast array of competencies, can lead to model smart-sourcing candidates because getting the necessary expertise would be difficult, costly and risky to manage. For instance, the turbulent tax and regulatory environment has led to many processes becoming quite complex (e.g. tax reporting, marketing and regulatory compliance, risk management and reporting), requiring a multitude of experts to complete successfully. The non-compliance burden attached to them greatly increases the importance of these services: in 2014, US and European banks paid an astronomical amount of US\$ 65 billion in penalties and fines⁴.

- **Commodity services**—another facet that makes a service a suitable candidate is that it is conceived as a commodity, allowing firms to choose between several outsourcing providers competing on the best and most innovative services but also on prices. In addition, commodity services allow for greater cost forecasting and budget predictability as service providers tend to follow the pay-as-you-go model, which greatly reduces fixed costs, giving the client more autonomy.

4 “For Banks, 2014 Was a Year of Big Penalties”, The Wall Street Journal, 30/12/2014, <http://www.wsj.com/articles/no-more-regulatory-nice-guy-for-banks-1419957394>

2.2. Be ready to change to become faster, stronger, better

In many cases where outsourcing failed to capture its potential, the client did not see the relationship between themselves and the service provider as a partnership, thus creating innovation deficits. A typical error for an outsourcing project would consist in “copy-pasting solutions” (or “lift and shift” solutions), where the client simply asks the vendor to follow the legacy processes they were using, often defeating the purpose of outsourcing in the first place as they failed to take advantage of the vendor’s strengths.

The point is that firms must agree to transform themselves (for the better) and allow service providers to follow their own modus operandi.

This is a small cost in comparison to the potential benefits of smart-sourcing:

- **Volume resilience**—the smart-sourcing model usually comes with a gain in flexibility, which is significant in cases where there is a sudden increase or decrease in processing volume. It is easy and far more cost-effective to adapt the resources required if going through a service provider, reducing the inefficient allocation of resources and

the response time to market movements – a highly useful tool in today’s turbulent environment.

- **Global reach**—especially for firms active in cross-border markets, smart-sourcing solutions would enable firms to gain immediate access to a specialized pool of resources with superior expertise and technical knowledge. Allowing vendors to use their own processing system enables them to leverage their network of expertise in different countries, leading to correct and specific solutions.
- **Innovation**—as the process being outsourced is part of the core activities of the smart-sourcer, it will continue developing and improving its services, providing you with innovative solutions that would most likely not have been on your own development agenda.

2.3. When smart-sourcing, do no “micro-outsource”. Think about the global picture.

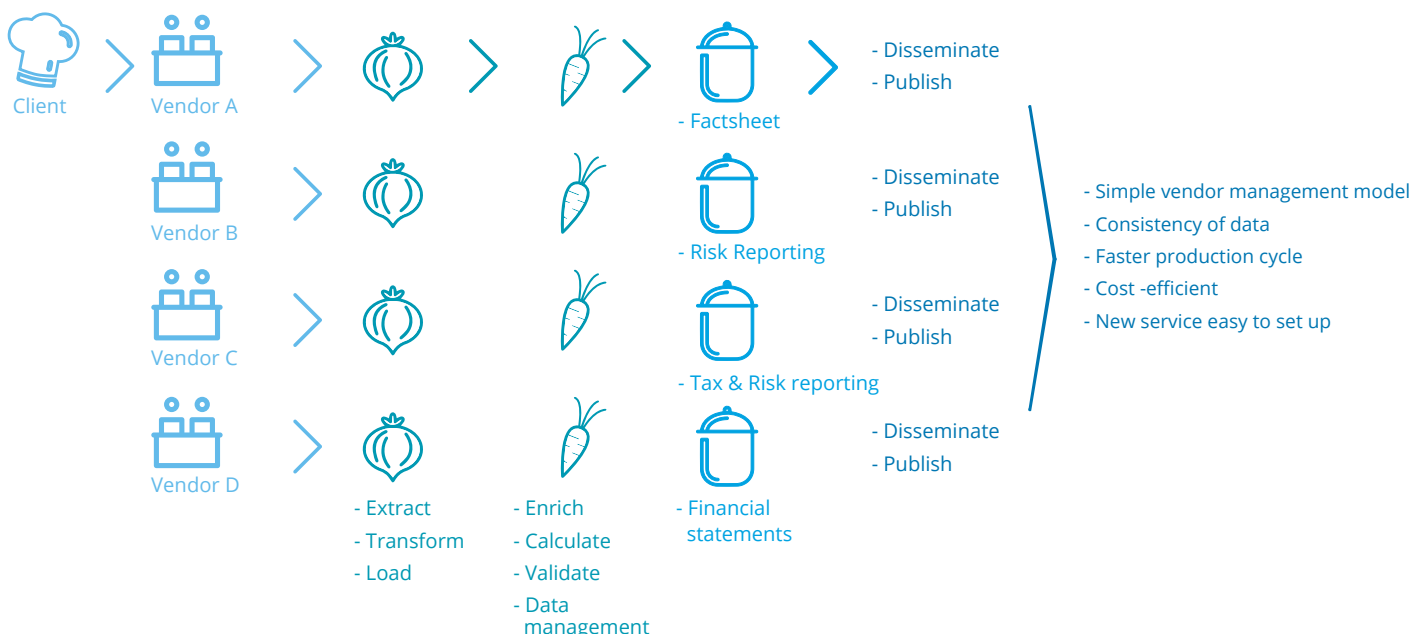
Of course, outsourced processes must not be done independently from the big picture; the overall model must remain coherent and efficient. As a matter of fact, a number of firms address new business challenges (such as a new regulatory reporting requirement) by immediately

outsourcing the issue at hand... and ultimately fail to reap the benefits of smart-sourcing. This type of strategy may lead to immediate pain relief, but does not constitute an effective solution that is sustainable in the long run.

Indeed, we have observed a number of firms that chose to outsource a multitude of problems to a multitude of specialized vendors. The objectives pursued in those cases were to quickly benefit from the expertise of specialised vendors. Such a strategy relying on multiple vendors creates in the long run a very challenging environment where the benefits gained are wiped out by the efforts necessary to coordinate the various service providers. Often, such setups lead to unforeseen delays and suffer from a lack of consistency in terms of quality. This is especially true in cases of high level of inter-dependency between vendors where the mistakes or delays of one vendor can bring the entire system to a halt.

A more effective arrangement is to select a service provider that offers a breadth of activities and skills, acting more as an integrated solution for outsourced services. This significantly cuts down the web of complex relationships to be supervised and synchronized. ➡

Outsourcing to a multitude of vendors inevitably leads to inefficiencies and quality issues



A smart-sourcing model is synergetic by design



In addition, the service provider is tasked to coordinate operations internally, leading to a much more cohesive process, which can often mean the difference between success and failure. Furthermore, the client is also able to receive output that is consistent, and the service vendor is able to take advantage of any synergies that may be present, creating value for both parties.

A concern related to the centralized vendor model is the risk of increased dependency on one external service provider. As the saying goes, "You should always be careful before putting all your eggs in one basket" and this is true; there is certainly a need for caution. However, issues usually only occur due to poor vendor management where there has been a lack of controls implemented at the beginning of the relationship.

2.4. Some risks are inherent in outsourcing and need to be tackled

While smart-sourcing offers numerous advantages transforming the way day-to-day business is conducted at a firm in the Financial Services Industry, it also comes with potential risks and drawbacks. It is worth noting, however, that most of these risks result from poor vendor management and a misalignment of expectations.

While proper management agreements and transparency with your service provider can usually mitigate these risks, there are a few considerations a firm must make before taking the decision to outsource process functions.

- **Control**—arguably, the risk most cited by organizations is the loss of control or visibility in the processes that are outsourced to BPO providers. There may be cases where the service provider carries out processes in a way that is not desired by the client, leading to unfavorable outcomes that the client has no control over without significantly renegotiating the terms of agreements. Quite often, contracts are signed with fixed terms which takes away a level of flexibility from the client if processing volumes change.
- **Dependency**—equally important is the risk of increased dependency on an external service provider. This has become even more relevant due to incoming regulations that make clients liable for the actions of their third-party service providers. Hence, clients must be fully aware of the importance of the functions being outsourced and the risks that this entails.
- **Confidentiality**—loss of confidentiality is also a considerable risk, especially given the regulations and privacy in the financial services sector. This risk also plays a role in the location of outsourcing, for example, keeping the outsourcing within the same country boundaries. Related to this are the considerations that many clients of the firm may not be comfortable with their data being in the hands of a third party and may affect the perception of the firm negatively.
- **Image**—customer perceptions in general pose a significant risk, even without the risk of underlying

confidential data. For many customers, the perception of outsourcing carries negative connotations and can drastically alter their relationships with the firms if the outsourcing relationship becomes public knowledge. In cases where the customer is forced to interact directly with the service provider, it can lead to the rise of potential conflicts or a gap in knowledge which creates a negative perception in the eyes of the customer.

- **Knowledge loss**—another less common risk is the loss of knowledge and expertise that was created by keeping the functions in-house. This is especially true in cases where firms have had successful outsourcing relationships for a few years, where the in-house knowledge of these functions or processes has been eroded over time. Hence, it is important to have a few key stakeholders or knowledge repositories that are capable of having a nuanced view of the outsourcing relationship between vendor and client.
- **Cost**—last, but not least, the business case behind outsourcing business processes may be rendered invalid as firms are unable to realize the cost advantage that was one of the main factors behind the reason to outsource in the first place. This is mainly due to poor management of the vendor relationship but can often be a costly mistake, forcing the firm to backtrack and insource the function back, or spend further resources to find a new service provider.

Last, but not least, the business case behind outsourcing business processes may be rendered invalid as firms are unable to realize the cost advantage that was one of the main factors behind the reason to outsource in the first place.

Key objectives pursued by an effective vendor management function

1. Manage successful completion of transition
2. Ensure service providers' adherence to commitments
3. Manage budgets and unknown costs
4. Control scope through structured processes.
5. Ensure invoicing accuracy.
6. Perform necessary financial planning
7. Ensure improvement by implementing industry leading practices
8. Proactively manage issues, risks and disputes
9. Build vendor governance processes and controls
10. Maintain an independent and unbiased approach to service providers
11. Ensure service providers meet process improvement and innovation expectations
12. Effectively improve collaboration and reduce conflict of interest among service providers

3. Conclusion

Firms operating in the financial services industry are seeing their business models squeezed and profitability pressurized. These challenges are compounded due to many reasons such as the fast-paced changes in client expectations, the complex regulations at local and global levels, the disruption caused by the digital revolution, and lastly, the forces of globalization.

Reducing costs through outsourcing is possible and remains a valid business objective. Nevertheless, this should not be the only motivation for outsourcing.

Financial firms should reject conventional wisdom and use smart-sourcing to delegate non-core but high-value processes while mitigating global compliance risks and reducing costs.

Smart-sourcing definitely offers great opportunities for working more efficiently, proposing innovative services and standing out in the competitive landscape; globalization-driven processes in the fields of tax, compliance, risk management, and regulatory affairs are just a few of those processes ideally positioned to be smart-sourced. ●

From happy hippies to tenacious traders?

Welcome to conscious capitalism

Julie Becker

Head of International
Primary Markets
Member of the Executive
Committee
Luxembourg Stock Exchange

Talk of caring for the environment may have once conjured up images of happy hippies huddled together around a campfire or doggedly scaling tall buildings. But, as green goes mainstream, that image may soon be replaced by... bond traders?

Julien Froumoult

Head of Business Project
Management
Luxembourg Stock Exchange

Chiara Caprioli

Business Development
Manager
Luxembourg Stock Exchange

Pascal Martino

Partner
Deloitte Digital Leader
Deloitte

Louisa Bartolo

Consultant
Technology & Enterprise
Application
Deloitte

When two worlds collide

Next time you're at a dinner table with a mix of traders, financiers and environmental activists and fearing an uncomfortable silence, you may want to turn the conversation to green bonds. First issued by the EIB in 2007, this unconventional—and increasingly promising—financial instrument is emerging as definitive proof that something a little bit magical happens when the worlds of finance and environmental do-gooding collide.

But first, what is a green bond?

There is currently no legal definition of green bonds. A green bond is technically a “private purpose bond,”¹ no different from any other plain bond. It works in much the same way: investors buy the bond from an issuer, and the latter pays investors the principal amount back, plus interest over a set period of time (until the

bond reaches maturity). What makes a green bond distinctive, though, is that it carries with it the promise that the bond's proceeds will be “earmarked”—and go toward projects that have a positive environmental impact.

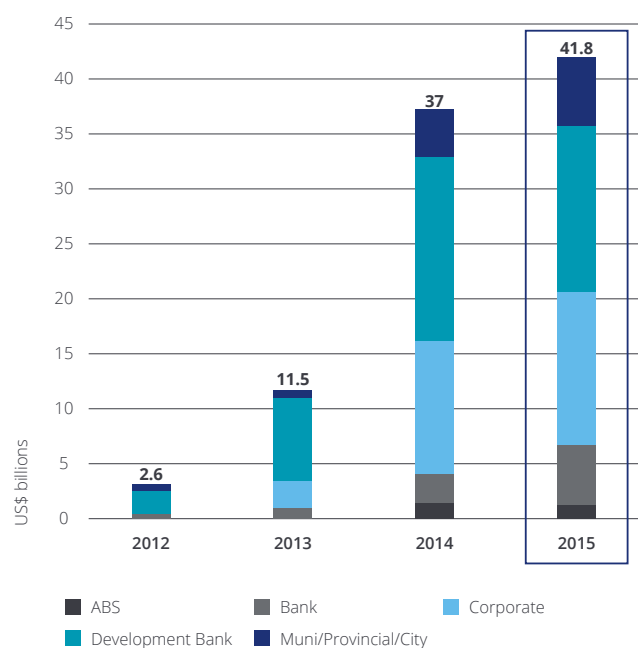
Notwithstanding this widely accepted description of a green bond, the lack of a legal definition means that the market is composed of issuers that are, effectively, self-labelling and self-regulating. Currently, it is issuers themselves who determine if their bonds are green and, by means of the investment information disclosed in the prospectus, how green they are (although many are increasingly turning to second opinions in an effort to reinforce the credibility of their investment statements, satisfy an increasingly demanding investor class and allay fears of “greenwashing”).



Sizing the market

In many ways, the excitement around green bonds is related more to their apparent potential than their current market share. Indeed, to date, the green bonds market is still a very young market in spite of having been launched in 2007. Relative to the fixed income space, outstanding green bonds represent just close to 1 percent of all outstanding bonds. Still, the year-on-year growth of the market has been impressive. With US\$41.8 billion worth of labelled green bonds issued in 2015² and a truly global presence,³ there's certainly cause for enthusiasm. Expected green bond issuance volumes are situated somewhere between US\$50 billion and US\$100 billion in 2016 according to reputable sources such as Bloomberg and Moody's. That's not a small sum. ➤

Annual issuance of green bonds (2012-2015)



Source: Climate Bonds Initiative: 2015 Green Bond Market Roundup

Despite the historic (and continued) importance of multilateral development banks, corporates are a growing class of green bond issuers

To understand the momentum behind green bonds, we need to answer two key questions: first, why is there a move toward funding green projects at all? And, second: why has there been such growth in the climate bonds/green bonds market specifically, versus “traditional” approaches such as public sector funding and bank loans?

1. Why go green?

Business as usual is hurting us

The mammoth global impact of seemingly small changes in temperature can be difficult to fathom, but it is very real. A mere 5 to 6 degrees separate current temperatures from those experienced during the last ice age.⁴ The International Panel on Climate Change (IPCC)’s 2014 report⁵ cites, with varying levels of confidence, population displacement, violent conflict, an undermining of our food and water supplies’ sustainability, and an exacerbation of health problems as among the consequences of global warming.

Although measuring the economic cost of climate change has proven difficult and contentious, a recent study projects that if past adaptive patterns were to be replicated into the future, we can expect that sustained global warming will lead to a drop in average global incomes of approximately 23 percent by 2100 and an exacerbation of global income inequality, as compared to projected scenarios where there is no such climate change.⁶

The private sector is growing increasingly aware of the economic costs of climate change. Unilever’s Chief Executive Officer went on record last year claiming that climate change was setting his company back an astounding €300 million to €400 million a year.⁷

In its 2014 survey of business executives, Deloitte found that, of those operating in emerging markets (in other words, countries disproportionately affected by the ravages of climate change), 72 percent cited “minimizing negative environmental impacts” as an “extremely” or “very important” business concern for them, and 49 percent of their counterparts operating in developed markets said the same.⁸

To a greater or lesser extent, businesses thrive when they have a dependable supply of resources on which to bank, and they can grow and develop when their supply chain is sustainable. Many companies are increasingly finding that hurting the

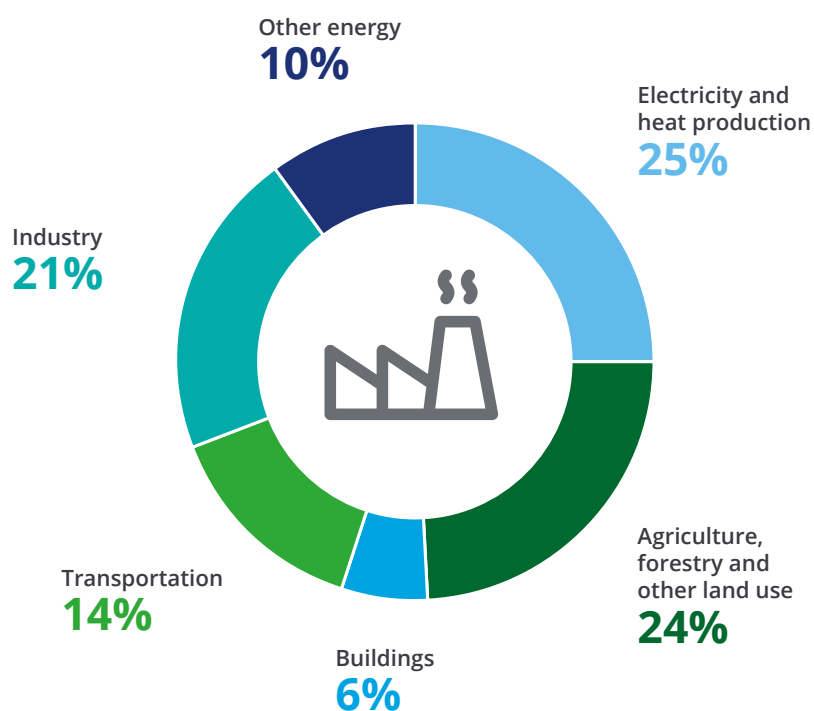
environment also hurts long-term profits and viability. In this regard, it is interesting to note that, despite the historic (and continued) importance of multilateral development banks, corporates are a growing class of green bond issuers.⁹

It pays

The growing acceptance that the economic and non-economic case for departing from “business as usual” is solid has coincided with a greater understanding of the cost and pay-off that comes with getting serious about going green.

Let’s take a quick look at some evidence. As a first step, our evaluation requires appreciating which sectors are the greatest emission offenders. We can then calculate how much investment would be required to make those sectors green(er). The chart below, taken from the IPCC’s 2014 report, makes it clear that the key “culprits,” namely energy, land use, industry and transport, require careful attention.

Global Greenhouse Gas Emissions by Economic Sector



Source: IPCC 2014, cited in United States Environmental Protection Agency (EPA). Global Greenhouse Gas Emissions Data: <http://www3.epa.gov/climatechange/ghgemissions/global.html>

Estimates suggest that transitioning to a green economy in two of the greatest climate-offending sectors, energy and land use, would mean redirecting financing in excess of US\$1 trillion on an annual basis until 2050¹⁰ and that the total investment required in transport, energy and water over the coming decade and a half will reach a whopping US\$93 trillion.¹¹ That's a lot of money.

The good news for low-carbon advocates, though, is that the high cost is not a consequence of going "green." As the OECD notes, the sectors identified above will require major infrastructural investment in the coming years—whether we like it or not—and adopting a low-carbon approach to transport, energy and water infrastructural developments would not significantly increase costs compared to high(er)-carbon alternatives.

Indeed, the report estimates a 4.5 percent higher cost for low-carbon approaches compared to approaches which do not specifically set out to be low-carbon. In other words, the infrastructural investment required in these sectors is high—regardless of the infrastructure's environmental credentials.

As the report correctly points out, the positive impact a low-carbon approach would generate, ranging from human health to traffic management and energy sustainability, would seriously dwarf this 4.5 percent extra expenditure.¹²

To take human health, consider that as of September 2015, WHO projections were estimating that in the period between 2030 and 2050, climate change would cause in the region of 250,000 additional deaths annually, from diseases such as malnutrition, malaria, diarrhea and heat stress.¹³ Although the case to go low carbon is robust, a clear investment gap exists. The Climate Bonds Initiative estimates that there is an annual shortfall of over US\$1 trillion in infrastructural investment and, worse still, that a mere 7 to 13 percent of today's infrastructure projects are considered low carbon and designed in a way that makes them resilient to climate change.¹⁴

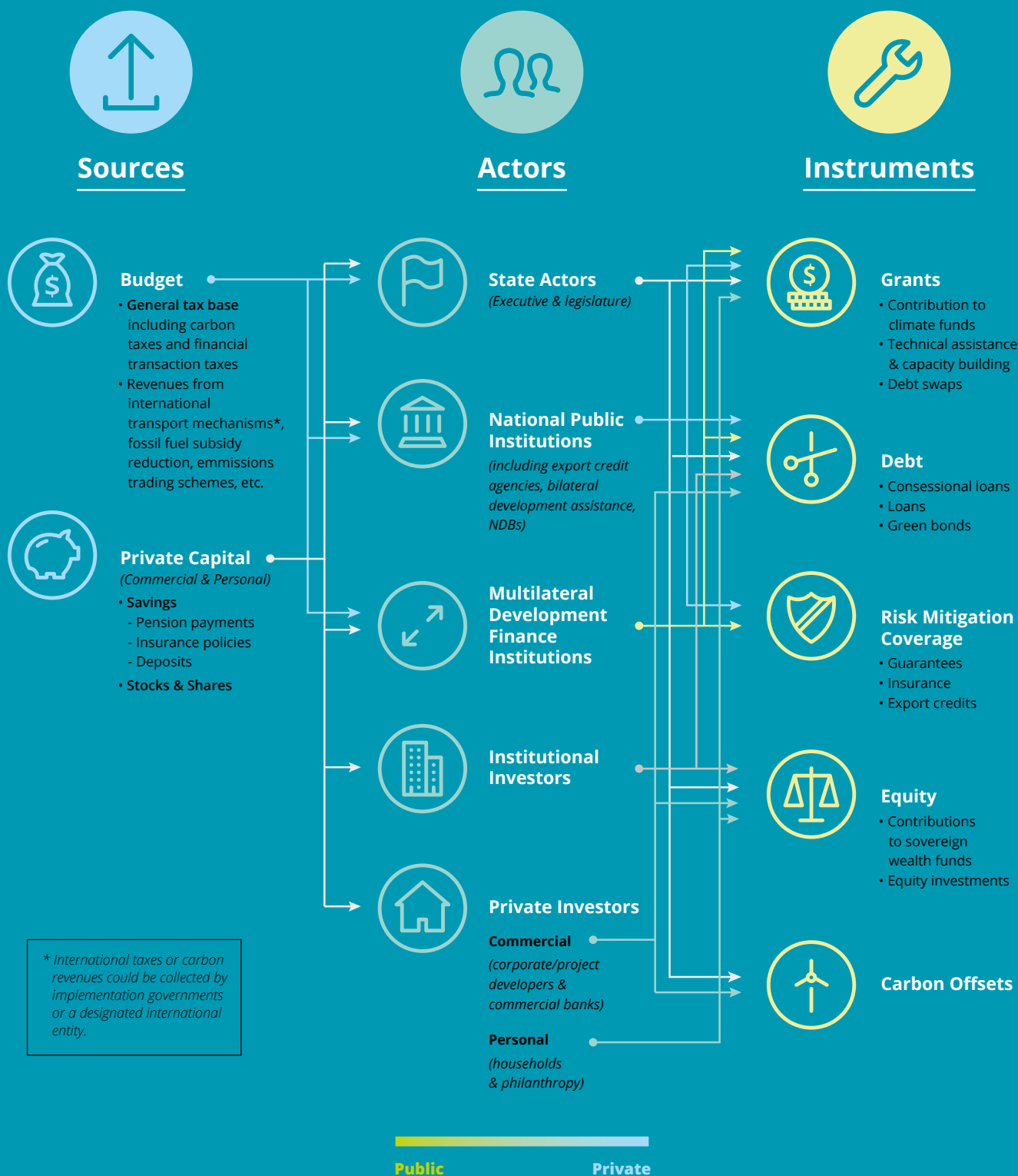


2. Why green bonds? It's the economy!

So, we've identified a clear green investment gap. The question, then, is to understand the drive to "marketize" and bring in private sector investment for what is clearly a public good. The answer is that traditional approaches are increasingly seen as insufficient.¹⁵ Clearly, governments simply do not have the capital required to carry the investment cost alone. Banks, as Deloitte's research has shown, are similarly constrained. Coming to terms with stricter post-crisis lending standards, providing traditional loans to fund major infrastructural projects is challenging.¹⁶ Against this backdrop, there has been a strong push for alternative and innovative financial instruments to support low-carbon projects as well as projects that aim to generate a positive environmental impact, in areas ranging from waste management to water conservation. ➤

The Climate Bonds Initiative estimates that there is an annual shortfall of over US\$1 trillion in infrastructural investment.

Green bonds are just one innovation within the broader “green finance” space



Source: CPI and Cicero (2015) cited in Buchner, B. and Wilkinson, J. 2015. Pros and cons of alternative sources of climate change financing and prospects for 'unconventional finance', Fig.2: The climate finance system in Barrett, S.; Carraro, C.; and de Melo, J. (2015) (eds.) Towards a Workable and Effective Climate Regime, p. 487

One commonly cited concern, for example, is that most projects behind green bonds are actually not new projects, but old projects or projects that would have been funded anyhow.

It is clear that green bonds have emerged as one of these important innovations. As the OECD notes, green bonds are especially valuable as financial instruments. The reason for this is that critical green investment needs, such as infrastructural investment related to the renewable energy sector, are typically amenable to bond financing—combining, as they frequently do, high initial capital costs with long-dated income streams that tend to be inflation-linked.¹⁷

Still, even if we accept the strong economic and non-economic case for green investment wholesale, and the robust argument that bonds are, for a variety of reasons, potentially a good instrument for funding low-carbon infrastructure, it is clear that the demonstrable necessity, even cost-effectiveness, of climate action does not, by itself, generate a market for green bonds. For this, we need to look more closely at issuer and investor incentives in this space.

Issuer incentives

At first glance, it is not clear why there is such a drive among issuers (a population comprising, in order of significance: multilateral development banks, bilateral development and trade agencies,

subnational bodies and cities, energy and utilities companies, corporations and commercial banks)¹⁸ to opt for green bonds. The World Bank¹⁹ suggests that this is something of a long-term strategy, since market trends could see pricing variation emerge in the future, should demand for green bonds continue to grow (there is currently no price advantage for green bonds as compared to regular ones). If that is the case, indications are positive, with the Climate Bonds Initiative's 2015 report citing *"continuously growing investor demand, particularly by institutional investors and corporate treasuries ... shown in oversubscriptions as well as billions in pledges ... [by a range of banks] ... to invest in green bonds."*²⁰

Moreover, as the World Bank notes, green bonds have the advantage of allowing issuers to diversify their investor portfolio. Environmentally conscious investors (forming part of the SRI investor family) are a particular and growing target population that green bonds have allowed issuers to tap into, perhaps for the first time. This enables the growth of economies of scale, which is clearly a financially attractive prospect particularly since, as the OECD notes, the bulk of costs for issuers are the upfront costs of setting up processes.²¹

Green bonds have also served as a communication tool, allowing issuers to show their investors the types of climate project that they are funding, and increase their reputational capital.²² For governments and international development banks, the incentive to demonstrate their green credentials is obvious. But there's an incentive for corporates too (a burgeoning class comprising the green bond issuer community). Earlier in the article, we noted how sustainability is becoming a core business concern. Against this backdrop, as Zurich Insurance Group's Responsible Investment Chief Manuel Lewin pointedly states: *"Issuing a green bond is a signal to the market that here is a company that thinks about risks related to climate change and to other environmental challenges and has a plan for how to tackle them by making investments to address them. This could and should affect the broader assessment of the credit risk of that issuer."*²³

The more skeptical perspective of green bonds as a vehicle for shoring up "reputational capital," of course, is the view of green bond issuance as either a relatively shallow marketing ploy or as an attempt to pour old wine into new bottles. One commonly cited concern, for example, is that most projects behind green bonds are actually not new projects, but old projects or projects that would have been funded anyhow, but that are now increasingly being wrapped up as green. There are also concerns that issuers might be using the green label to gain market attention in the broader corporate bond market, which is developing for reasons that are potentially broader than green finance. These concerns are partly driving the trend we are seeing for increasingly stringent (albeit currently still voluntary) standards and second opinions on the credentials of issues in the green bond space.

Investor incentives

For investors, a range of incentives have been cited. There is some debate, but little in the way of clear evidence, as to whether investing in green bonds is—from a purely financial perspective—preferable to regular vanilla bonds. ➤

So far, the supply of green bonds is not matching the massive demand, and green bonds tend to be largely oversubscribed.

Nevertheless, Bank of America Merrill Lynch has pointed to the fact that the green bonds listed in its index have proven to have a lower credit risk rating and that returns on these bonds show less volatility as compared to their non-green counterparts.²⁴

The OECD²⁵ lists a number of possible investor incentives. In addition to the fact that green bond investments fulfil ESG (Economic and Social Governance) requirements and mandates, the “green” label holds bond issuers to more stringent transparency standards in relation to their use-of-proceeds reporting compared to regular vanilla bonds, and this allows investors to better assess their risk. Another incentive the OECD cites is portfolio diversification: particularly for investors whose portfolio includes a strong focus on carbon-intensive investments, green bonds offer an opportunity to hedge against risk.

Ulrik Ross, Global Head of Public Sector and Sustainable Finance at HSBC, suggests we think of the green investor class as comprising different sub-classes characterized by different “shades of green.” First, there are the “dark green” investors, which tend to be churches, charity foundations, private banks or asset managers serving clients who are strongly committed to socially responsible investing. Ross notes that this group has always placed sustainability at the heart of its investment strategy, but that doing so has been facilitated by the green bond market. A second group of investors have delved into the sustainable investment

space more recently, and will use green bonds to complement their existing investments, as a strategy for diversifying their portfolios in ways that meet their stakeholders’ wishes regarding investing in environmentally responsible causes. Finally, we can find what Ross refers to as an “opportunistic investor group”: a group that will invest based on the credit history of the institution or company, regardless of its green credentials.²⁶

Whichever grade of green they occupy, an interesting trend for a growing number of investors to think differently about their investments—that is, to value sustainability and long-term performance as well as, and perhaps more than, short-term financial gains—has been observed.²⁷ Moreover, Deloitte’s 2016 survey of millennials²⁸ shows that this generation of future leaders and investors care about companies’ triple bottom line and defines success in terms of both profit and purpose.

Whatever is driving it, investor appetite is most definitely growing. Indeed, so far, the supply of green bonds is not matching the massive demand, and green bonds tend to be largely oversubscribed. What’s more, investor appetite is set to expand from institutional investors and pension funds to the whole spectrum of investors including retail, especially if public authorities create appropriate incentives for the asset class.

Although the sector is currently not offering higher returns than non-green bonds of the same grade (green bonds currently price flat on issuance with the issuer’s other debt), they are expected to yield higher returns in a long-term cycle. Also, as the spectrum of investors grows, the market will become more liquid, improving performance on the secondary market (for the time being green bonds trade at a premium on the secondary market up to 20 basis points tighter than conventional bonds, due to high investor demand on supply).

As the market goes mainstream, we expect that financial innovation will bring about product diversification so as to potentially match all risk profiles and investment policies, from green ABS products secured

by long-lived assets, to green covered bonds and green inflation-linked products, to name but a few. These innovations will generate an appetite for green bonds across a wider range of investors with diverse profiles, needs and incentives.

Policy propellants

When it comes to shaping, directing and ultimately activating issuer and investor incentives, the right policy landscape is key. In this respect, the COP21 Paris agreement reached in December 2015 was broadly (though by no means universally) seen as marking an historic shift.²⁹

Its ambitious targets will see pressure mount to implement enabling policies seeking to unlock private sector finance for low-carbon projects. This could be a boon for the green bond market and comes on the back of a policy environment which has, in the last few years, become increasingly favorable to such innovative financial instruments. The EU, for example, has been pushing to move from a grants-based approach—where projects are directly funded by the EU itself without relying on, or generating, additional investment from elsewhere—to an approach where, in collaboration with bilateral and multilateral development banks and local public and private sector players, grants are applied in ways that attract and activate private sector investment in the green space to amplify results.

Between the years 2014 and 2020, the EU has committed to investing €2 billion of grants that are expected to generate €50 billion in investments. The EU has also committed to generating a supply of private finance for funding renewable energy projects via an electrification financing initiative called ElectriFI, for which it will invest €270 million.³⁰

Emerging markets are not wasting any time either. As the Global Climate Initiative notes, last year saw the introduction of a range of policy commitments including inaugural bonds and a green bond framework in China (Goldwind and Agricultural Bank of China) and India (including the likes of Yes Bank, CLP, Export-Import Bank of India, and IDBI).³¹



How green is it really? Getting tough on greenwashing

In disclosure terms, requested prospectus information and ongoing disclosure obligations for green bonds are the same as for any other ordinary bond. Similarly, guarantees on the green use of proceeds, as normally described in the bond documentation, are generally not included as contractual covenants investors can enforce. Instead, they must rely on market reprobation to ensure issuer compliance.

As a result, one concern that is repeatedly raised is the danger of “greenwashing,” which can span from simple breaches of trust to serious green fraud. For us, the prevalence of the term “greenwashing,” reflects the fear that issuers of green bonds will not use bond proceeds in a way that is consistent with the bond’s declared green credentials. The practice—and fear—of greenwashing seriously damages the perceived integrity of the market. When two Forbes contributors angrily proclaimed that *“when greenwashing occurs, we’re all taken to the cleaners,”*³² they were thinking mainly in terms of swindled consumers in the eco-friendly product market. In our context, if you agree that the green bond market is an important element of a broader green strategy (which we do), any undermining of the green bond market as a result of real or perceived greenwashing harms us all.

It’s made more complicated by the fact that even if issuers are not out to dupe investors, the flexible definition of “green” can give rise to controversial uses of proceeds. Just look at the furor raised when it turned out that one of the projects being funded by the Massachusetts State College Building Authority—using money it raised through a green bond—was a multi-story car park for 725 cars³³ and the heated debate over whether an oil company should be allowed to issue green bonds.³⁴

Definitions of “green” are based on a complex and fragmented classification system that will need urgent harmonization to ensure a safe and thriving market. Market practices and related initiatives are pushing in the direction of a harmonized framework and definition of Green Bonds

Principles³⁵ covering the following aspects:

- The guarantee by the issuer of the adequate (i.e., green) use of the proceeds raised by the bond
- The evaluation and validation by the bank in charge of the issuance of the green aspect of the underlying project financed by the bond
- Regular audits on the use of the proceeds (until maturity) and related disclosure/reporting

Control and certification is key in the whole process to ensure that information disclosed by issuers can provide investors and the market with a sufficient level of independent assurance.

Many actors—from banks to auditors—are trying to define the best practices that will be adopted as standards by the market and therefore shape future regulations.

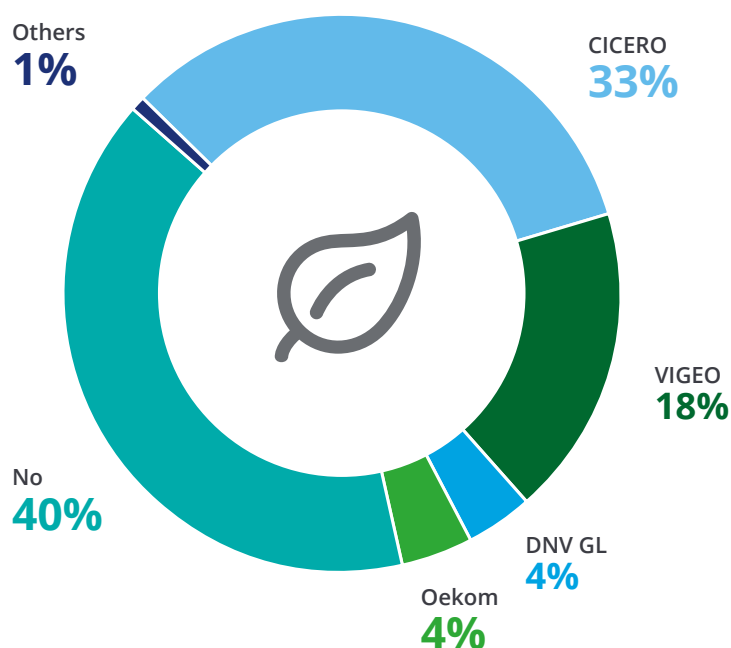
Bridging the trust gap: principles, second opinions and indices

Two main initiatives stand out from the mass of guidance propositions: a group of over 50 large institutions have developed

the Green Bonds Principles and an international non-profit organization—the Climate Bonds Initiative—has proposed Climate Bonds Standards. These lay the foundations for internationally agreed standards that could be adopted to define what can be considered as green, which partly means evaluating whether a project funded by a bond meets certain criteria intended to ensure a positive environmental impact. A report³⁶ included in the broader projects on Greening China’s financial markets also refers to these standards as a “step-by-step” guide to issuing a green bond in China.

Third-party control is required to assure investors that independent compliance assessment with reference to defined rules and criteria is taking place. The drive to ensure investor confidence has given rise to a growing number of second reviewers, who are taken on by issuers to back up their green claims. The big players here are CICERO and VIGEO, and a number of smaller players are now jostling for space in this market. The Climate Bonds Initiative noted that, in 2015, 60 percent of all green bonds came with this “second opinion” assurance.

Third-party control of green bonds



Source: Bonds and Climate Change: The State of the Market in 2015, p.11



The Climate Bonds Standards Board has approved a list of verifiers issuers can contact if they wish to have a “climate bond” checked and formally certified; issuers subsequently receive a formal assurance report based on developed and vetted standards. This remains, however, a voluntary process for issuers.

A revised version of those standards is expected in 2016 covering in particular the special status that could be given to “pure-green” companies to facilitate green bond issuance.

Yet, even if pre- and post-issuance controls exist, there are no clear and standardized criteria to validate a bond as green, and the scope for interpretation is wide. Moreover, the move from national references to an international (even supranational) approach is unlikely to happen overnight: there are currently upwards of 400 different standards in existence.³⁷

Faced with such a rapidly evolving environment, the market has started to self-regulate both on product structuring—the issuance process—and the qualification of the green aspect of the project behind such bonds. In France, the issuance of a green bond by EDF in 2014 paved the way for defining a framework for the use of proceeds and became a reference for

subsequent green bonds. The same was true for Sweden with the Gothenburg Municipal Green Bond.

Despite all the efforts made so far, extra-financial ratings agencies remain critical with regard to the way financial institutions communicate their green funding and investment product ranges. Common reporting standards would allow a transition from marketing-only communication to transparent disclosure of the issuer’s approach to managing and tracking green bond proceeds and to monitoring the environmental impact of the funded projects.

While such initiatives certainly support the booming development of green bonds, only independent, accepted and international/supranational standards would guarantee the certification of some bonds as green and their recognition by all (investors, financial institutions and supervisors) as such.

In the rush to define convergent standards, however, we need to ensure that those standards are not so onerous as to crowd out issuers, particularly in light of the existing issuance gap. Currently, issuance costs under the best disclosure practices are far too high for infrequent issuers. The industry is considering how

to improve standards (taxonomy, use and management of proceeds, financial and impact reporting, assurance/second opinions, etc.) without jeopardizing the market and limiting access for non-recurrent issuers. So while stringent standards are necessary, it is expected that the criteria will remain holistic rather than prescriptive and that investors will continue to carry the onus to perform their due diligence and assess whether the green value of the bond is in line with their environmental and performance objectives.

Finally, an interesting trend witnessed over the last few years has been the creation by a number of different players, including ratings agencies and financial institutions, of indices to rate different green bond issuers. Among these are the Solactive Green Bond Index, the S&P Green Bond Index and S&P Green Bond Project Index, Bank of America Merrill Lynch Green Bond Index and MSCI Barclays Green Bond Index. Though still nascent, the trend toward green bond indices demonstrates the growing significance of the green bond market, its dynamism—and the demand among investors and potential investors for reliable information to facilitate decision making.

Luxembourg stock exchange: our role as we see it

In a context where standards are very likely to remain open, even if better defined, transparency will be paramount: that is where stock exchanges will have to play a fundamental role in enabling markets to trust particular products.

At this stage, we see our mission as threefold. First, pushing for transparency and disclosure; second, actively supporting the development of industry standards, and, third, accelerating market developments. ➔



1. Transparency and disclosure in a complex market with multiple approaches

In the aftermath of COP21, policy makers have indicated that they will increasingly dedicate specific attention to transparency, accountability and compliance. In relation to transparency, we strongly believe that voluntary best practice will need to be defined with more granularity and be based on an industry agreement on definitions, in order for these to serve as

a baseline against which environmental performance and comparability can be tracked and measured. We understand the market is likely to remain self-regulated for a while, which will have the advantage of allowing for an open approach that gives green bond issuers a certain flexibility in the labelling of their green products, but industry, and stock exchanges in particular, should carefully balance this flexibility against investors' trust. Otherwise, this flexibility will be at risk of jeopardizing the

whole asset class, not least the issuers themselves. Our own reputation for high-quality and stringent standards will need to be proved in this unique new market context. Appropriate disclosure will need to be matched by further convergence of minimum common standards to allow, among other things, for product and performance comparability. What we predict is that the ultimate onus, even under more stringent standards to come, is likely to continue to be on investors, who will be obliged to perform their due diligence (sometimes having to rely on the advice of specialized agencies) according to their specific investment goals.

2. Actively supporting the development of standards

A stock exchange's role, nowadays, is more than facilitating dialogue between issuers and investors. Exchanges have a responsibility to establish sound capital markets and can extend their role into capacity building and educating market participants. This is why we are taking an active role with some of the most relevant constituencies, such as the Sustainability Working Group within the WFE (World Federation of Exchanges), the Sustainable Stock Exchanges Initiative (SSE) under the auspices of the UN and the Green Bond Principles (GPB) group in

1. See article by Philippe THOMAS "Nature juridique des green bonds", *Revue de Droit Bancaire et Financier*, December 2015
2. Climate Bonds Initiative 2015. "2015 Green Bond Market Roundup," <http://www.climatebonds.net/files/files/2015%20GB%20Market%20Roundup%2003A.pdf>
3. Ross, U. 2015. "Green Bond Drivers" HSBC: <http://www.gbm.hsbc.com/insights/responsible-business/green-bond-drivers>
4. See McGrath, M. 2015. "COP21: Why do two degrees matter?" BBC News (25/11/15). Available at: <http://www.bbc.com/news/science-environment-34920941>
5. See high level findings here: http://www.ipcc.ch/report/ar5/wg2/docs/WGIIAR5_SPM_Top_Level_Findings.pdf
6. Burke, M.; Hsiang, S.M.; Miguel, E. 2015. "Global non-linear effect of temperature on economic production" *Nature* 527, 235-239 (12 November 2015) doi: 10.1038/nature15725. Available at: <http://www.nature.com/nature/journal/v527/n7577/full/nature15725.html#access>
7. Harrabin, R. 2015. "Unilever boss urges world leaders to reduce carbon output" BBC News (18/05/15). Available at: <http://www.bbc.com/news/business-32740359>
8. Evans, R.; Siesfeld, T. 2014. "Business and Social Impact: Business Trends 2014" Deloitte University Press. Available at: <http://dupress.com/articles/business-trends-2014-business-social-impact/>
9. See: <http://www.worldbank.org/en/topic/climatechange/brief/green-bonds-climate-finance>
10. Steiner, A. 2015. Climate Financing Speech by Achim Steiner, UNEP Executive Director EU Informal Council of Environment Ministers, Luxembourg. UNEP News Centre (22/07/15). Available at: <http://www.unep.org/newscentre/Default.aspx?ArticleID=35272&DocumentID=26831>
11. OECD 2015. "Green bonds: Mobilising the debt capital markets for a low-carbon transition" Policy Perspectives citing research by New Climate Economy (2014)
12. OECD 2015. "Green bonds: Mobilising the debt capital markets for a low-carbon transition" Policy Perspectives, p. 2
13. World Health Organization (Media Centre) 2015. "Factsheet n°266: Climate change and health" (Updated September 2015). Available at: <http://www.who.int/mediacentre/factsheets/fs266/en/>
14. Climate Bonds Initiative 2015. "Scaling up the Green Bonds Market for Sustainable Development" Available at: <http://www.climatebonds.net/files/files/Guide%2030Nov15%20FINAL.pdf>
15. Climate Bonds Initiative "Scaling up green bond markets for sustainable development: An Executive Briefing for the public sector to stimulate private sector market development for green bonds" Available at: <http://www.climatebonds.net/files/files/Guide%2030Nov15%20FINAL.pdf>, p.2
16. See: <http://www2.deloitte.com/za/en/pages/finance/articles/project-bonds-an-alternative-to-financing-infrastructure-projects.html>
17. OECD 2015. "Green bonds: Mobilising the debt capital markets for a low-carbon transition" Policy Perspectives, p. 3
18. World Bank Green Bonds, "How has the profile of issuers changed?" <http://treasury.worldbank.org/cmd/htm/Chapter-2-Issuer-Profile.html>

Initiatives to make the green bond market more attractive are flourishing throughout financial centers.

order to anticipate appropriate guidance and innovation. We have been pioneers of the industry, admitting the EIB's first ever carbon awareness bond, which launched the market in 2007, and see ourselves as having a role within the setting of standards before the market becomes mature or regulated. Although it is premature to anticipate how disclosure will evolve in the interests of investors without discouraging issuers, we are closely monitoring industry developments and pragmatically seeking out reasonable solutions to be implemented in a swift way based on evolving market needs.

3. Accelerating market developments

Considering the supply shortage, our role is to encourage new issuance, especially of high-quality green bonds. There are in fact now only a limited number of green bonds that fully commit to all four pillars of the GBPs (use of proceeds, project eligibility, management of proceeds,

reporting and third-party assurance). Having an active secondary market will also help boost liquidity in this segment as the market grows.

Initiatives to make the green bond market more attractive are flourishing throughout financial centers. Luxembourg's agile attitude, including the proactive alignment of institutions and industry participants and the ability to attract skilled workers to new growing areas of business, will certainly translate into a sophisticated climate finance toolkit as the market matures. In this context, our stock exchange is likely to play a pivotal role, incentivizing disclosure and creating substance out of broad, high-level principles.

The future looks green

Looking ahead, what can we expect? Available indications suggest that green bonds are not a passing fad. If anything, current demand is far outstripping supply—so we should expect more market growth. Perhaps as exciting as the growth in the green bond market is its evolution: the continued definition of standards, second opinions and associated indices.

There are growing signs that supranational regulation and standardization is on the horizon. It's a development suggesting

that issuing and investing in green bonds has gone far beyond a pure marketing ploy. That is likely to have implications beyond the green space. The ESG market is still under-developed in this respect, and trust in it has suffered as a result. We anticipate further development of the broader ESG market in line with the green bond market's evolution: stringent standards, external reviews and growing credibility.

The current open market approach, which allows many shades of green to intermingle, is likely to be sustained—but is not without its challenges, and these will need to be managed carefully. Finally, as the industry opens itself up to more and more players, it will be critical to ensure that there is a “chorus approach”—and that their activities in this space reinforce a common set of principle and standards. A failure to do so risks undermining the entire market.

Either way, next time you're at a dinner table with a mix of traders, financiers and environmental activists, there is no danger of any awkward silences. ●

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19. World Bank Green Bonds: <http://treasury.worldbank.org/cmd/htm/Chapter-3-Benefits-and-Potential.html>
 20. Climate Bonds Initiative 2015. “2015 Green Bond Market Roundup” <http://www.climatebonds.net/files/files/2015%20GB%20Market%20Roundup%2003A.pdf>
 21. OECD 2015. “Green bonds: Mobilising the debt capital markets for a low-carbon transition” Policy Perspectives, p. 11
 22. World Bank Green Bonds: <http://treasury.worldbank.org/cmd/htm/Chapter-3-Benefits-and-Potential.html>
 23. Cited in Snowden, C. 2015. “Green Bonds Survey: What investors want” <http://www.euromoney.com/Article/3491829/Green-Bonds-Survey-What-investors-want.html>
 24. Ma, B. 2014. “Green Bonds. Financing a Healthier Planet. BofA Merrill Lynch Global Research” (Recorded on 17 December 2014): <https://mlaem.fs.ml.com/content/dam/ML/Articles/pdf/transcript-the-greening-of-the-bond-market.pdf>
 25. OECD 2015. “Green bonds: Mobilising the debt capital markets for a low-carbon transition” Policy Perspectives, p. 11
 26. Ross, U. 2015. “Green Bond Drivers” HSBC: <http://www.gbm.hsbc.com/insights/responsible-business/green-bond-drivers>
 27. For interesting reading around this topic, see “Focusing Capital on the Long Term” <http://www.fclt.org/en/ourthinking/ourthinking/Aroadmapforfocusingcapitalonthelongterm.html>
 28. Check it out here: <http://www2.deloitte.com/content/dam/Deloitte/at/Documents/human-capital/millennial-innovation-survey-2016.pdf>
 29. See, for example McGrath, M. 2015. “Has history been made at COP21?” BBC News (12 December 2015). Available at: <http://www.bbc.com/news/science-environment-35085758>; Sinha, A. 2015. “COP21: History made in Paris, world reaches deal to save Earth” The Indian Express (13 December 2015). Available at: <http://indianexpress.com/article/world/world-news/paris-climate-talks-nearly-200-nations-ink-deal-to-slow-global-warming/>; Dokoupil, T.; Chuck, E. 2015. “World leaders in Paris agree to ‘historic’ deal on climate change” NBC
 30. See: http://ec.europa.eu/economy_finance/articles/international/2015-10-09_climate_finance_en.htm
 31. Climate Bonds Initiative 2015. “2015 Green Bond Market Roundup” <http://www.climatebonds.net/files/files/2015%20GB%20Market%20Roundup%2003A.pdf>
 32. See: <http://www.forbes.com/sites/realspin/2012/03/20/greenwashing-deceptive-business-claims-of-eco-friendliness/#3493dae558b1>
 33. See: <http://www.climatechangenews.com/2015/01/13/green-bond-to-fund-multi-storey-car-park/>
 34. See, for example: <http://www.corporateknights.com/channels/responsible-investing/thai-oil-company-allowed-issue-green-bond-14258969/>
 35. See: “Green Bonds Principles, 2014, Voluntary Process Guidelines for Issuing Green Bonds”, 13 January 2014 (ICMA)
 36. Climate Bonds Initiative “How to issue a Green Bond in China” <https://www.climatebonds.net/files/files/How-to%20GreenBonds%20China.pdf>
 37. European Union Financial Services Committee (23 October 2015): FSC Issues Note: “The financial sector and climate change”, p.5.

Money makes the world go around—or does it?

Why CSR is no longer just an option and how to make the most of it

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& Corporate Finance
Deloitte

In 1970, renowned economist, Milton Friedman, wrote: “*The social responsibility of business is to increase its profits,*” suggesting that corporate directors are accountable only to their shareholders, and only on financial metrics. Since then, however, a fundamental paradigm shift has occurred, and Corporate Social Responsibility (CSR), which the European Commission defines as “*a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis,*” is moving to the top of board agendas.

An advert by Colgate during this year’s Super Bowl powerfully emphasized how companies are becoming increasingly concerned about social impact. Colgate, rather than advertising its product, chose to spend 30 seconds of advertising time during the 2016 Super Bowl—estimated to cost around US\$5 million—to tell viewers to save water, spreading a socially conscious message.

Does this evolution mean that Milton Friedman was wrong with his statement? Well, yes and no. This article outlines why companies need to care about more than just financial impact, negating Friedman’s statement, but also that profit and CSR do not need to be mutually exclusive, nor competing concepts. Moreover, CSR strategy can directly contribute to profits by encouraging revenue growth through the Five P marketing mix (Product, Place,

Promotion, Price, People) and driving efficiency gains such that we may rephrase Friedman’s statement to assert that the social responsibility of business can increase its profits.

CSR is no longer just an option for companies

The financial crisis and the stock market crash in 2008 sparked the view among many that stock prices are no longer sufficiently reliable indicators of sustainable business and management performance¹, reflecting short-term results rather than long term viability of companies. Confidence in banks and the financial markets in particular, but also in other corporations, plummeted and ignited public pressure on companies to reconsider their management approach, and monitor and improve their social impact as a result of the financial crisis.



This phenomenon has been accelerated through digitalization and social media, which facilitate information exchange. Nowadays, even just a handful of customers are able to generate severe consequences for companies. A poor performance in terms of sustainability is quickly noted and can attract scorn in social media, creating significant negative impacts on the business, which can include loss of customers and difficulty to attract talent.

Furthermore, certain companies are faced with legal obligations as the European Commission and national governments reinforce their efforts to encourage sustainable business behavior by increasing regulatory requirements; these include the EU directive on the disclosure of non-financial and diversity information by certain large undertakings and groups (Directive 2014/95/EU), which will require larger companies² to issue a non-financial statement disclosing information regarding their environmental, social and employee-related impact from 2017 onwards at a European level, as well as the Grenelle II Act in France and the Sustainable Economy Law in Spain.

But companies are still confusing CSR with philanthropy, missing out on strategic opportunities for value creation

So companies no longer have a choice, they need to engage in CSR; however, CSR can take a variety of shapes and forms. For example, a recent study carried out by the Boston Consulting Group shows that a large number of companies engage in some sort of CSR activity—mainly philanthropy. While these companies do give back to society, they are unable to realize a number of opportunities to create true added value for society and the company. At the same time, others engage in “propaganda”: communicating on social impact and sustainability without creating any real value.

This approach needs to change, as best practice examples show. Philanthropy and communication can constitute a part of a CSR program, but trailblazing companies are actually capitalizing on their existing resources and core capabilities to create an environmental or social impact. Through these CSR strategies, they can actually create financial value in a way that is already traditionally taken into account by the market—through growth and return on capital. ➤

1. Why Companies Can No Longer Afford to Ignore Their Social Responsibilities, Knowledge at Wharton 2012.
2. Defined as public interest entities exceeding on their balance sheet dates the criterion of the average number of 500 employees during the financial year.

How can a CSR strategy based on core capabilities and existing resources be developed?

Phases of CSR-Strategy selection



If a company wishes to craft a CSR strategy based on core capabilities and create the maximum added value for society and the environment, but also for its own purposes, it needs to follow a structured approach, starting with a detailed preparation phase. This preparatory phase should incorporate an analysis of the current strategy and business model of the company, including its core capabilities and the supply chain, as well as the most important environmental and societal challenges.

In the subsequent strategic analysis phase, a mapping of core capabilities with current environmental and social challenges allows the identification of activities that will generate the most added value for both society at large and the company in particular. Combining this with the strategic objectives of the firm will allow executives to design an appropriate CSR strategy in the selection phase, before proceeding to implementation.

A well-crafted CSR strategy requires a company to reconsider its entire supply and distribution chain, and to identify possibilities for positive social or environmental impact.

Social impact and sustainability contribute to profits by encouraging revenue growth through the Five Ps of the marketing mix and driving efficiency gains

A CSR strategy that is based on core capabilities, will create significant opportunities and can generate added value beyond mere compliance for companies. A well-crafted CSR strategy contributes directly to generating profits by

1. Encouraging revenue growth through contributing to the Five Ps of the Marketing Mix,
2. Driving efficiency gains.

So let's have a closer look at these business benefits!

1. Encouraging revenue growth through contributing to the Five Ps of the marketing mix

Social impact and sustainability can have a positive effect on each of the five dimensions of the Five Ps marketing mix:

- Products
- Place
- Promotion
- Price
- People

Products: An in-depth analysis of societal and environmental challenges combined with a mapping of company strategy and objectives encourages innovation and allows the development of new products.

A company developing a well-crafted strategy for sustainability and social impact will need to analyze societal and environmental challenges in detail and compare these with the core capabilities and strategic objectives of the company. This will create partnering opportunities, which create value for both the company and society, rather than just philanthropic activities or propaganda.

This process will help companies to better understand customers and identify currently underserved needs. The identification of these underserved needs leads to innovation and market opportunities.

A key example of a company that has been able to capitalize on its CSR strategy and engage in product innovation is Vodafone. Vodafone's M-Pesa product, which generated significant social impact, has also become the worldwide largest mobile payment service and helped Vodafone to diversify its product portfolio from pure telecommunications to include operations typically associated with the banking sector.

Place: Identifying new distribution channels to access new customers and disposing of inefficient or costly channels.

The Vodafone case study also highlights the opportunities that CSR can generate in terms of product distribution. Although it initially capitalized on its existing network of vendors, Vodafone was able to develop a much larger network of individual vendors through M-Pesa, eventually reaching a much larger part of the Kenyan population than before and consequently being able to access new customers.

A well-crafted CSR strategy requires a company to reconsider its entire supply and distribution chain, and to identify possibilities for positive social or environmental impact. This in-depth analysis allows the company to identify new innovative distribution channels and dispose of costly, less efficient channels, all while having a positive social or environmental impact.

Promotion: Communication on social and environmental impact has a multitude of benefits.

In terms of promotion, CSR can have two key benefits. Firstly, a stringent CSR strategy will allow a company to actively communicate about it and engage in credible cause marketing, which can have significant benefits for a company. ➤



Case Study: Vodafone— business model innovation through CSR

In 2004, Vodafone carried out a study on CSR, which showed that information and communication technologies were one of the main tools in combating social and economic challenges in third world countries. The CSR team subsequently decided to reflect upon CSR initiatives that Vodafone could undertake in this area.

The CSR team leader, Nick Hughes, proposed a concept using Vodafone's existing mobile network in Kenya to provide a mobile payment solution called M-Pesa to a largely unbanked population. Initially, the board, which was preparing the launch of 3G at the time, did not support the project. Hughes believed in his project, however, and obtained almost £1,000,000 in funding from the UK Government's Challenge Fund, which covered 50 percent of his capital requirements. Returning to the CFO of Vodafone with this backing, he was more successful. Vodafone's CFO now supported Hughes' project, recognizing its potential business benefits.

M-Pesa was launched as a pilot product in Kenya through Vodafone's subsidiary Safaricom in 2007 and allowed Kenyans to deposit, withdraw and transfer money using mobile phones. M-Pesa provides payment services to a largely unbanked population in developing countries.

A market study carried out by Safaricom shows that Kenyans identify the following as the main positive social impacts: increased personal savings due to less money being lost to theft, increased convenience and reduced transaction costs when sending money, reduced

travel costs when receiving money through M-Pesa and increased access to funds, especially in remote locations.

Within three years of its launch, M-Pesa had more than 10 million users and supported transactions amounting to US\$375 million every month. In 2013, the Economist reported that 25 percent of Kenya's GDP flowed through M-Pesa.

M-Pesa was able to generate business benefits beyond returns for Vodafone and the product has been internationally rolled out in other countries, such as India and South Africa. Some of the tangible benefits M-Pesa generated for Vodafone are:

- **New profits:** Safaricom, Vodafone's subsidiary, reported a record profit of approximately US\$315 million. M-Pesa was the key driver in revenue growth, contributing 20 percent of revenues in 2015.
- **New customers:** Vodafone was able to gain new customers through its M-Pesa offering, which attracted a great following, especially as network effects started to materialize with increasing market penetration.
- **Long-term customer loyalty:** M-Pesa is credited with reducing churn rates and binding customers to Safaricom in the long term. In 2011, Kenya introduced mobile number portability and Safaricom was concerned it might lose up to 1 million customers. In reality they lost only 30,000—research carried out by the independent research institute CGAP shows that attachment to M-Pesa was the main reason for this.



Besides workforce efficiency, operational efficiency is also one of the elements that can be significantly improved through CSR measures.

Examples of the benefits of communicating about a CSR strategy include increased customer identification with the brand, customer loyalty and brand perception, share of wallet and buy willingness³. A study carried out by a market research institute in Canada in 2014 showed that 84 percent of people interviewed stated that—if price and quality were similar—they would switch to a brand that is affiliated with a good cause.

The second benefit of a CSR strategy with a real environmental or social impact is that it may generate promotion by customers themselves through word of mouth or the viral effect of campaigns: convinced cause supporters share the message, allowing companies to engage in less costly promotion and reach new customers.

Price: Price premiums for social or environmental impact coupled with increased efficiency can drive margins.

An effective CSR strategy may also be beneficial for companies' margins. The Canadian study shows that the affiliation of a product with a cause is important for customers and can constitute a decisive buying factor if the price and quality are similar.

Moreover, times are changing and customers may actually be willing to pay more for companies with a positive social or environmental impact. Following a study carried out by Nielsen in 2014, more than 50 percent of online customers are willing to pay higher prices for a company with a positive social or environmental impact⁴, allowing companies to generate a price premium and higher margins as a result. This finding was confirmed by a study carried out by the Tuck School at Dartmouth, which found that a 1-unit improvement in social and environmental impact (proxies for this were fair employee treatment and local sourcing) was able to generate a price premium of between 12–16 percent compared to the original price⁵.

The food and beverages industry is currently one of the leading industries when it comes to making customers pay for social and environmental impact, with companies such as Exki, KZ Noir and Starbucks being able to set significantly higher prices; however, other industries are following suit and capitalizing on their social impact (e.g. Fairtrade) to set higher prices and generate higher margins.

People: In the marketing mix, people are the last of the Five Ps and an essential embodiment of the product. Staff should be able to identify with the brand, the product and the company in order to be able to deliver the best possible customer service, and support the four Ps outlined above.

While the link between CSR and the “People” factor may not seem obvious at first, recent research has shown that employees are highly motivated when working for a company that is considered to have a positive social or environmental impact and are consequently likely to perform better.

Furthermore, studies also show that there is a strong link between a CSR strategy perceived as being successful and the identification of employees with the company through perceived external prestige (PEP)⁶. A company can therefore

take advantage of a well-defined CSR strategy to create true brand ambassadors, who are proud of their company, and thus increase the potential for superior customer service.

2. Driving efficiency gains

While the contribution of CSR to the Five Ps allows companies to support revenue growth, CSR can also lead to significant efficiency gains. The main sources of such gains are linked to the efficiency of the workforce and existing operations. The motivational aspect and the influence of PEP on employee motivation discussed earlier have been shown to have a positive effect on employee turnover. In particular for larger companies, which tend to invest large amounts in recruitment and retention⁷, reducing employee turnover through effective CSR measures can lead to cost reduction in terms of recruitment and training of new staff, and improving workforce efficiency.

Besides workforce efficiency, operational efficiency is also one of the elements that can be significantly improved through CSR measures. Although this often involves a large up-front capital investment to increase operational efficiency through measures such as reducing energy use, improving processes and changing packaging practices, subsequent cost savings can represent an advantage for companies. This effect will be compounded in the future as resource scarcity intensifies and resource costs increase.

CSR is an opportunity for companies: they just need to seize it

In conclusion, CSR is no longer something boards can neglect, but has become a must. However, this challenge—like all challenges—represents an opportunity for those companies that embrace it and try to devise creative strategies to implement it.

In the long term, the companies that consider their social and environmental impact in building their corporate strategy will have an advantage. They will be able to benefit from growing revenues and increased efficiency to create a sustainable future. ●



Case Study: EXKI— recruiting with sustainability

EXKI, a Belgian quick service restaurant chain founded in 2000, has put social and environmental impact at the center of its strategy. The four sustainability cornerstones of EXKI's strategy are:

- 1. Health:** EXKI communicates to consumers that it favors natural, additive-free, local and seasonal products.
- 2. Environment:** EXKI communicates extensively on its sustainability measures, such as eco-friendly packaging, restaurants within reach of public transport and loyalty cards that reward sustainable behavior.
- 3. Work:** EXKI specifies the measures it takes to encourage staff development and training.

4. Partnership: EXKI has created partnerships with other companies to optimize its environmental and social impact (e.g. Deloitte).

The company actively uses its CSR efforts to promote the brand. For example, the company offers a so-called "Green Card", which is a loyalty card that also rewards sustainable behavior of consumers, and charges premium prices for its organic produce.

EXKI furthermore capitalizes on its positive social and environmental impact to recruit its staff. Open positions are systematically advertised with the slogan "Are you looking for a sustainable job?"

3. e.g. Wu and Wang (2014): Impact of CSR Perception on Brand Image, Brand Attitude and Buying Willingness: A Study of a Global Café
4. <http://www.nielsen.com/us/en/press-room/2014/global-consumers-are-willing-to-put-their-money-where-their-heart-is.html>
5. <http://adage.com/article/cmo-strategy/corporate-social-responsibility-build-customer-loyalty/227729/>
6. Kim, Lee, Lee, Kim (2010), Corporate Social Responsibility and Employee Company Identification
7. <http://www.forbes.com/sites/insead/2013/08/14/when-it-comes-to-csr-size-matters/#5f0635dc1b6f>

Social impact corner

Gates Strategy Officer on the evolving philanthropic space

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Deloitte caught up with Gates Strategy Officer **Skye Gilbert** to talk about the growing role of business in philanthropy and the importance of balancing the drive for metrics with a focus on deep and rich contextual understanding.

Much has been written about the difference between philanthropy and charity—where do you see the most significant differences between the two? And do you consider them to be important differences?

On the difference between philanthropy and charity, the most elegant statement I've heard is, *"Charity is the act of providing fish to a hungry man; philanthropy is the act of teaching that man how to fish."* Both charity and philanthropy have a critical role to play in the development space, and are most effective when they happen together. Charity alone creates dependency which, over time, can become disempowering rather than helpful. If someone is giving you a fish every day, there's a danger that you'll start to believe either that you aren't capable of learning how to fish, or that you deserve the fish that you are given and never need to learn to fish.

I don't often come across articles talking about the danger of philanthropy by itself, but it's no accident that effective philanthropic interventions are difficult to scale. Atul Gawande's *Slow Ideas*¹ notes that anesthesia spread in years while sterilization took decades; though the latter saved far more lives, the former alleviated human suffering. If there was a way to bundle sterilization and anesthesia, think of how much faster sterilization would have spread and how



many more lives could have been saved. If you fed people before teaching them how to fish, think of how much easier it would be for them to learn.

Knowing the conceptual difference between philanthropy and charity is critical, to ensure that you have the right mix of both when trying to help a population in need. Understanding a beneficiary's state of mind, and alleviating acute suffering, are important charitable contributions to more ambitious philanthropic aims.

What role are businesses playing in the evolving philanthropic space—and where do you think their role is most valuable?

I am excited by the many creative ways businesses are engaging in the philanthropic sector. A growing cohort of social entrepreneurs, with

As a paying customer, the beneficiary has more influence on the business that is trying to benefit her, and that's a good thing.

philanthropic missions and profitable unit economics, has been challenging the status quo in both the start-up and philanthropic spaces. Scale continues to be a challenge, but by moving toward a self-sustaining model, these businesses are doing two powerful things: increasing the amount of global capital that is allocated to philanthropic mission-based work, and in some cases, changing the beneficiary relationship to one where the beneficiary is also a paying customer. As a paying customer, the beneficiary has more influence on the business that is trying to benefit her, and that's a good thing. Traditional businesses are also increasingly involved. As growth opportunities dwindle in established

markets, I am seeing renewed effort to create value for increasingly remote, low-income populations. Established companies are uniquely positioned to solve some of the most intractable problems in philanthropy. They often have larger, more diverse R&D units, and as long as their portfolio is sufficiently diversified, they can tolerate longer timelines to profitability for specific projects.

But perhaps the most powerful, game-changing moment will be when increasing numbers of large businesses embrace the "do no harm" tenet, even if it conflicts with their bottom line. This is already a major theme in some countries and businesses, but in my work I continue to see factory pollution making fields impossible to farm, junior staff only receiving a portion of the income they are getting on paper (the rest being skimmed by middle management), or a child growing sick after touching a needle that a hospital disposed of improperly. Leaders could ask hard questions about their operations more systematically, and pro-actively manage the negative externalities that disproportionately affect marginalized communities.

As different players in the philanthropic space come under increased pressure to demonstrate the impact of the work they are doing, we are seeing a greater move toward, and demand for, "strategic" philanthropy, metrics and KPIs. How critical do you think this measurement aspect is? What are some of the benefits, but also the dangers, of this approach?

Strategic philanthropy, metrics and KPIs are all attempting to address a very real problem—the lack of visibility into why many philanthropic initiatives don't achieve their goals. I'm heartened by the appetite for visibility and the interest in improving approaches to philanthropy. I'm also worried that the industry is rushing to solutions without spending enough time understanding the problem. The concern about "ineffective philanthropy" has created an environment

where people only want to spend where the impact is clear. It's very difficult to articulate the impact of exploratory ethnographic and anthropological research, and this can be a costly endeavor. But if you cut it entirely, you risk not knowing the true root cause of a problem, nor, and this is even more dangerous, the complex system in which that problem resides. Take the infamous *PlayPump*² example. The project provided African villages with a merry-go-round that pumped water into a village tank when children played on it, improving access to water in regions with shortages. PlayPump created a lot of excitement and generated significant donor funding, but never took time to learn why water shortages existed, whether children would play enough on the merry-go-round, and whether villagers preferred this or a regular pump or another solution. More strategy, metrics and KPIs would not have helped make this product a success, but more investigation into the issues might have.

I want philanthropy to be more strategic, use better metrics and define clear KPIs. But it needs to be based on a deep, foundational knowledge of the problem. Without that, we risk setting policies and incentives that encourage unproductive behavior and stifle adaptive problem-solving. ●



Skye Gilbert

Profession: Strategy Officer, Gates Foundation (on assignment to Logistimo)

Interests: mountaineering, reading, writing

Greatest influence: my high school economics teacher, who changed the course of my life

1. <http://www.newyorker.com/magazine/2013/07/29/slow-ideas>

2. http://www.huffingtonpost.com/entry/the-next-big-thing-is-a-s_b_7178652.html?section=india





Insurance M&A

In search of profitability and capital optimization

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2015 was characterized by a great deal of movement in the field of mergers and acquisitions (M&A). In general, the present macroeconomic environment, the abundance of capital in the insurance market, the pressure on margins, and the entry into force of demanding insurance regulations are some of the key drivers. ➤

Below we show how M&A can be attractive from the perspective of both the acquirer and the seller:

Acquirer's motivation to enter into an M&A

01

The low levels of claims arising from catastrophes during 2015 has generated an excess of capital in the market. An increase in capital pushes the Return on Equity (RoE) further down, putting more pressure on margins. This forces undertakings to look for attractive businesses in order to reinvest the excess of capital and increase the RoE.

02

The excess of capital in the insurance market, plus the tightening of capital requirements under the Solvency II framework, explains why capital optimization has become a must, and in particular the optimization of capital allocation. This means that insurers are carefully evaluating which business they should enter into, keep or let go of, according to their optimal capital allocation strategy.

03

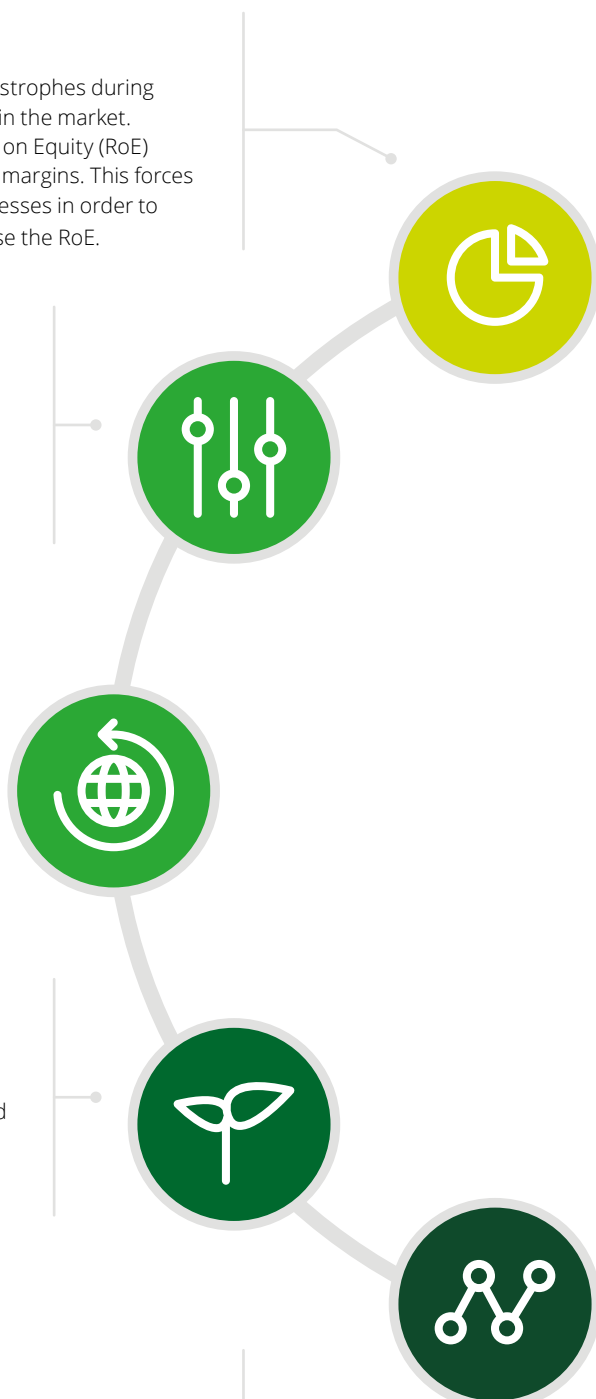
Incentives for diversification increase since diversification implies that less capital is needed to support the underlying risk. This allows insurance undertakings to enter into new business with less capital and increase the RoE.

04

Organic growth has become harder to pursue for insurance undertakings in mature markets. The effort to reach new customers is highly competitive. Insurance undertakings are forced to lower premiums in order to remain attractive to policyholders and this keeps pushing down margins. The alternative is to enhance growth in the customer base through M&A.

05

In recent years, PE firms, hedge funds, and conglomerations backed by PE have increased their activity in the life insurance business (mainly in unit-linked business). The fact that both annuity and life insurance business are characterized by high Asset-to-Equity ratios is very appealing to these types of business, as this allows them to have access to a relatively large portfolio of assets with low capital requirements as well as benefit from increased investment expertise to make the portfolio more profitable.



Seller's motivation to enter into an M&A



Where is the excess of capital in the insurance market allocated?

The evolution of the solvency margin shows that the insurance industry is currently in a phase of surplus capital. Although the industry's Solvency II ratios have not yet been disclosed to the public, the evolution of the Solvency I ratio is an indicator of the high levels of capital in the market.

In Q2-2015, the median on solvency levels rose to 254.4 percent and 198 percent for non-life and life business respectively. Nevertheless, compared with Q4-2014, the solvency ratios have started to decrease.

Although the panorama changes slightly when comparing the results with the Solvency Capital Requirement (SCR) introduced by the Solvency II regulation, the non-life industry is still overcapitalized under this framework. This is due to the low level of losses in non-life insurance business throughout the industry in recent years.

Under Solvency I, the solvency margin does not fully consider the movement of the financial markets. Keeping this in mind, due to the low interest rate environment and the negative duration gap that is characteristic of the life insurance business, under Solvency II we expect a strong deterioration of the solvency ratios for life insurance business in the coming years.

SOLVENCY I RATIO, INTERQUARTILE RANGE AND 10TH AND 90TH PERCENTILE

Figure 1: Life insurance business

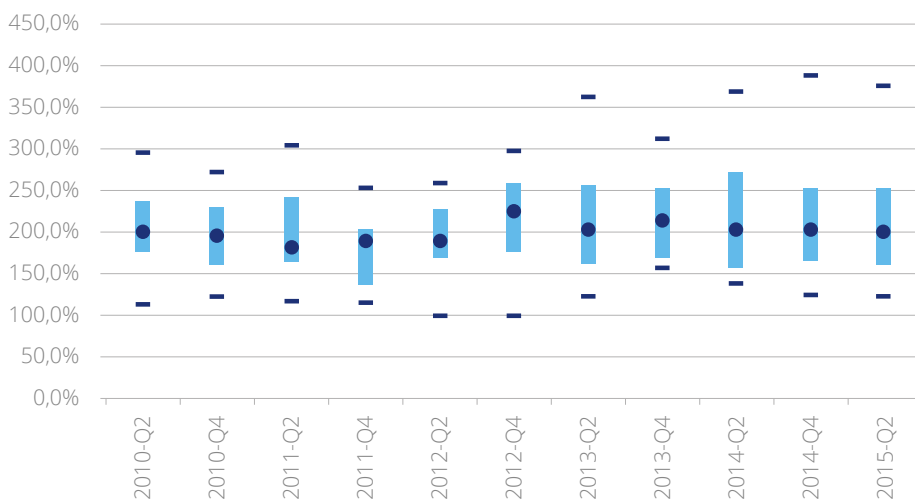
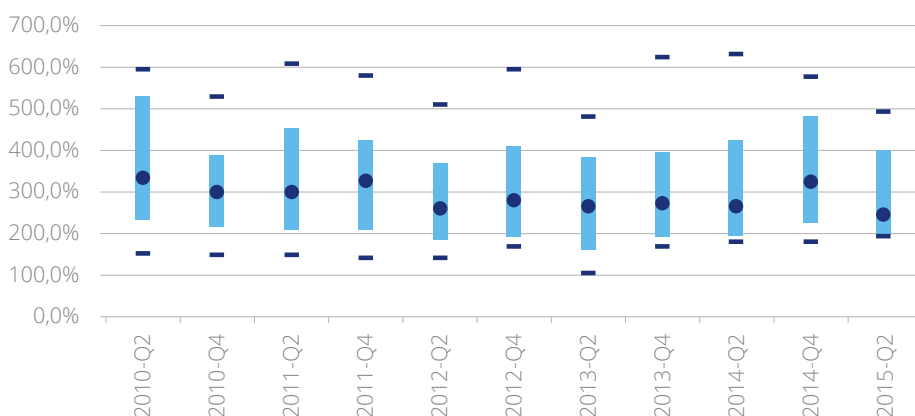


Figure 2: Non-Life insurance business



Source: EIOPA Financial Stability Report December 2015
(sample based on 32 large insurance group in EU and Switzerland)

Under Solvency II we expect a strong deterioration of the solvency ratios for life insurance business in the coming years.

What are the main factors for the current low margins in the insurance business?

The insurance market in 2015 shows stable but low profitability, which, in fact, conceals a major disparity between life and non-life insurance business, as reflected in the last stock market performance:

The persistency of the low yield environment, which is close to its lowest levels, has a negative impact on the profitability of the insurance market, mainly life insurance business. At the same time, non-life insurance and reinsurance undertakings delivered a positive return, due to the fact that short-term business is less sensitive — but not invulnerable — to the economic environment and due to the lower levels of claims that would normally arise from catastrophic events.¹

The low interest rate environment increases pressure on profitability

The prolonged low interest rate phase further increases the risk of reinvestment for the (re)insurance business, as maturing assets are reinvested either in low-return assets, pushing down profitability margins further, or in non-core (presumably riskier) assets.

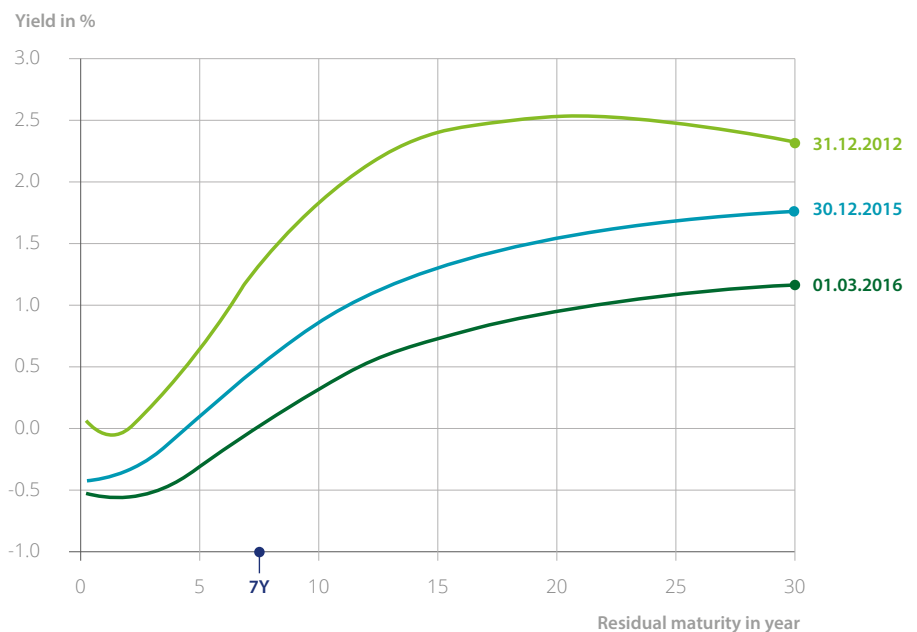
The graph on the right (figure 4) shows how the spot rate for AAA bonds in the euro area has decreased between 2012 and today: In life insurance business, due to the mismatch in duration between the technical provisions and the asset portfolio, the effect of the current low interest rate environment has had a negative impact on the expected profitability margin. This is even more pronounced for savings portfolios in Europe, where insurance undertakings still have long-term guaranteed rates up to 4 percent or 5 percent, without the possibility of changing the contract terms. This situation makes it very tempting for life insurance undertakings to consider M&A as one of the best ways to diversify the risk or get rid of unprofitable blocks of fixed-rate savings and annuity business, even if such deals could be very expensive. ➤

Figure 3: Market Returns

	1M	3M	6M	12M	3Y
Life	3.7%	-6.8%	-10.9%	0.4%	59.9%
Non-Life	10.5%	8.7%	15.8%	33.0%	60.1%
Composite	6.7%	0.0%	-1.5%	12.2%	65.8%
Reinsurance	12.3%	8.0%	13.1%	37.6%	67.2%
DJ STOXX INSURANCE	7.9%	1.3%	1.6%	18.9%	74.2%

Source: EIOPA Financial Stability Report December 2015

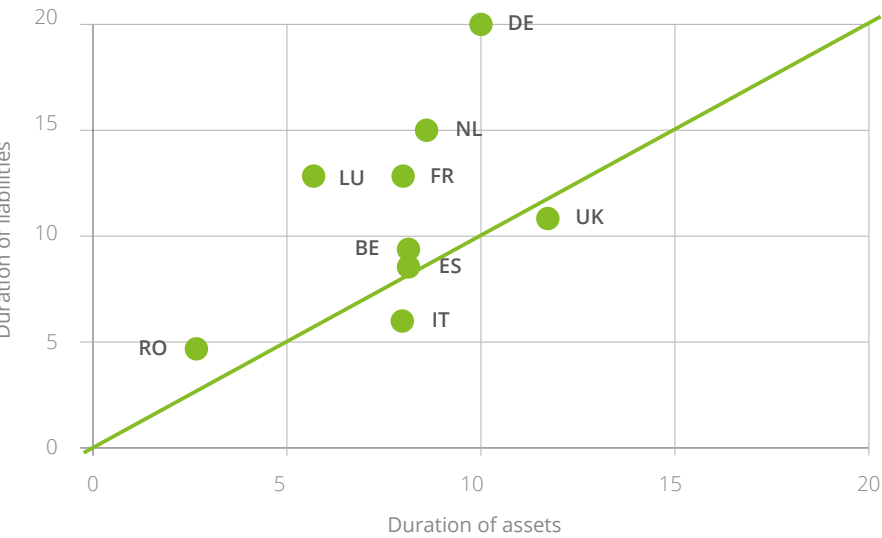
Figure 4: European Central Bank: euro area yield curve



In life insurance business, due to the mismatch in duration between the technical provisions and the asset portfolio, the effect of the current low interest rate environment has had a negative impact on the expected profitability margin.

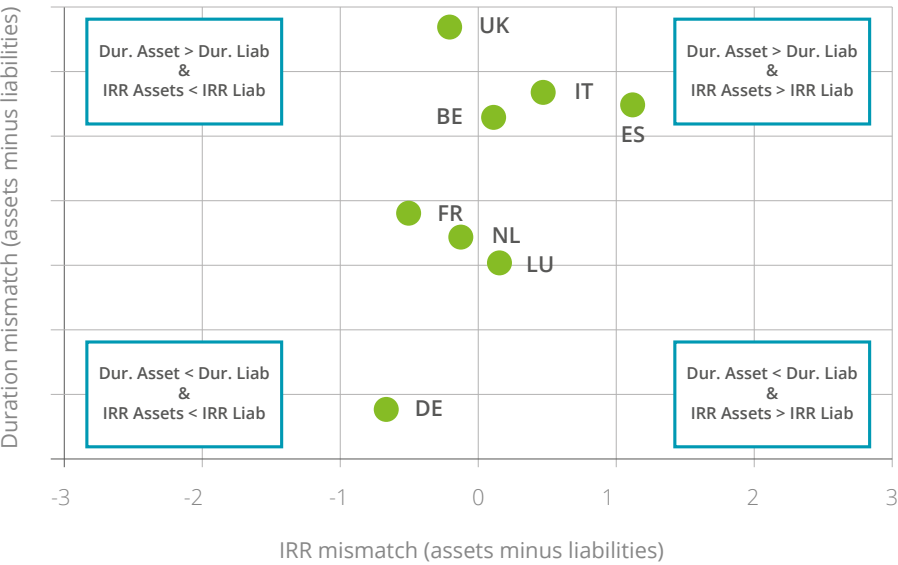
1. <http://www.wsj.com/articles/ace-agrees-to-buy-rival-insurer-chubb-1435748869>

Figure 5: Duration mismatch



Source: EIOPA Financial Stability Report December 2015

Figure 6: Joint mismatch between IRR and duration



Source: EIOPA Financial Stability Report December 2015

In non-life insurance business, the impact on the financial result increases the pressure on the underwriting margin, leaving no leeway to offset unexpected high losses due to catastrophe claims against the financial result. In this context, M&A deals become very attractive as it is a way of reducing costs, increasing the level of diversification and, therefore, boosting long-term profitability.

Finally, the low levels of catastrophe claims during the year generated an excess of capital in the market. Subsequently, if there is a weak financial result and no dividends are paid to shareholders, this might push the RoE further down, increasing pressure on margins for non-life (re)insurance business.













Key indicators to monitor profitability

In order to be able to offer a competitive return to policyholders and cover obligations, insurance undertakings have to carefully monitor certain key indicators and develop new strategies to optimize the financial and technical return, taking into account the underlying risk.

To assess the profitability of an insurance undertaking or to value the return of a portfolio requires specific technical ability to:

- Identify future profits related to the insurance liabilities in a prospective manner
- Consider the cost of the capital which is tied up to cover the risk arising from market and underwriting risk, based on the new Solvency II regime
- Manage interactions between assets and liabilities with an economic and best estimate vision.

Some key indicators of profitability commonly used in the insurance business are more applicable to life business than non-life business. The relevance of these metrics also depends on the target audience (investors, policyholders, management, regulatory supervisors, etc).

Key Indicators	Description	Focus
MCEV	<p><i>"The Market Consistent Embedded Value is a measure of the consolidated value of shareholders' interests in the covered business."</i> (CFO Forum)</p> <p>The future business is excluded from the MCEV.</p>	
CoR	<p>The Combined Ratio is calculated by dividing the sum of incurred losses and expenses by the earned premiums. When this ratio is below 100 percent, it means that the undertaking is making an underwriting profit (the company received more money in premiums than it paid in claims). This ratio does not take into account the investment income.</p> <p>The combined ratio is one true measure of the insurer's profitability, as it takes into account the loss ratio, the expense ratio and the policyholder's dividend ratio. It is particularly useful for monitoring business lines in non-life insurance companies.</p>	
PVFP	<p><i>"The Present Value of Future Profits reflects the intrinsic value of financial options and guarantees on in-force covered business."</i> (CFO Forum)</p> <p>The PVFP represents the present value of anticipated profits from in-force insurance contracts.</p>	
RoE	<p>The Return on Equity (RoE) is equal to the Net Income over the Shareholders' Equity. This indicator allows a comparison to be made of the profitability of different entities, as it reveals how much profit is generated with the equity invested by the shareholders.</p>	 
EVA	<p>The Economic Value Added. $EVA = \text{Net Operating Profit After Taxes (NOPAT)} - (\text{Capital} * \text{Cost of Capital})$.</p> <p>The EVA corresponds to the realized profit in excess of the cost of capital. It means that value is added when the realized return is above the cost of capital.</p>	 
RAROC	<p>The Risk Adjusted Return on Capital. The RAROC is a risk-adjusted profitability indicator. It is the expected return/economic capital.</p>	 
RORAC	<p>The Return on Risk Adjusted Capital is calculated as the net income divided by the allocated risk capital.</p> <p>The RORAC is similar to the RAROC; in this case, however, it is not the rate of return that is adjusted for risk, but rather the capital.</p>	 
NBM	<p>The New Business Margin represents the created value arising from new business or additional premium. It is calculated as $VNB/PVNB$, i.e. the profit on new business over the Present Value of New Business Premiums.</p> <p>The higher the ratio, the higher the portion of the premiums that accrue to shareholders as profit.</p>	



Changes in regulation

A tightening of the regulations might be quite expensive because it implies more administrative costs in order to fulfill the regulation standards (PRIIPS, Solvency II, FATCA, CRS, SST, IDD, SFTR, NAIC Regulations in the United States, etc.). Rising costs and capital requirements are an incentive to enter into an M&A.

As part of Solvency II, strong data quality management is required. Data must be appropriate, complete, accurate and secure. "Complete" and "secure" data means powerful data storage solutions are needed. This requires insurance undertakings to either augment the capacity of the data storage systems or outsource it to IT specialists in order to bring down the costs. Implementation of regulations such as Common Reporting Standards (CRS) demands strict reporting obligations that ultimately have to be outsourced.

The complex elaboration of the Key Investor Information Document (KIID) for each Packaged Retail and Insurance-based Investment Products (PRIIPS) will require volume management and have an impact on the distribution process. Each regulation is very demanding in terms of compliance and reporting and this triggers high management costs.

The costs arising from an increased regulation may not be sustainable by smaller or specialized insurers, and this will push them to seek economies of scope or scale. They will need to reallocate or release capital or sell portfolios that are not part of their core business or not in line with their risk appetite.

What is the key to generating value in life and non-life insurance business?²

Life insurance business

For life insurance business, the indicators that measure the return on investments such as the Return on Assets (RoA) and Assets-to-Equity are suitable indicators to monitor the profitability of the business. This is due to the fact that the margin on life insurance business can be divided into the margin on the interest rate, margin on risks, and margin on expenses:

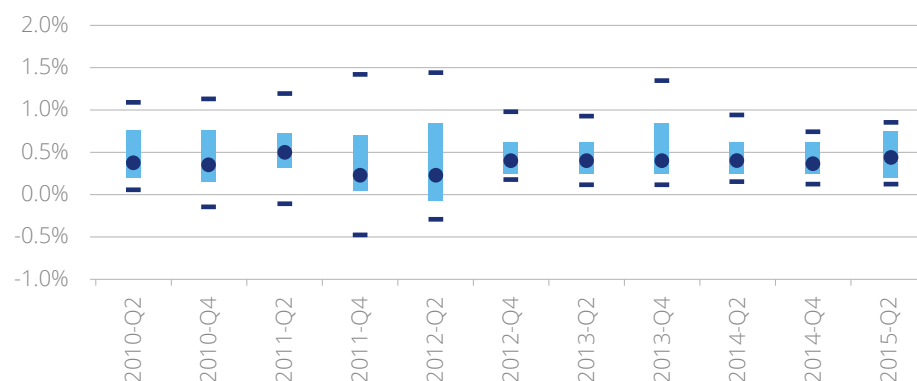
- The margin on the interest rate corresponds to the difference between the net financial interest and the guaranteed interest rate
- The margin on risks corresponds to the expected claims assumed on the pricing and the effective claims in a given period
- The margin on expenses is the difference between the estimated costs implied on the pricing of the product and the real costs incurred.

Historically, the most important component of the overall margin has been the margin on the interest rate. This is due to the fact that it is difficult to enhance profit on the expenses component, while the margin on the risks depends on exogenous variables such as the effect of longevity, leaving very little scope to enhance this margin by management actions.

Moreover, the fact that the life insurance industry prefers to promote unit-linked products and limit, reduce or indeed eliminate guaranteed savings products increases the correlation of the performance of life insurance business with the financial markets. This trend introduces a challenge for insurance undertakings to give added value to policyholders as an alternative to other banking and investment products.

The graph below shows how the RoA median for life insurance business has remained stable but low in the past couple of years. For Q2-2015, the median was 0.4 percent. However, this result has not factored in the decrease in bond yields (due to recent stock market trends, the cashing out of bonds, and derivative positions).

Figure 7: Evolution of the Return on assets (RoA) for Life insurance business
Total. Median. interquartile range and 10th and 90th percentile



Source: EIOPA Financial Stability Report December 2015
(sample based on 32 large insurance group in EU and Switzerland)

2. Study based on the EIOPA Stability Report Dec 2015.

However, the residual bulk of the fixed-rate guaranteed portfolio, combined with the low level of the ROA indicator, might encourage life insurance undertakings to reallocate their investment portfolios to riskier assets, which could make them more vulnerable to adverse market risk movements.

Non-life insurance business

The combined ratio and the loss ratio measure the underwriting results, or more specifically, what is the revenue due to written premiums as opposed to how much has been paid and reserved in order to properly cover the underlying risk that is assumed by the insurance undertaking. The difference between the CoR and the Loss Ratio is that the CoR includes expenses, while the Loss Ratio measures the profitability of the pure underwriting risk. In order to measure the enhanced value of the underwriting result, close monitoring of the Loss Ratio and the CoR is necessary (figure 8).

The graph on the right shows the quarterly evolution of the CoR for non-life insurance business. In Q2-2015 the median of the combined ratio was 95 percent. Nevertheless, we observe in some markets that the underwriting results are not sufficient to cover the operational cost, and the global profitability is mainly due to the financial result. This is usually referred to as financial underwriting. An example of this is motor liability insurance, where the low interest rate environment has severely affected this business line:

Overall insurance business

The RoE and the RORAC are quite relevant for insurance business, as these indicators measure how much capital the undertaking must set aside to cover the underlying risk and how much it has gained from this capital. In Q2-2015 the RoE increased with respect to the previous quarter to 9.8 percent, but it remains within approximately the same spectrum as 2010 (figure 9). ➤

Figure 8: Evolution of the Combined ratio for Non-Life business

Non-Life. Median, interquartile range 10th and 90th percentile

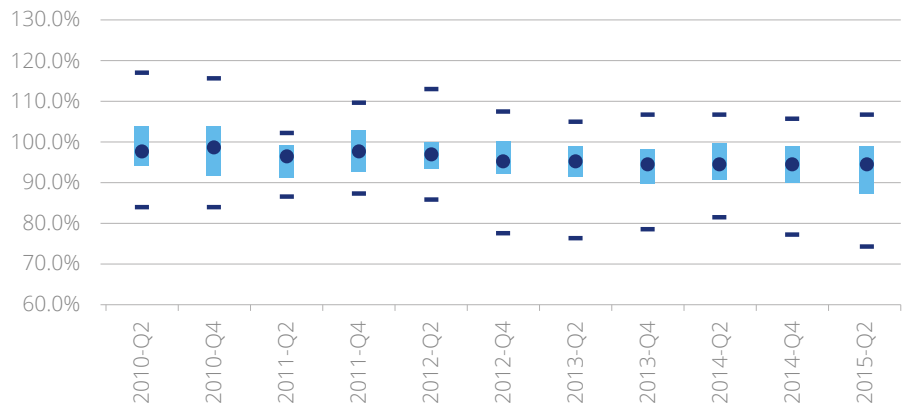
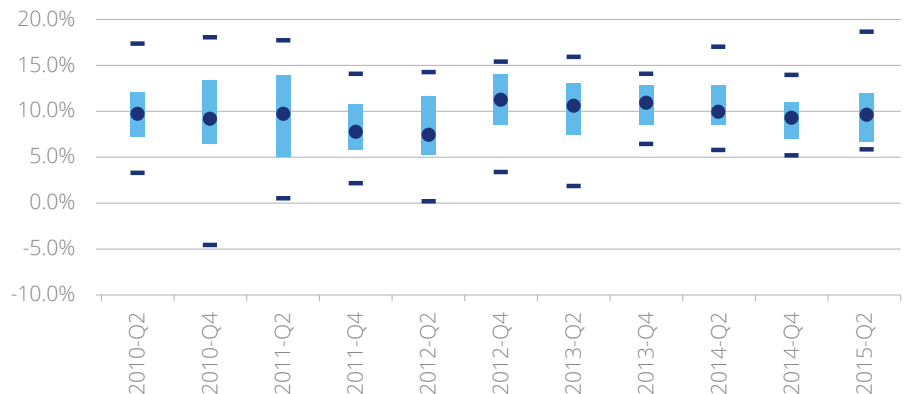


Figure 9: Evolution of the Return on Equity (RoE)

Total, Median, interquartile range and 10th and 90th percentile



Source: EIOPA Financial Stability Report December 2015
(sample based on 32 large insurance group in EU and Switzerland)

We observe in some markets that the underwriting results are not sufficient to cover the operational cost, and the global profitability is mainly due to the financial result. This is usually referred to as financial underwriting.



Incentives for the PE involvement in the insurance M&A activity

From the point of view of a PE firm, the long duration of the technical provisions inherent in life insurance business is a funding vehicle that allows them to enter into long-term investments with higher yield rates that are more illiquid than those offered by other investments.

On the other hand, the attractiveness of non-life (re)insurance business for PE investors is due to the diversification benefits that the investment might offer to its asset's portfolio. This is the case of the recent acquisition of Partner Re made by Exor for USD 6.9bn. According to the Financial Times, the Italian investment company (which owns a large share of Fiat Chrysler Automobiles, Ferrari and CNH) was determined to buy the reinsurer to diversify its industrial investments.

PE firms established in places with higher interest rates where funding is expensive have shown greater

interest in insurance undertakings based in the United States and Europe, in order to have access to the low interest rate funding and use it in overseas investment strategies.

Nevertheless regulatory pressure on solvency capital requirements through the implementation of Solvency II is generating uncertainty for M&A and might hold some potential deals. Similarly, in the broker and agency's M&A arena, regulation might also undermine the involvement of PE actors interested in these deals due to the ease of access to the market and the underlying cash flows.

Finally, it is important to notice that insurance regulators can be quite reluctant to authorize this type of deal.

The latest techniques to optimize capital allocation involve maximization of the RoE and the RORAC. Allocating the capital to business units allows managers to estimate the amount of risk borne by each business unit and how expensive each business unit is in terms of capital. The technique focuses on finding the optimal set of business units (business lines, insurance products, or any other risk segmentation) and on how to allocate the invested capital within the units so that it maximizes the RoE and/or the RORAC.

The optimization of capital allocation in today's macroeconomic conditions and low interest rate environment enhances profit and provides a clear view of the underlying risk within the insurance undertaking.

Conclusion

The low interest rate environment, combined with the increased regulatory burden, will require a review of the technical leverage and strategic approach.

The complexity of such a review is due to the interaction between the different variables that are intertwined in the objective of enhancing profits. These are:

- **The capital requirements** established by the regulation
- **The desired amount of capital** to be invested according to the shareholders' strategy and expected return (expected RoE and RORAC)
- **The capital needed** to fully support the underlying risk of the undertaking
- **The leverage needed** to promote the growth of the policyholder base
- **The various options** for allocating this capital to enhance growth.

Based on a review of the technical leverage, the most profitable option for the undertaking may be to transfer a portfolio, consider the BPO of a business unit or proceed to a full M&A. ●

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Going global

HR as the ultimate change agent

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In the business world, “globalization” refers to the integration of corporate operations, processes, technologies and strategies into various cultures, products, services and ideas. As businesses become increasingly global, organizations are seeking to improve their ability to attract, build and retain a global workforce, but more importantly, to enable productive and efficient synergies between people with different cultures, personal values and ways of working.

To stay competitive in an increasingly global environment, corporations must secure capabilities that will enable them to realign their workforce effectively within a changing and constantly evolving business environment. Such capabilities may include a digital culture that facilitates and enables communication and collaboration; improved global mobility programs that make it possible to move employees between countries efficiently and easily; and standardized and repeatable HR processes and systems to (i) manage talent supply and demand, and (ii) manage global development programs or even new staffing models that use outsourcing, contingent workers, and strategic partnerships to improve scalability and flexibility.

Such global exposure forces organizations to shift toward more agile and innovative operating models, as a response to the requirements of a more and more demanding labor market, characterized by new generational traits. The days when the

majority of workers could expect to spend a career moving up the ladder at one company are over. Young people anticipate working for many employers and demand an enriching—and therefore challenging—experience at every stage. This leads to expectations for rapid career growth, a compelling and flexible workplace, and a sense of mission and purpose at work.

Indeed, organizations all over the world are seeking to become “employers of choice” in this globalized context, yet many companies lack the HR practices, culture, or leadership support to manage the new requirements of the labor market.

How should these changes be addressed?

Before elaborating on how to address these changes, we first need to gain in-depth understanding of what is actually changing. Indeed, globalization forces organizations to reinvent themselves to stay competitive but also to attract a new, demanding and more agile workforce.

Globalization forces organizations to reinvent themselves in order to stay competitive but also to attract a new, demanding and more agile workforce.



What does this mean in practice?

Staying competitive is often correlated with higher revenue, which will most likely be driven by increased market exposure and easy access to customers. Even though organizations appear to understand the individual role each employee plays in boosting their competitiveness, they often fail to understand the core values and aspirations of their own workforce. Many employers choose to promote the label of “employer of choice” without having accurate knowledge of the core concept.

Becoming an “employer of choice” means ensuring that people in the labor market are eager to work for the organization; people on the outside envy its employees and most of its employees stay throughout their careers. As such, managing talent is not only about attraction and retention or even development; more than this, it is about finding ways to make employees love their work and give their all, because at the end of the day they know there is a future for them, whether this means taking on a

management role or simply being content in their job and career development. But who in the organization is best placed to manage these objectives? And what role should HR play?

In many organizations around the world, HR seems to be perceived as a “cost center” rather than a strategic department. As such, the globalization of operations calls for a fundamental cultural shift in the mindsets of many organizations. It is clear that HR should be involved in strategic business decisions, so as to ensure the most appropriate selection of talent from both the employer’s and the employee’s perspective. Furthermore, aside from the cultural shift in terms of the business mindset and the role of HR within the organization, a similar shift is also necessary with regard to the way organizations create a multi-cultural working environment and harmonize ways of working to enable their entire workforce to be productive, efficient and collaborative.

What’s there to think about? Let’s just change...

One common mistake organizations often make is to take change for granted, rather than adopting a carefully thought-through approach at every step of the transformation. Change is not always an easy subject, especially when a great majority of the workforce is made up of people with over 15 years of experience.

When people have been used to working under specific conditions and in certain ways for many years, they often become experts in their own domain. Their way, at least from a personal perspective, has not turned out to be a bad way. As such, how can these people be convinced that now is the time for change? ➤



To make people willing to change, organizations need to create a sense of urgency with regard to specific changes.

Creating a sense of urgency—everything starts from the top

Managing change is about promoting a future in which employees will be able to fulfil their personal aspirations. People usually resist change because of the potential losses/disadvantages the change might bring to them on a personal level. Our first reaction to major changes is always: what does it mean for ME?

To make people willing to change, organizations need to create a sense of urgency with regard to specific changes. This sense of urgency is rooted in a common understanding that change is necessary to survive or thrive in a given situation. As such, a sense of urgency must be driven from the top, with strong leadership alignment on a shared message and a vision of the future transmitted to the overall population. The leadership team can create a meaningful first impression with the vision it is sharing. When a meaningful vision is communicated well, people buy into the idea and understand

the role they will play in achieving it. However, before sharing their vision with their employees, leaders need to understand and believe in the importance of the future shift themselves; people can spot “fake” messages from miles away and this only gives them one more reason to resist change.

Understanding the “Why?”

The same phenomenon occurs in the context of operating in a global environment. The key to a successful transformation is understanding the *why* of the change. Leaders will have to adapt their statements and the vision they transmit depending on the reasoning behind the change. Even though globalization itself might be a driver of change, the objectives behind particular changes might differ. For example, in the context of creating a shared service center, where the objective is to cut costs, the statements and vision of the future promoted by the leadership team will fundamentally diverge from those associated with a change occurring in the context of the creation of a new global entity for the purposes of increasing international exposure. In the first case people might fear losing their jobs; in the second, people might hope for international mobility.

In light of this, leaders are obliged to create a vision and ensure it is clearly communicated to foster a sense of urgency based on the drivers of change. In any case rather than simply encouraging people to be willing to change, leaders need to enable people to implement change.

Enabling change at talent and HR level

Once the organization has created a vision and ensured it is understood by all, it must provide people with the necessary means to “survive” such a change. In the context of a globalized working environment, many things may have changed: from ways of working, to the skills and competencies employers look for when hiring new staff or training existing employees. As such, it is the organization’s role to enable existing employees to adapt to new requirements. The trouble is that companies with global exposure need to become more and more

agile and flexible in the way they operate, yet they find themselves with an increasing number of senior roles occupied by people of older generations (who are often resistant to change), and cannot choose to downsize toward a more agile and young workforce because they would no longer be perceived as the “employer of choice.”

Organizations must enable their existing workforce to adapt to new requirements and ways of working. The process of empowering people in this way involves considering what motivates them at work and what their long-term career and personal aspirations are. The aspirations and desires of the workforce need to be aligned with the new requirements of the business context. Often this will imply that employees might have to be coached or trained so that they fit in with the new organizational outlook. Furthermore, rather than simply training their employees, corporations must identify the most suitable synergies between different people to ensure viable and positive outcomes.

Like fitting pieces together in a jigsaw puzzle, organizations must place the right people in the right positions to create winning teams. The best teams are achieved when a company is able to match the best possible competencies, knowledge and expertise from different people with different backgrounds, cultures and visions to create value for the firm and its clients. Under such circumstances, who is the best person to understand business needs and set up a winning team: the team accountant or the coach?

Enabling HR as a strategic function in a global organization

It is fair to state that winning teams should be composed by the department that manages the human capital of a firm. In a global context, with shifting demographics and the need for new operating models, HR has to go beyond payroll and HR policies.

Shifting toward a “strategic HR function” is a change that would need to start from and be driven by the top level of the organization. Most organizations understand the importance of HR and its

relevance for strategic decisions; however, as of yet, most have not made the first step toward officially integrating the HR department into an executive role. Some may question why we need to make this official. The truth is that “official” is the equivalent of “legitimate” in the corporate world, and so an official role means that HR has an official mandate to take the actions it deems necessary in terms of talent management, business strategy and the related vision. Currently, too many talent-related decisions depend upon unrelated executive functions, which at

the end of the day have a great view of the business side, but are often miles away from understanding the essence of their workforce.

Many of the organizational changes arising from globalization have implications for talent management. The first step in ensuring a successful transition is to enable HR to take on a strategic role, which will then pave the way for a new talent-driven culture, empowering the workforce and boosting the company's growth. ●



Engaging the 21st century workforce in performance management

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In the middle of the first quarter of the 21st century, companies all over the world often come to the realization that the workforce is constantly changing and they need to find new ways to deal with this reality. Many competencies are quite rare; workers have high expectations. The workforce these days is completely diverse, globalized, highly connected, technology-savvy, and demanding. Its employees are young, ambitious, and filled with enthusiasm. Millennials are a main force—but so are older workers, who remain engaged and valuable contributors. Critical new skills are scarce—and their uneven distribution around the globe is forcing companies to develop new ways to find people, develop capabilities, and share expertise. As mobile, social, and cloud computing continue to expand, these tendencies transform the world of analytics as well as performance management.



For various reasons relating to professional satisfaction and finances, many workers are extending their work careers. These trends are producing a highly multi-generational workforce. How can companies deal with this highly diverse set of employees when their needs vary so widely? How can companies change their strategy for performance management to cope with these new workforce trends?

Even at the beginning of this century, most companies viewed performance management as a backward-looking assessment program managed by Human Resources. All of this is changing now. Performance management is taking a new turn and is becoming a forward-looking process: its aim is to improve employee engagement and drive enhanced financial results. Redesigned performance management processes sometimes include year-end evaluations but they tend to focus less and less on the assessment itself and more on the best ways to set goals, give regular feedback, do more and more coaching, and invest in employee development. The focus is moving away from distribution rankings to trying to make use of all available performance management categories and increasing the focus on coaching managers and employees to get the best results in their working lives. This type of change in direction is currently having quite an impact on performance management.

A strong focus on coaching and employee development

The so-called “traditional performance management” of ranking employees against their colleagues is disappearing. Research shows that more than half of the active workforce is employed in service or knowledge-related jobs. Their performance is driven by their competencies, their behaviors and daily attitude at work, and their customer focus as well as their ability to adapt to the constantly changing environment. All of these key competencies need to be acquired over time, and successful performance management must concentrate on the continuous development of skills, rather than employee rankings. Moreover, in today's fast-paced world, business priorities rarely



follow the annual evaluation cycle. Goals constantly change, the company redesigns its strategy from year to year, and employees often change jobs and work on different projects and with different team leads. This is a quickly moving environment, so it is not surprising that our research shows that organizations where workers review their personal goals several times a year are likely to score much better than those in which employees only have one yearly performance review.

Many companies understand that they have to rethink performance management. As employee retention and skills development are such important indicators of financial success, the performance management process needs to be organized around continuous coaching and employee development. The traditional way of simply evaluating employees' performance over the past year needs to be forgotten. Managers and team leaders who give regular feedback and opportunities to their teams to continually enhance their knowledge and skills are more likely to create high-performing teams than those who concentrate on backward-looking performance evaluation styles.

Follow the “long tail”

Perhaps the most important difference between traditional performance

management and the latest trends is that grading against the curve and obligatory employee rankings are disappearing. The latter, which used to be known as “rank and yank,” was widely used in many companies and often resulted in demoralized employees and even animosity. Some excellent employees even quit because of this system.

Nowadays, employee performance distribution increasingly follows the “long tail” rather than the traditional “bell curve.” This is especially true in high talent-demanding companies. It can be said that some employees are overachievers, while many others work at the middle level. In many demanding industries, top performers can often outperform mid-level performers by as much as tenfold. In these business contexts, the performance management system needs to treat high performers really well and also encourage mid-level employees to improve through managerial support, coaching and development. A “forced” bell curve can seriously lower the value of the best performers in each team and at the same time push many mid-level performers down to the bottom. When using this process, the best performers are often inadequately rewarded, while employees with mid-level performance do not receive sufficient motivation and encouragement from their managers. ➔

Rethinking the role of managers in performance management

Moving away from the traditional annual performance evaluation and toward continuous coaching and improvement requires a reappraisal of the role of the manager. Today, as high-performance is always required in teams, employees really must take ownership of their own performance and act by themselves to improve their capabilities. Managers are not evaluators anymore but they need to become coaches who continuously support their teams.

Separating the compensation and evaluation processes

An important component of the new “coaching and development” performance management model is the need to decouple the process of providing feedback to employees from the decision-making process with regard to salaries. Research has demonstrated that exchanges about remuneration packages often provoke an almost primordial gut reaction among employees to fight for a pay rise, which clearly has a negative influence on the coaching process.

The new tendency is to remove the former direct link between performance evaluations and salary increases or bonuses. All pay-related decisions should be based on the importance of workers' current competencies, the cost that the company would need to pay to replace them, their actual value to external clients. The wider labor market context must also be taken into account. Employees must be held accountable for the results they produce, as most employees secure the best results when they are given the appropriate tools to succeed and the necessary individual coaching to improve their own performance.

Providing regular feedback and focusing on team management

The current job market is also constantly changing and becoming more and more transparent. Talented employees ask for regular feedback as well as advice regarding their career evolution. They are not happy with the once-a-year,

old-fashioned performance reviews. This change perfectly demonstrates why performance management that is solely based on ratings negatively affects the company culture as well as the engagement of individuals. The key point now is to concentrate on strengths, encourage development and focus much less on current weaknesses. Individuals perform at their best when they have meaningful work tailored to their personal strengths that encourages them to be motivated.

Team management is also a very important component of the new style of performance management. The latest methodologies concentrate on teamcentric goal-setting and systems to enhance team collaboration and performance. The collection of both bottom-up and top-to-bottom feedback is important as it really supports managers in seeing their own areas of improvement.

Technology in performance management

Today, as the importance of technology increases on a daily basis in the HR world, it is becoming clear that transparent goalsetting and agile performance management is easier than ever. Many SaaS solutions are appearing on the market and being introduced into companies, facilitating the new performance management process, making things quicker, more visual and more intuitive. These new tools allow employees to share their own performance goals, and easily provide feedback and recognition to others online. All of this makes the performance management process a bit more “fun” and much more efficient.

What you need to take away

It is very important to rethink the way performance management is carried out as, if done in an undesirable way, it can waste valuable time and even have a negative effect on employee engagement and talent retention.

If you succeed in finding the right style, performance management can become one of the most inspiring and developmental aspects of an employee's career. It can also contribute to performance improvements across the organization and can even positively affect your financial results. It is time to take a good look at your performance management process and propose simplifications as well as new methods that support strength-based assessment and coaching. Make sure you train your managers on how to give the best type of feedback on an individual basis. Performance objectives need to be agile as well as updated regularly, and the systems used need to be simple and user friendly. By focusing on these simple steps, you will soon experience a positive change in your company's performance management. ●

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Corporate learning

How current trends are accelerating the demand for transformation

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Unlike their predecessors, many millennial and Generation X workers expect training and support services to be as readily available and rapidly accessible as most of the other information in their lives—available anytime, anywhere, on any device.

The past few years have seen corporate learning and development (L&D) come into sharp focus as an area in need of improvement within both HR departments and the wider business community, especially given the growing acknowledgement of its role in attracting and retaining staff.

According to executives participating in Deloitte's Global Human Capital Trends 2015 survey, retaining and developing existing talent—especially future leaders—will be a top priority over the next few years, as opposed to sourcing

it from outside the organization. Despite this, many of them also believe their organizations are doing a “fair/poor” job of leadership development and managing/delivering effective training programs. Clearly, there is a significant misalignment between the perceptions of management and the ability of L&D to deliver adequate solutions for the needs to be addressed. As factors like technological advances and demographic change challenge traditional perceptions of corporate learning, a number of key trends are emerging that signal the direction in which L&D transformation needs to head. ➔





Only 49 percent of organizations have a senior leader running the training function and fewer than 45 percent have a written business plan for learning.

Building an appropriate business case and a clear roadmap to the ensuing learning transformation and execution of the new strategy can be key not only in achieving a greater investment impact but also in promoting the buy-in of senior leaders, who typically challenge HR to be fact-based and cost-conscious.

Aligning enterprise learning strategy with business strategy

As maintaining and growing talent becomes an increasingly important priority, companies have started looking at learning and development as part of their overall strategy rather than as a small subset of the HR department's role. The most successful HR organizations have distinguished themselves by successfully aligning their learning and development strategies with business objectives. This has enabled the development of programs that:

- Rationalize spending on learning and optimize the use of the organization's human capital
- Streamline and outsource operations and simplify the technology landscape
- Focus on the learning programs that offer the best return on investment (ROI)
- Contribute to shaping skills and behaviors that reflect the company's strategic direction and help drive it toward its growth objectives
- Increase the learning impact not only globally but also locally, developing specific strategies to support, for example, key business lines or units

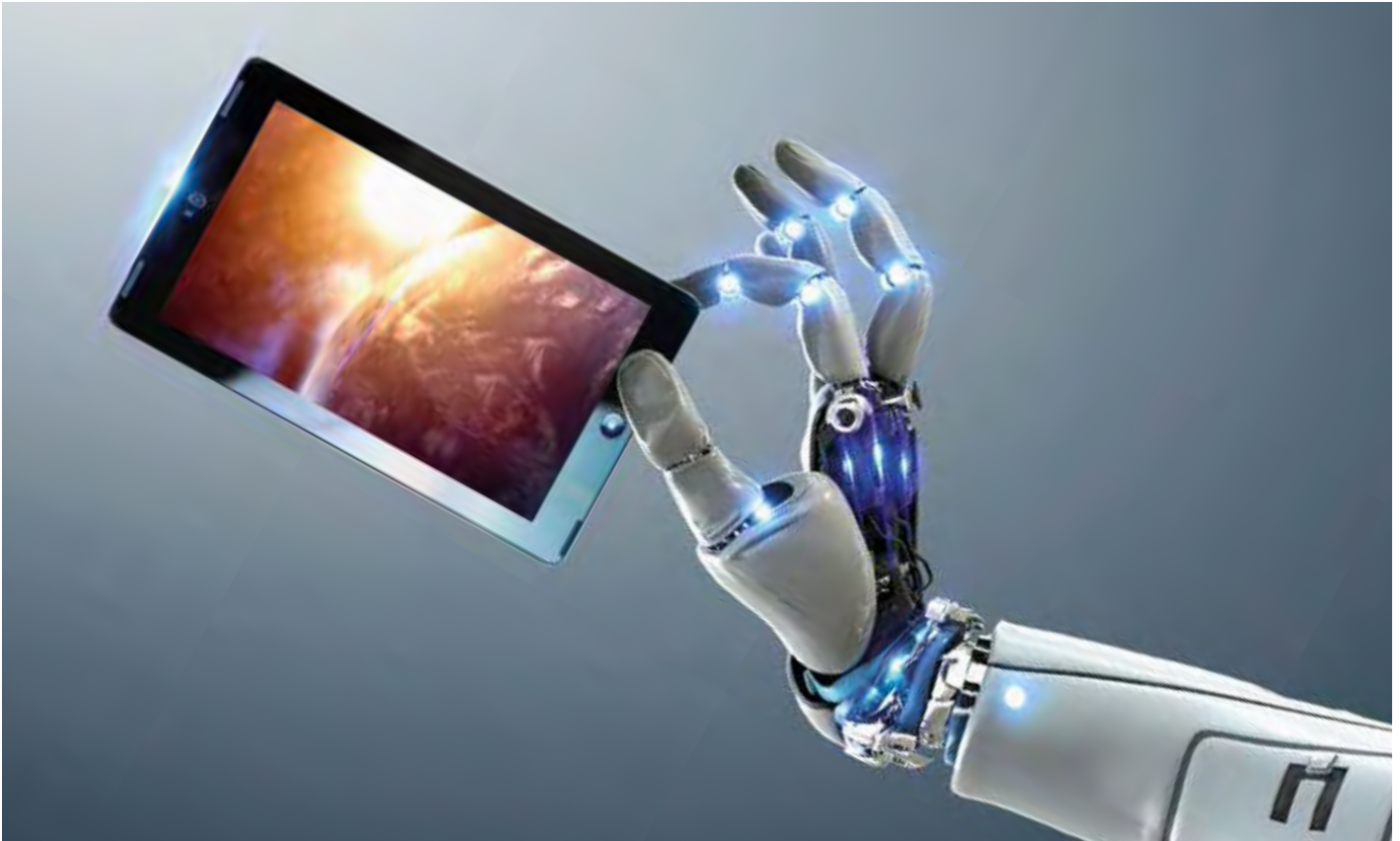
To reap these benefits and unlock the value of learning and talent, it is important to understand the business drivers and the forces affecting the overall organization and identify the potential limitations of the current learning strategy, operating model, governance, resources and learning offering. Different business contexts (e.g., changes in the regulatory landscape, mergers and acquisitions, global expansions, etc.) provide different opportunities to align the learning strategy and ensure that the L&D function is focusing on the right problems, with the right resources (i.e., time, money and people).

Building an appropriate business case and a clear roadmap to the ensuing learning transformation and execution of the new strategy can be key not only in achieving a greater investment impact but also in promoting the buy-in of senior leaders, who typically challenge HR to be fact-based and cost-conscious.

Optimizing operations and enhancing ROI

While many organizations already spend millions of euros on training, most lack any significant insight into how exactly this sizeable investment is spent or what results, if any, it delivers. The most glaring factor contributing to this opaqueness is the fact that the L&D function is not treated in the same way as other parts of the business; our research and conversations with clients show a surprising lack of discipline and structure within the training function at many companies. Only 49 percent of organizations have a senior leader running the training function and fewer than 45 percent have a written business plan for learning, let alone one that has been aligned with the organization's broader objectives.

Rarely is there a centralized department responsible for learning, so it's not entirely surprising that most training programs lack a cohesive strategy or direction aligned with that of the business, let alone any assessment of their effectiveness. This problem has been exacerbated by the relentless, ongoing nature of globalization, which has disrupted the traditionally linear



growth patterns of organizations with a sharp increase in M&A activity. This often results in learning groups operating largely independently of one another, within siloes which each have numerous learning management systems and vendors in use.

Many successful learning transformations have focused on transitioning decentralized learning operations to a shared operating model, developing common processes, setting up standard services for technology, content management and authoring tools, and consolidating vendors to rationalize training, reduce operating costs and provide a greater impact on the business without increasing expenses. The success or otherwise of these changes often depends to a high degree on improving visibility into how L&D funding is spent. Research shows that most companies underestimate their spending by a factor of two to three, as a result of uncoordinated and duplicated programs. Efforts aimed at identifying and rationalizing L&D spending often uncover opportunities for improvement with

minimal extra investment, or savings with minimal losses in the effectiveness of existing programs.

Developing a standardized approach toward L&D measurement and evaluation is the best way for a business to see how their training budget is being spent and to measure the ROI of these kinds of programs.

Moving from a “push” to a “pull” model

Training programs have historically been “push” based, with content distributed to employees in lectures or classes based on the training department’s schedule, and success typically measured by employee attendance rates. Today’s employees, however, have different expectations and preferences relating to how they want to acquire and develop their skills. Unlike their predecessors, many millennial and Generation X workers expect training and support services to be as readily available and rapidly accessible as most of the other information in their lives— available anytime, anywhere, on any device. ➔

The shift toward “employee-owned” learning has also disrupted the technology landscape, amid the massive digital transformation of recent years.



The need to provide a platform that meets these expectations, which contrast so starkly with those of past generations, has resulted in a so-called “pull” model, where L&D is seen as a continuous process and training is “pulled” through seamlessly by the employee when it suits them.

This arrangement is particularly suitable given that employees now seem to be willing to take an unprecedented amount of responsibility for continuously developing their skills throughout the course of their careers. In a “pull” learning environment, workers take it upon themselves to utilize available resources, improve their knowledge and share their expertise. In fact, our research has shown that creating this type of learning culture, which not only facilitates but encourages employees to share their skills and knowledge, is now one of the most important factors in achieving sustainable success.

This is contributing to a major shift in the role of L&D. Today, L&D leaders and professionals must come to view themselves as “learning experience designers” as opposed to “instructional designers.” Applying this idea to L&D involves firms studying their employees’ learning experiences and using the information to create all-encompassing, end-to-end experiences. The result of this is a learning program that is highly engaging for employees, because it allows them to find the learning they need rather than looking elsewhere, or even changing jobs, if they cannot. This theory aligns closely with Deloitte research which highlights “availability of learning” as one of the biggest factors in employees’ minds when it comes to retention and engagement—arguably two of the most important elements of today’s cut-throat labor market.

This transition toward employees being the active drivers of the learning experience has made HR’s role in the process both more interesting and more critical. HR departments are ground zero for efforts to ensure companies become more effective users of learning and development tools, and should strive to be facilitators of

learning and curators of content, rather than just developers and deliverers of training programs. They are well-placed to guide this transition, with most in possession of deep understanding of the capabilities and skills companies need to be successful—especially as the trend toward finding employees with financial or operational expertise in HR departments continues to accelerate.

The change itself is invariably a difficult process, as is identifying why, how and when it needs to occur. An organization's ability to adapt is dependent upon many factors, including its existing perceptions of L&D, existing programs, existing resources allocated etc., so it is unsurprising that many organizations struggle with the transition. Other organizations, however, are seizing the opportunity to promote new learning cultures and extract more value from their L&D activities; these agile first-movers are adopting new mindsets, and fundamentally rethinking the meanings of L&D in the context of their businesses. This process has seen people placed at the core of an employee-centric architecture and vision that treats learning not as a series of episodic events, but as one continuous process, the responsibility for which is spread throughout a company.

Using technology to drive "employee-owned" learning

The shift toward "employee-owned" learning has also disrupted the technology landscape, amid the massive digital transformation of recent years. The LMS market is changing and many of the legacy systems are not providing the user experiences that people want. The prevalence of highly customizable, interactive, user-friendly digital platforms like smartphone apps has led to employees wondering why their professional development experiences can't be as simple, and the answer is that there isn't a good answer. Most companies have simply been very slow to recognize and adapt to the opportunities that the digital age has created, instead forcing employees to persist with antiquated learning management systems when they already have access to a viable alternative in the palm of their hand. The ubiquity

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of constantly connected mobile devices, and their increasing affordability, makes learning theoretically available everywhere and accessible to all at low cost.

The last few years have witnessed an explosion of new learning solutions, including MOOCs (Massive Open Online Courses—offering free or low-cost courses), digital learning tools, video offerings, and new cloud-based training systems.

Newer products like SAP Jam and Workday Learning propose radically different approaches from traditional LMS tools, which are becoming "back-end" systems hidden from employees, and supporting the innovative, engaging, mobile and highly interactive "front-end" platforms driving a curated, on-demand and recommendation-based approach to learning.

In this consumer-centric reality, the employees are in charge and they expect L&D to standardize, simplify and integrate learning technology into a single platform, allowing them to access content, resources, tools and connections that will enable them to do their jobs and build their careers more successfully.

The best solutions will provide mobile and social capabilities, easily integrate any type of digital content and use analytics to recommend content in a manner similar to Netflix and Amazon. In other words, the learning team will no longer focus on telling people what to learn but instead show them what they can learn. Companies should be cautious before investing in massive new systems, and they should monitor developments from innovative vendors to help build effective learning applications.

Conclusion

Current trends present a unique opportunity for companies to reorient their learning and development programs toward the incoming generations of employees, providing them with more desirable skillsets that better meet the needs of businesses. Looking ahead, technology will continue to streamline the delivery of learning and development programs, creating a more enjoyable experience for the employee at reduced cost to the employer. Firms that are able to innovate by combining these new platforms with a strong understanding of their own strategic objectives are likely to see improvements in ROI, as well as in the engagement and retention of their workforce. ●

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Our expert authors, who are brimming with excitement about these disruptive topics, have written articles to help decision-makers to apprehend the new paradigms—
if not to understand them all



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