The Future of Financial Services
How disruptive innovations are reshaping the way financial services are structured, provisioned and consumed

An Industry Project of the Financial Services Community | Prepared in collaboration with Deloitte

Final Report • June 2015
Forward

Consistent with the World Economic Forum’s mission of applying a multi-stakeholder approach to address issues of global impact, the creation of this report involved extensive outreach and dialogue with the financial services community, innovation community, academia and a large number of financial technology startups. The dialogue included numerous interviews and interactive sessions to discuss the insights and opportunities for collaborative action.

Sincere thanks are extended to the industry experts and emerging disruptors who contributed their unique insights to this report. In particular, the members of the Project’s Steering Committee and Working Group, who are introduced in the following pages, played an invaluable role as experts and patient mentors.

We are also very grateful for the generous commitment and support to Deloitte Consulting LLP in the U.S., an entity within the Deloitte\(^1\) network, in its capacity as the official professional services advisor to the World Economic Forum for this project.

Contact
For feedback or questions, please contact:

R. Jesse McWaters
jesse.mcwaters@weforum.org
+1 (212) 703-6633

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Acknowledgements
## Acknowledgements

### Members of the Steering Group

The following senior leaders of global financial institutions have provided guidance, oversight and thought leadership to the "Disruptive Innovation in Financial Services" project as its Steering Group:

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Organization</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oliver Bussman</td>
<td>Chief Information Officer, UBS</td>
<td></td>
</tr>
<tr>
<td>Ann Cairns</td>
<td>President, International Markets, MasterCard</td>
<td></td>
</tr>
<tr>
<td>David Craig</td>
<td>President, Financial and Risk, Thomson Reuters</td>
<td></td>
</tr>
<tr>
<td>Fred Crawford</td>
<td>Chief Executive Officer, Alix Partners</td>
<td></td>
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<tr>
<td>Stephen Cross</td>
<td>Chief Executive Officer, Aon GRIP Solutions, Aon</td>
<td></td>
</tr>
<tr>
<td>Anna Ewing</td>
<td>Executive Vice President, Global Technology Solutions, NASDAQ</td>
<td></td>
</tr>
<tr>
<td>John Flint</td>
<td>Chief Executive Officer, Retail Banking and Wealth Management, HSBC</td>
<td></td>
</tr>
<tr>
<td>Jason Harris</td>
<td>Chief Executive Officer, International Property and Casualty, XL Group</td>
<td></td>
</tr>
<tr>
<td>Michael Harte</td>
<td>Chief Technology Officer, Barclays</td>
<td></td>
</tr>
<tr>
<td>Rob Heyvaert</td>
<td>Corporate Executive Vice President, FIS</td>
<td></td>
</tr>
<tr>
<td>David Puth</td>
<td>Chief Executive Officer, CLS Group</td>
<td></td>
</tr>
<tr>
<td>Joanna Rotenberg</td>
<td>Chief Marketing Officer and Head of Strategy, BMO Financial Group</td>
<td></td>
</tr>
<tr>
<td>Neeraj Sahai</td>
<td>President, Standard &amp; Poor’s</td>
<td></td>
</tr>
<tr>
<td>Lance Ugglia</td>
<td>Chief Executive Officer, Markit Group</td>
<td></td>
</tr>
<tr>
<td>Dieter Wemmer</td>
<td>Member of the Board of Management, Finance, Controlling, Risk (CFO), Allianz SE</td>
<td></td>
</tr>
</tbody>
</table>
**Acknowledgements**

**Members of the Working Group**

The project team would also like to acknowledge the following executives of global financial institutions who helped define the project framework and shape strategic analyses as its Working Group:

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rachel Bale</td>
<td>VP Mobile Converged Payments, MasterCard Worldwide</td>
<td></td>
</tr>
<tr>
<td>Tom Brown</td>
<td>Partner, Paul Hastings</td>
<td></td>
</tr>
<tr>
<td>Francis Bouchard</td>
<td>Group Head of Government and Industry Affairs, Zurich</td>
<td></td>
</tr>
<tr>
<td>Fabrizio Campelli</td>
<td>Head of Group Strategy, Deutsche Bank</td>
<td></td>
</tr>
<tr>
<td>Ericson Chan</td>
<td>Chief Information Officer Hong Kong and Greater China, Standard Chartered</td>
<td></td>
</tr>
<tr>
<td>Robert Coppola</td>
<td>Chief Technology Officer of S&amp;P Capital IQ and S&amp;P Dow Jones, McGraw Hill</td>
<td></td>
</tr>
<tr>
<td>Christof Edel</td>
<td>Global Head of Trading Strategy &amp; Business Development, Thomson Reuters</td>
<td></td>
</tr>
<tr>
<td>John Edge</td>
<td>Chairman, Digital Stored Value Association</td>
<td></td>
</tr>
<tr>
<td>Ignacio A. Goicoechea</td>
<td>Head of IT and Operations, Banorte</td>
<td></td>
</tr>
<tr>
<td>Robert Hedges</td>
<td>Managing Director, AlixPartners</td>
<td></td>
</tr>
<tr>
<td>Neil Mumm</td>
<td>VP Corporate Strategy, Visa</td>
<td></td>
</tr>
<tr>
<td>Matthew Levin</td>
<td>EVP and Head of Global Strategy, Aon</td>
<td></td>
</tr>
<tr>
<td>Victor Matarranz</td>
<td>Director of Strategy &amp; Chief of Staff to the CEO, Santander</td>
<td></td>
</tr>
<tr>
<td>Max Neukirchen</td>
<td>Head of Strategy, JP Morgan Chase</td>
<td></td>
</tr>
<tr>
<td>Christine O’Connell</td>
<td>Global Head of Strategy &amp; Business Development, Thomson Reuters</td>
<td></td>
</tr>
<tr>
<td>Kosta Peric</td>
<td>Deputy Director Financial Services for the Poor, Bill and Melinda Gates Foundation</td>
<td></td>
</tr>
<tr>
<td>Ignacio A. Goicoechea</td>
<td>Head of Strategy, Banorte</td>
<td></td>
</tr>
<tr>
<td>Peter Rutland</td>
<td>Senior Managing Director, CVC Capital Partners</td>
<td></td>
</tr>
<tr>
<td>Nicolas de Skowronski</td>
<td>Chief of Staff, Bank Julius Baer</td>
<td></td>
</tr>
<tr>
<td>John Smith</td>
<td>IT Director, Group Head Office, Prudential PLC</td>
<td></td>
</tr>
<tr>
<td>Huw Van Steenis</td>
<td>Head of Financial Services Research, Morgan Stanley</td>
<td></td>
</tr>
<tr>
<td>Andrew Tarver</td>
<td>Head of UK Operations, FIS / Capco</td>
<td></td>
</tr>
<tr>
<td>Colin Teichholtz</td>
<td>Partner &amp; Co-Head of Fixed Income Trading, Pine River Capital</td>
<td></td>
</tr>
<tr>
<td>Fabien Vandenreydt</td>
<td>Head of Markets Management, Innotribe &amp; the SWIFT Institute, SWIFT</td>
<td></td>
</tr>
<tr>
<td>Derek White</td>
<td>Chief Design &amp; Digital Officer, Barclays</td>
<td></td>
</tr>
<tr>
<td>Rob Galaski (Project Advisor)</td>
<td></td>
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</tr>
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<td>Rob Galaski (Project Advisor)</td>
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</tbody>
</table>

*Deloitte Canada*
Acknowledgements

List of innovators and subject matter experts (1 / 2)

In addition, the project team expresses its gratitude to the following innovators and subject matter experts who contributed their valuable perspectives through interviews and workshops (in alphabetical order):

Asheesh Advani  
CEO, Covestor

Jeremy Allaire  
Co-Founder & CEO, Circle

Giles Andrews  
Co-Founder & CEO, Zopa

Radhika Angara  
Chief Marketing Officer, Fastacash

Yoni Assia  
CEO, eToro

Jolyon Barker  
Deloitte UK

Alex Batlin  
Group CTO, Applied Innovation and Market Research, UBS

Inga Beale  
CEO, Lloyd’s

Nick Beecroft  
Emerging Risks and Research Manager, Lloyds of London

Eric Benazeh  
Director, International Development, Meniga

Sarah Biller  
President, Capital Market Exchange

Stephen Bingle  
Business Development Asia, Smart Engine

Dave Birch  
Director, Consult Hyperion

Josh Bottomley  
Global Head of Digital, HSBC

Catherine Brown  
Group Strategy Director, Lloyd’s

Chris Brycki  
CEO, Stockspot

Olaf Carlson Wee  
Head of Risk, Coinbase

Ulf Carlsson  
General Manager, North Asia & Japan, Nasdaq

Bhaskar Chakravorti  
Senior Associate Dean, The Fletcher School of Law and Diplomacy, Tufts University

James Chappell  
CTO, Digital Shadows

Gongpil Choi  
Senior Advisor, Korea Institute of Finance

Jonathan Coblentz  
CFO, Progress Financero

Claire Cockerton  
CEO / Founding Director, Innovate Finance

Charlotte Cowell  
Head of Product, Wealth Management, MetLife

Eugene Danilakis  
CEO, Mambu

Bruce Davis  
Joint Managing Director, Abundance Generation

Thomas Deluca  
CEO, Advanced Merchant Payment

Marten Den Haring  
Chief Economist and Product Officer, Digital Reasoning Systems

Samir Desai  
Co-Founder & CEO, Funding Circle

Maciej Dolinski  
CEO & Founder, Friendly Score

Matt Dooley  
Managing Director, Connected Thinking Asia

Paul Drake  
Managing Director, Strategy & Business Development, Standard & Poor’s

Leigh Drogen  
CEO, Estimize

Aron Dutta  
Head of Strategy for Financial Markets, Cisco

Grechen Effgen  
Head of Business Development, Zipcar

John Fawcett  
CEO, Quantopian

Lin Feng  
CEO, Deal Globe

Clare Flynn Levy  
Founder & CEO, Essentia Analytics

Dave Girouard  
Founder & CEO, Upstart

Colin Gleeson  
Deloitte UK

Matthew Goldman  
CEO, Wallaby

Russell Gould  
Product Manager, Mobile Wallet Solutions, Vodafone

Ian Green  
Co-Founder & CEO, eCo Financial

Julia Groves  
Chair, UKFCA

Sarah Haberfield  
Deutsche Bank

William Harris Jr.  
CEO, Personal Capital

Jilliene Helman  
CEO, Realty Mogul

Dylan Higgins  
CEO, Kopo Kopo

Dorothy Hillenius  
Director Group Strategy, ING

Reid Hoffman  
Innovator, Investor and Author

Brian Hong  
Managing Director, Financial Services, CVC Capital Partners

Kaori Iida  
Senior Editor, Economic News Division, NHK

Bert Jan Van Essen  
Managing Director & Co-Founder, Dragon Wealth

Paul Jung  
Vice-President, Head of Emerging Products and Innovation, North Asia, Visa Inc.

Sony Kapoor  
Managing Director, Re-Define

Brad Katsuyama  
CEO, IEX

Tom Keene  
Anchor & Editor-at-Large, Bloomberg

James Kennedy  
CEO, Asia Pacific, UBS

Damian Kimmelman  
CEO, DueDil

David Kirkpatrick  
Founder & CEO, Techonomy

Andy Kooper  
Founder & CEO, LeapfrogInvestments

Christian Lanning  
CEO, Tradeshift

Francine Lacqua  
Anchor & Editor-at-Large, Bloomberg

Renaud Laplanche  
CEO, Lending Club

Chris Larsen  
CEO, Ripple

Michael Laven  
CEO, Currency Cloud

Gerard Lemos  
Chairman, UK Payments Council

Max Levchin  
Founder, Affirm

Michael Li  
CEO, CTQuan

Sandra Linhan  
CEO, Lark

Nektarios Liolios  
Managing Director, Startupbootcamp Fintech

Ken Lo  
Co-Founder & CEO, ANX
## Acknowledgements

**List of innovators and subject matter experts (2 / 2)**

In addition, the project team expresses its gratitude to the following innovators and subject matter experts who contributed their valuable perspectives through interviews and workshops (in alphabetical order):

<table>
<thead>
<tr>
<th>Name</th>
<th>Title/Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bo Lu</td>
<td>CEO, Future Advisor</td>
</tr>
<tr>
<td>Jeff Lynn</td>
<td>CEO, Seeds</td>
</tr>
<tr>
<td>John Macdonald</td>
<td>Director, Risk Analytics &amp; Customer Solutions, IBM</td>
</tr>
<tr>
<td>Kevin Mak</td>
<td>Managing Director, IronFly Technologies</td>
</tr>
<tr>
<td>Paul Makin</td>
<td>Head of Mobile Money, Consult Hyperion</td>
</tr>
<tr>
<td>Demetrios Marantis</td>
<td>Head, International Policy and Regulatory Affairs, Square</td>
</tr>
<tr>
<td>Emmanuel Marot</td>
<td>Co-Founder &amp; President, Lending Robot</td>
</tr>
<tr>
<td>Kevin Martin</td>
<td>Head of Retail Banking and Wealth Management, Asia Pacific, HSBC</td>
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<td>Mike Massaro</td>
<td>CEO, peerTransfer</td>
</tr>
<tr>
<td>Mike Mathias</td>
<td>Deloitte China</td>
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<tr>
<td>Steve Mendel</td>
<td>Co-Founder &amp; CEO, Bought by Many</td>
</tr>
<tr>
<td>Douglas Merrill</td>
<td>Founder &amp; CEO, Zest Finance</td>
</tr>
<tr>
<td>Liao Min</td>
<td>Director-General, Shanghai Office, China Banking Regulatory Commission</td>
</tr>
<tr>
<td>Rory Moloney</td>
<td>CEO, Aon Global Risk Consulting, Aon</td>
</tr>
<tr>
<td>Daniel Nadler</td>
<td>CEO, Kensho</td>
</tr>
<tr>
<td>Mas Nakachi</td>
<td>CEO, Open Gamma</td>
</tr>
<tr>
<td>Mike Naughton</td>
<td>Managing Director of Asia for Strategic Customers &amp; Solutions, Thomson Reuters</td>
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<tr>
<td>Christian Nentwich</td>
<td>CEO, DuCo</td>
</tr>
<tr>
<td>Zhu Ning</td>
<td>Deputy Director and Professor of Finance, Shanghai Advanced Institute of Finance</td>
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<td>Michael Nugent</td>
<td>CEO, Bson</td>
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<td>Stephen Pair</td>
<td>CEO, bitpay</td>
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<td>Kyung Yang Park</td>
<td>CEO, UbiPay</td>
</tr>
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<td>Kitty Parry</td>
<td>CEO, Templiers</td>
</tr>
<tr>
<td>Loren Pastore</td>
<td>Business Development Manager, UpSlide</td>
</tr>
<tr>
<td>Andy Patton</td>
<td>VP, EMEA International Business Development, AMEX</td>
</tr>
<tr>
<td>Leslie Payne</td>
<td>Director of Public Affairs, Lendup</td>
</tr>
<tr>
<td>Sandy Peng</td>
<td>CEO, UCIC</td>
</tr>
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<td>Anthony Pereira</td>
<td>Founder &amp; CEO, Percentile</td>
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<td>Claudine Perlet</td>
<td>Head of COO Office, Allianz</td>
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<tr>
<td>Jonas Pielot</td>
<td>Founder, Avuba</td>
</tr>
<tr>
<td>Basil Qunibi</td>
<td>CEO, Novus</td>
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<td>Simon Redfern</td>
<td>CEO, Open Bank Project</td>
</tr>
<tr>
<td>Josh Reich</td>
<td>CEO, Simple</td>
</tr>
<tr>
<td>Selma Ribica</td>
<td>Principal Product Development Manager, Mobile Payments, Vodafone</td>
</tr>
<tr>
<td>Christoph Rieche</td>
<td>Co-Founder &amp; CEO, iwoca</td>
</tr>
<tr>
<td>Antonia Rofagha</td>
<td>Communications Manager, Transferwise</td>
</tr>
<tr>
<td>Yin Rong</td>
<td>Deputy Director, IT, Bank of China</td>
</tr>
<tr>
<td>Jeff Rosenberger</td>
<td>VP, Research &amp; Customer Development, Wealthfront</td>
</tr>
<tr>
<td>Kevin Sara</td>
<td>Chairman, Batan Limited</td>
</tr>
<tr>
<td>Arjan Schutte</td>
<td>Managing Partner, Core Innovation Capital</td>
</tr>
<tr>
<td>Vasuki Shastry</td>
<td>Group Head of Public Affairs, Standard Chartered</td>
</tr>
<tr>
<td>Hyunwook Shin</td>
<td>CEO, Popfunding</td>
</tr>
<tr>
<td>Barry Shrier</td>
<td>Founder &amp; CEO, Liquity</td>
</tr>
<tr>
<td>Barry Silbert</td>
<td>Founder, Second Market</td>
</tr>
<tr>
<td>Brian Sin</td>
<td>Former Head of Innovation, Cigna</td>
</tr>
<tr>
<td>Gurjeet Singh</td>
<td>CEO, Ayasdi</td>
</tr>
<tr>
<td>Balvinder Singh</td>
<td>CEO, ToolPay</td>
</tr>
<tr>
<td>Siddarth Singh</td>
<td>Head of Programme, Pivotal Innovations</td>
</tr>
<tr>
<td>Maria Sit</td>
<td>Regional Managing Director, Asia, Health Wallace</td>
</tr>
<tr>
<td>Paul Sonderegger</td>
<td>Big Data Strategist, Oracle</td>
</tr>
<tr>
<td>Stan Stalnaker</td>
<td>CEO, Hub Culture</td>
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<td>Jeff Stewart</td>
<td>CEO, Lenddo</td>
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<td>CEO, Prosper</td>
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<tr>
<td>Stu Talyor</td>
<td>Co-Founder &amp; CEO, Algomi</td>
</tr>
<tr>
<td>Matin Tamizi</td>
<td>Co-Founder &amp; CEO, Balanced Payments</td>
</tr>
<tr>
<td>Donald Tang</td>
<td>CEO, China, D.E. Shaw &amp; Co. LP</td>
</tr>
<tr>
<td>Spiros Theodossiou</td>
<td>VP Product Strategy, Skrill</td>
</tr>
<tr>
<td>James Tickner</td>
<td>VP, Corporate Solutions, Nasdaq</td>
</tr>
<tr>
<td>Don Trotta</td>
<td>Global Head of Banking, SAP</td>
</tr>
<tr>
<td>Eric Van der Kleij</td>
<td>Head, Level39</td>
</tr>
<tr>
<td>Mark Wales</td>
<td>Deloitte China</td>
</tr>
<tr>
<td>Karen Webster</td>
<td>Managing Director, Market Platform Dynamics</td>
</tr>
<tr>
<td>Karsten Wenzlaff</td>
<td>Leader, German Crowdfunding Network</td>
</tr>
<tr>
<td>Darren Westlake</td>
<td>CEO, Crowdcube</td>
</tr>
<tr>
<td>Paul Wilkins</td>
<td>Chairman &amp; CEO, Marsh (MMCo), Hong Kong SAR</td>
</tr>
<tr>
<td>Jeremy Wilson</td>
<td>Vice Chairman, Corporate Banking, Barclays</td>
</tr>
<tr>
<td>Andrew White</td>
<td>CEO, FundApps</td>
</tr>
<tr>
<td>Edan Yago</td>
<td>CEO, Epiphyle</td>
</tr>
<tr>
<td>Roger Ying</td>
<td>Co-Founder &amp; CEO, Pandai</td>
</tr>
<tr>
<td>Joyce Zhang</td>
<td>VP, Oriental Patron</td>
</tr>
<tr>
<td>Giuseppe Zocco</td>
<td>Co-Founder, Index Ventures</td>
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Acknowledgements

Project Team and Additional Thanks

Project Team

The “Disruptive Innovation in Financial Services” project team includes the following individuals:

World Economic Forum Project Team
Giancarlo Bruno, Senior Director, Head of Financial Services Industry
Abel Lee, Director, Insurance and Asset Management Industry
Matthew Blake, Director, Banking and Capital Markets Industry
Jesse McWaters, Project Manager, Disruptive Innovation in Financial Services – Report Editor

Professional Services Support From Deloitte
Rob Galaski, Deloitte Canada
Hwan Kim, Deloitte Canada

Additional Thanks

In addition, the project team expresses its gratitude to the following individuals for their contribution and support throughout the project (in alphabetical order):

Mika Ciotola
Frank Oberholzner
Maja Schwob

Eva-Maria Thurnhofer
Joerg Weydanz

Market Color (Digital Production)
The Value Web (Event Facilitation)
Level 39 (Location Services)
Executive Summary
The mandate of this project was to explore the transformative potential of new entrants and innovations on business models in financial services

**Project Context**

We set out to address three major problems that have prevented a comprehensive understanding of the state of disruptive innovation in the industry:

- There is no common taxonomy or understanding of which innovations are the most relevant
- There is no clear understanding of the evolutionary path of emerging innovations
- The implications of those evolutions on incumbent business models are unclear, creating significant uncertainty for traditional players as they strive to react to growing competitive pressures

**Project Approach**

We structured our research around three main questions, each requiring distinct actions:

1. **Which emerging innovations are the most impactful and relevant to the financial services industry?**
   
   *Action:* We identified 11 key clusters of innovations based on how they impact the core functions of financial services

2. **How will these innovations impact the ways in which financial services are structured, provisioned and consumed in the future?**
   
   *Action:* We considered a range of scenarios for the degree and nature of impact each cluster of innovation could have

3. **What would be the implications of these changes on customers, financial institutions, and the overall financial services industry?**
   
   *Action:* We analysed the implications of each scenario on customers, incumbent institutions and the overall financial services ecosystem
Over 15 months of research we engaged with industry leaders and innovators through interviews and multi-stakeholder workshops.

**Industry Leaders**
- Oversight, guidance and thought leadership from 16 C-suite executives and 25 strategy officers of global financial institutions

**Innovators**
- In-person and phone interviews with 100+ innovative new entrants and subject matter experts

**Global Workshops**
- Facilitated six multi-stakeholder workshops at global financial hubs with 300+ total participants including industry leaders, innovators, subject matter experts, and regulators

- **Hong Kong SAR**
  - 4 Sep. ‘14

- **Tianjin, China**
  - 11 Sep. ‘14

- **Boston, USA**
  - 30 Sep. ‘14

- **New York, USA**
  - 21-22 Oct. ‘14

- **London, UK**
  - 2 Dec. ‘14

- **Davos, Switzerland**
  - 21 Jan. ‘15
The outcome of this work is the first consolidated taxonomy for disruptive innovation in financial services

Research Framework

We have structured our framework against six functions of financial services and eleven clusters of innovation.

Functions of Financial Services
Even in an environment of rapid change to the design, delivery and providers of financial services, the core needs those services fulfill remain the same. We have identified six core functions that comprise financial services:

- Payments
- Market Provisioning
- Investment Management
- Insurance
- Deposits & Lending
- Capital Raising

Clusters of Innovation
We have identified 11 clusters of innovation exerting pressure on traditional business models.
We have synthesised six high level insights on innovation in financial services

<table>
<thead>
<tr>
<th>Key Research Findings</th>
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</thead>
<tbody>
<tr>
<td><strong>1</strong> Innovation in financial services is <strong>deliberate and predictable</strong>; incumbent players are most likely to be attacked where the <strong>greatest sources of customer friction</strong> meet the <strong>largest profit pools</strong></td>
</tr>
<tr>
<td><strong>2</strong> Innovations are having the <strong>greatest impact</strong> where they employ business models that are <strong>platform based, data intensive, and capital light</strong></td>
</tr>
<tr>
<td><strong>3</strong> The most <strong>imminent</strong> effects of disruption will be felt in the banking sector; however, the greatest <strong>impact</strong> of disruption is likely to be felt in the insurance sector</td>
</tr>
<tr>
<td><strong>4</strong> Incumbent institutions will employ <strong>parallel strategies</strong>; aggressively <strong>competing with new entrants</strong> while also leveraging legacy assets to provide those same new entrants with <strong>infrastructure and access to services</strong></td>
</tr>
<tr>
<td><strong>5</strong> <strong>Collaboration</strong> between regulators, incumbents and new entrants will be required to understand how new innovations alter the <strong>risk profile of the industry</strong> – positively and negatively</td>
</tr>
<tr>
<td><strong>6</strong> Disruption will not be a one-time event, rather a <strong>continuous pressure to innovate</strong> that will shape customer behaviours, business models, and the <strong>long-term structure of the financial services industry</strong></td>
</tr>
</tbody>
</table>
In the following pages, we have summarised our insights by function and cluster.

### Insight Summary – Reading Guide

This section provides a summary of our findings, divided by function and clusters within the functions. For each cluster of innovation we have defined the major disruptive trends, summarized the impact, and examined key implications for institutions in that function and cluster.

#### Function grouping

#### Innovation cluster

#### Key trends driving disruption in financial services business model

#### Summary of the activity that the cluster of innovation is creating

#### Major implications for financial institutions as a result of activity within the cluster

<table>
<thead>
<tr>
<th>Key Findings</th>
<th>Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cashless World</strong></td>
<td><strong>Emerging Payment Rails</strong></td>
</tr>
<tr>
<td><strong>Key Disruptive Trends</strong></td>
<td><strong>Key Disruptive Trends</strong></td>
</tr>
<tr>
<td>Mobile Payments</td>
<td>Cryptographic Protocols</td>
</tr>
<tr>
<td>Streamlined Payments</td>
<td>Interchangeability</td>
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<tr>
<td>Integrated Billing</td>
<td>Next Generation Security</td>
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<tr>
<td>Next Generation Security</td>
<td>Mobile Money</td>
</tr>
</tbody>
</table>

**Summary**

New consumer functionalities are being built on existing payment systems and will result in meaningful changes in customer behaviour.

**Implications for Financial Institutions**

- Financial institutions may lose control over their customers’ transaction experience as payments become more integrated.
- With reduced visibility, becoming the card of first choice among specific customer segments will become critical.
- Winning issuers will gain visibility into more of customers’ spending patterns and build more holistic understanding of customers.

**Summary**

The greatest potential for cryptocurrencies may be to radically streamline the transfer of value, rather than as store of value.

**Implications for Financial Institutions**

- As more efficient alternative rails are adopted, the role of traditional intermediaries as trusted party may diminish.
- Financial institutions may face a new set of risks (e.g., reputation, security) and regulatory issues as they participate in new rails.
- Applications of these technologies can expand beyond money transfer to modernise other financial infrastructures.
## Key Findings | Payments

### Cashless World

#### Key Disruptive Trends
- Mobile Payments
- Streamlined Payments
- Integrated Billing
- Next Generation Security

#### Summary
- **New consumer functionalities** are being built on existing payment systems and will result in **meaningful changes in customer behaviour**

#### Implications for Financial Institutions
- Financial institutions may lose control over their customers’ transaction experience as payments become more integrated
- With reduced visibility, becoming the default card among specific customer segments will become critical
- Winning issuers will be able to gain visibility into more of customers’ spending patterns, build more holistic understanding of customers, and create more competitive offerings

### Emerging Payment Rails

#### Key Disruptive Trends
- Cryptographic Protocols
- P2P Transfers
- Mobile Money

#### Summary
- The **greatest potential for cryptocurrencies** may be to radically **streamline the transfer of value**, rather than as store of value

#### Implications for Financial Institutions
- As more efficient alternative rails are adopted, the role of traditional intermediaries as a trusted party may diminish
- Financial institutions may face a new set of risks (e.g., reputation, security) and regulatory issues as they participate in new rails
- Applications of these technologies can expand beyond money transfer to modernise other financial infrastructures
### Key Findings | Insurance

#### Insurance Disaggregation

<table>
<thead>
<tr>
<th>Key Disruptive Trends</th>
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</thead>
<tbody>
<tr>
<td>Disaggregated Distribution</td>
</tr>
<tr>
<td>Sharing Economy</td>
</tr>
<tr>
<td>Self-Driving Cars</td>
</tr>
<tr>
<td>3rd Party Capital</td>
</tr>
</tbody>
</table>

#### Connected Insurance

<table>
<thead>
<tr>
<th>Key Disruptive Trends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Smarter, cheaper sensors</td>
</tr>
<tr>
<td>Wearables</td>
</tr>
<tr>
<td>Internet-of-Things</td>
</tr>
<tr>
<td>standardised Platforms</td>
</tr>
</tbody>
</table>

#### Summary

Emergence of online insurance marketplaces and homogenisation of risks will force big changes in insurers’ strategies.

#### Implications for Financial Institutions

- In an increasingly commoditised environment, the risks of customers being more fickle will increase and creating loyalty through innovation will become more important.
- Insurers’ ability to benchmark against competitors will become more important as customers gain ability to comparison-shop.
- With increased margin pressure, insurers will need to increase their size by expanding either scope or scale.
- As customer relationships evolve from short-term product-based to long-term advisory, capturing customers early on becomes critical.
- As insurers become a hub for customer data, their strategic value within full-service financial institutions will grow.
- Forming partnerships with data providers, device manufacturers and other ecosystem participants will be critical to enable connected insurance.

#### Ubiquity of connected devices

- Will enable insurers to highly personalise insurance and proactively manage clients’ risks.

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## Key Findings | Deposits & Lending

### Alternative Lending

#### Key Disruptive Trends

- P2P
- Lean, Automated Processes
- Alternative Adjudication

#### Summary

New lending platforms are **transforming credit evaluation and loan origination** as well as opening up consumer lending to **non-traditional sources of capital**.

#### Implications for Financial Institutions

- Intensified competition will narrow spread between deposits and loans, decreasing financial institutions’ profitability.
- As savers turn to alternative platforms, traditional deposits and investment products will be eroded.
- Distribution of customers’ credit portfolio over a large number of alternative platforms may make it difficult to measure customer’s creditworthiness.

### Shifting Customer Preferences

#### Key Disruptive Trends

- Virtual Banking 2.0
- Banking as Platform (API)
- Evolution of Mobile Banking

#### Summary

New entrants will make meeting customer demands more important, creating an imperative for banks to **reconsider their roles**.

#### Implications for Financial Institutions

- Financial products will increasingly be offered on a stand-alone basis, limiting incumbents’ ability to competitively cross-subsidise.
- Financial institutions’ ability to collaborate with non-traditional players and other institutions will become essential.
- Financial institutions will need to choose where they will specialise and where they will leverage external partners (e.g., product manufacturing vs. creation of customer experience).
Key Findings | Capital Raising

Crowdfunding

Key Disruptive Trends

- Empowered Angel Investors
- Alternative Adjudication

Summary
Crowdfunding platforms are **widening access** to capital raising activities, making the **overall ecosystem richer**

Implications for Financial Institutions

- Access to more diverse funding options allow new companies to grow at a quicker pace and shorten the average time between early funding stages

- Distribution platforms create a venue for investors to tailor their investment portfolio across dimensions beyond financial return

- As the barriers to enter the asset class fall, it becomes ever more important for traditional intermediaries’ profitability to find undiscovered “start” investments
Key Findings | Investment Management

Empowered Investors

Key Disruptive Trends

- Social Trading
- Automated Advice & Wealth Management
- Retail Algorithmic Trading

Summary

Robo-advisors are improving accessibility to sophisticated financial management and creating margin pressure, forcing traditional advisors to evolve.

Implications for Financial Institutions

- New entrants will place pressure on margins and intensify competition among traditional players in more specialised segments.
- As more advisory functions become automated, distributing wealth products via proprietary advisory channels will become less effective.
- As new entrants widen the access for mass customers, they will compete for customers’ traditional savings deposits.

Process Externalisation

Key Disruptive Trends

- Advanced Analytics
- Natural Language
- Process-as-a-Service
- Capability Sharing

Summary

The scope of externalisable processes is expanding, giving financial institutions access to the new levels of efficiency and sophistication.

Implications for Financial Institutions

- The ability to access sophisticated capabilities without large infrastructure investments flattens the playing field for mid-sized institutions.
- Organisational agility will become critical to sustain competitiveness as high-value capabilities are continued to be commoditised.
- Externalisation of capabilities may result in workforce skill loss by preventing the development of a holistic view of operations.
Key Disruptive Trends

**New Market Platforms**
- **Fixed Income**
- **Funds / Fund of Funds**
- **Private Equity / Venture Capital Shares**
- **Private Company Shares**
- **Commodities & Derivative Contracts**

**Summary**

New information platforms are improving connectivity among market constituents, making the markets more liquid, accessible, and efficient.

**Implications for Financial Institutions**
- As traditional differentiators among intermediaries (e.g., ability to discover counterparty) become commoditised, the importance of advisory services will increase.
- Information platforms will evolve the standards for best-execution from a best-efforts basis to more quantifiable and comparable metrics.

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**Key Findings | Market Provisioning**

**Implications for Financial Institutions**
- As traditional differentiators among intermediaries (e.g., ability to discover counterparty) become commoditised, the importance of advisory services will increase.
- Information platforms will evolve the standards for best-execution from a best-efforts basis to more quantifiable and comparable metrics.

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**Summary**

As the popularity of high frequency trading declines, the focus of algorithmic trading may shift to smarter, faster response to real-life events.

**New information platforms** are improving connectivity among market constituents, making the markets more liquid, accessible, and efficient.

**Implications for Financial Institutions**
- The impacts of event-driven algorithmic trading on liquidity, spread and systemic stability are unclear.
- With end-to-end trading activities automated, even small errors in data integrity, trade strategy, and execution will lead to large impacts.
- Regulators have the potential to significantly alter the course of developments in this area.

---

**Key Disruptive Trends**

**Smarter, Faster Machines**
- **Machine Accessible Data**
- **Artificial Intelligence / Machine Learning**
- **Big Data**

**Summary**

As the popularity of high frequency trading declines, the focus of algorithmic trading may shift to smarter, faster response to real-life events.

**Implications for Financial Institutions**
- The impacts of event-driven algorithmic trading on liquidity, spread and systemic stability are unclear.
- With end-to-end trading activities automated, even small errors in data integrity, trade strategy, and execution will lead to large impacts.
- Regulators have the potential to significantly alter the course of developments in this area.
We identified six important themes that cut across functions and touch multiple clusters of innovation

1. **Streamlined Infrastructure**
   - Emerging platforms and decentralised technologies provide new ways to aggregate and analyse information, improving connectivity and reducing the marginal costs of accessing information and participating in financial activities.

2. **Automation of High-Value Activities**
   - Many emerging innovations leverage advanced algorithms and computing power to automate activities that were once highly manual, allowing them to offer cheaper, faster, and more scalable alternative products and services.

3. **Reduced Intermediation**
   - Emerging innovations are streamlining or eliminating traditional institutions’ role as intermediaries, and offering lower prices and/or higher returns to customers.

4. **The Strategic Role of Data**
   - Emerging innovations allow financial institutions to access new data sets, such as social data, that enable new ways of understanding customers and markets.

5. **Niche, Specialised Products**
   - New entrants with deep specialisations are creating highly targeted products and services, increasing competition in these areas and creating pressure for the traditional end-to-end financial services model to unbundle.

6. **Customer Empowerment**
   - Emerging innovations give customers access to previously restricted assets and services, more visibility into products, and control over choices, as well as the tools to become “prosumers”.
At the conclusion of the research phase, the Steering Committee gave us a mandate to dive more deeply into high-potential areas of disruption.

### Next Steps

We have identified three major challenge areas related to innovation in financial services that will require multi-stakeholder collaboration to be addressed effectively. We are launching a project stream related to each area, with the goal of enabling tangible impact.

The Forum is uniquely positioned to support advancements against each challenge due to its ability to:
- Convene senior multi-stakeholder groups and align diverse perspectives
- Create thought leadership on cutting-edge issues with long-term implications to the industry

<table>
<thead>
<tr>
<th>Challenges</th>
<th>Projects</th>
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<tbody>
<tr>
<td><em>New financial products and services are creating significant regulatory uncertainty and fueling perceptions of regulatory arbitrage</em></td>
<td><em>Regulatory Models for Innovation</em></td>
</tr>
<tr>
<td><em>Decentralised systems, such as the blockchain protocol, threaten to disintermediate almost every process in financial services</em></td>
<td><em>Applications of Decentralised Systems</em></td>
</tr>
<tr>
<td><em>Outdated identity management protocols create risks and inefficiencies for both service providers and consumers</em></td>
<td><em>Blueprint for Digital Identity</em></td>
</tr>
</tbody>
</table>

*We will be presenting outcomes from these projects in early 2016*
Reading Guide for the Detailed Sections of the Report
The following detailed sections of the report are organised based on key innovation clusters and how they map to the core functions of financial services.
We have analysed the relevant cluster of innovations for each key area of impact and developed scenarios that present potential answers.

**Report Structure**

**A Background Context**
- Brief analysis of current state business models and processes in the impacted function
- Summary of historical developments
- Key pain points and challenges with the current state

**B Analysis of Innovations**
- Overview of key innovations impacting the topic
- Key characteristics of the innovations
- Impact of the innovations on the current state value chain
- Comparison of the current state models and innovations

**C Future Characteristics**
- Key characteristics of future models of financial services enabled by innovations for the impacted function

**D Scenarios**
- Summary of potential outcomes related to the key question for the topic in a scenario format
- Narratives and case studies to further illustrate each scenario
- Necessary conditions required for each scenario to be realised
- Implications of the scenario on customers, incumbents and overall industry
- Key opportunities and risks associated with the scenario

*Key insights from the analysis of each topic and relevant cluster of innovations have been summarised in the Executive Summary and Conclusions pages in each module.*
Detailed Research Modules
Payments

How will customer needs and behaviours change in an increasingly cashless payments landscape?
Executive Summary

Context / Innovation
- A number of innovations have emerged in the past five years leveraging mobile devices and connectivity to make payments simpler and more valuable. Examples range from digital wallets to automated machine-to-machine payments.
- The majority of these innovations will modify front-end processes to improve the customer and merchant experience while leaving the underlying payments infrastructure undisrupted.

Future of Payments
- These innovations will reduce the use of cash and make payments less visible to payers. They will also enable financial institutions and merchants to use data-driven customer engagement platforms:
  - As more payment solutions allow customers to link their bank accounts for direct payment and seamless point-of-sale vendor financing, the use of credit cards could be displaced by these platforms.
  - Customers may lose visibility into their payment choices, increasing their default cards’ share of wallet and reducing the importance of some traditional differentiators like brand and design.
  - The elimination of a need to carry physical cards and the emergence of payment decision support systems could support the proliferation of niche and merchant issued cards, splintering wallet share among many cards.

Key Implications
- Success of any innovative payment solution will require a strong customer rationale to switch, as most customers do not consider the existing payment regime to be broken.
- In an increasingly cashless future payment providers who can embrace emerging payment innovations to offer differentiated, value-adding digital experiences will be able to deepen their relationships with customers and take a dominant place in the changing market landscape.
The payments industry has continuously evolved over time, but there are still some challenges to make the world cashless

**History of the payments industry**
- Since the introduction of credit cards in the 1950s, debit cards in the 1980s and the rise of e-commerce through the 1990s, electronic payments have grown in popularity, displacing cash and cheques. In 2012 they accounted for 68 percent of U.S. transactions in value.
- Electronic transactions rely on a number of intermediaries, which provide acceptance, convenience and security of transactions, and are generally coordinated by large scale-based payment networks.

**Benefits of electronic transactions**
- **Convenience**: Reduces the need for customers and merchants to carry cash, reducing associated costs, including trips to banks, price inflexibility and opportunity costs (i.e., interest earned).
- **Efficiency**: Reduces the cash management costs for businesses and financial institutions as fewer bills are exchanged by hand and money movements are settled electronically.
- **Traceability**: Enables a greater degree of visibility into the flow of money for financial institutions and regulators, facilitating taxation, transparency, and information gathering.
- **Protection**: Protects customers and merchants from fraud and theft by documenting transaction records and reducing the need to hold cash.

**Key challenges inhibiting the cashless world**
- **Merchant Adoption**: Electronic payments are not accepted by every merchant due to the infrastructure costs, high fees and settlement delays.
- **Convenience**: Small denomination payments are often still conducted reducing the number of processing steps and time to complete a transaction.
- **Accessibility**: Under-banked population does not have access to primary accounts and therefore only uses cash in transactions.
- **Fraud**: Despite the safety measures increasingly adopted, electronic transactions create opportunities for fraudulent activities.
A number of payments innovations have emerged in the past five years, leveraging mobile and connectivity to make payments simpler and add value.

Key innovations for the cashless world

- **Mobile Payments**
  - Mobile wallets
  - Mobile-based merchant payment solutions

- **Integrated Billing**
  - Mobile ordering & payment apps
  - Integrated mobile shopping apps

- **Streamlined Payments**
  - Location-based payments (geotagging)
  - Machine-to-machine payments

- **Next Generation Security**
  - Biometrics / location-based identification
  - Tokenisation standards

Common characteristics of successful payments innovations

- **Simplicity**
  - Payments innovations allow customers to make payments in a single tap or automatically by leveraging connectivity (e.g., wireless network, near-field communications)

- **Interoperability**
  - Most innovative payment solutions are not restricted to a single payment method, allowing customers to manage and use a variety of credit cards, debit cards or bank accounts for payment

- **Value-Add Services**
  - Many innovative solutions offer value-add functionalities in addition to payments, enabling merchants and financial institutions to interact more closely with customers and deliver additional value (e.g., loyalty, offers)
Most payment innovations do not disrupt the existing payment processes, but rather modify front-end processes to improve customer and merchant experience.

How different types of innovative payment solutions interact with today’s payment process:

**Open-loop mobile payment solutions**
- Allows for increased consumer access by using existing payment network ecosystem to connect to parties already on the platform (including a large number of merchants) and make payments more convenient for customers leveraging new form factors (e.g., NFC, QR code).

**Closed-loop mobile payment solutions**
- Consolidates the POS, acquirer and payment network as a single entity to create a more flexible experience, requiring consumers, issuers, and merchants to participate. Often allows consumers to fund transactions via the traditional payment network ecosystem.

**Mobile merchant payment solutions; Integrated payment apps; Streamlined payment solutions**
- Aims to replace or complement the current POS infrastructure by leveraging mobile connectivity (and aggregate transactions in some cases) to make the payments process more effortless and accessible by more merchants.

*Illustrative Diagram*
Innovations will make payments more cashless and invisible in the future, while enabling data-driven engagement platforms for customers

Key characteristics of the future of payments

- **Cashless**: More cash will be displaced by electronic transactions as payments innovations make it beneficial for customers to use payment cards even in small denomination transactions.

- **Back of Mind**: As more transactions become virtual and automated, more payments processes will become invisible to end customers, changing their needs and behaviours.

- **Engagement**: As payments and mobility becomes more integrated, the importance of payment transactions as a potential customer interaction point will increase for merchants and financial institutions.

- **Data-Driven**: With greater adoption of electronic payments, more data will be accumulated from payment transactions, allowing financial institutions, services providers and merchants to gain greater understanding of customers and businesses.

- **Increased Access to Loans**: As more payments are processed through electronic rails, financial institutions’ visibility into individuals’ and businesses’ cashflow and spending patterns will increase, improving their ability to extend loans to customers previously less understood.

- **Reduced Costs**: Because innovative solutions build on the existing infrastructure, which has very low variable costs, the cost of making electronic transactions will fall as electronic payments gain more volume.

As innovations change customer behaviours by making payments more effortless and provide financial institutions and merchants with data, what will be the payments landscape in the future?
How will changing customer needs and behaviours in an increasingly cashless world change the payments landscape?

Potential impact on the payments landscape

1. Consolidation of the Payment Market
   - Today: Customers use bank accounts and default cards.
   - Future: Customers use digital wallets and merchant issued cards.
   - Key change to payment behaviour: Customers lose visibility into their payment choices as innovations like Amazon’s 1-click and Uber’s seamless payments push more transactions to a single default card.

2. Fragmentation of the Payment Market
   - Today: Customers use bank accounts and default cards.
   - Future: Customers use digital wallets and merchant issued cards.
   - Key change to payment behaviour: The successful deployment of digital wallets eliminates the need to own/carry physical cards and enable decision support systems to help customers optimise card usage.
   - This drives a proliferation of niche and merchant issued cards, splintering share of wallet across many providers.

3. Displacement of Credit Cards
   - Today: Customers use bank accounts and credit cards.
   - Future: Customers use digital wallets and bank accounts.
   - Key change to payment behaviour: Customers with revolving balances elect to use innovative point of sale vendor financing schemes offering preferable terms.
   - Credit card usage is eroded as transactional card users migrate to payment solutions that seamlessly link to their bank accounts.

The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions.

These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time.
Scenario 1: Consolidation of the payment market (1 / 2)

Narrative

To avoid “moments of truth” in customer decision-making, more merchants and payment solutions will adopt an automated or one-click / one-touch / one-tap check-out in both virtual and physical marketplaces. These “seamless” check-out environments will rely on a default card that will be used unless customers make a conscious choice to change cards. As a result, default cards will become significantly stickier and receive a higher share of total customer spend.

Card issuers will respond to the changing landscape by developing products that provide the best loyalty points and benefits in aggregate to compete for the role of the default card.

Summary of impact

- Customers lose the desire to regularly use a variety of cards as payment innovations enable a seamless transaction experience in one-click / one-touch or less
- Driven by simplicity and convenience, customers push more transactions to a single default card, increasing the default card’s share of wallet
- As customers’ desire to switch cards decreases, traditional differentiators like card brand and design may become less prominent, making it more difficult for card issuers to differentiate

Case studies

In-app purchases within mobile apps can turn traditional physical purchases into online purchases and combine purchase and payment into a single tap, eliminating the step for payment method selection

Virtual payment processing services store customers’ payment credentials and allow customers to use those credentials in one-click or tap to maximise convenience and improve security
Scenario 1: Consolidation of the payment market (2 / 2)

**Necessary conditions for the scenario**

- Availability and widespread adoption of seamless payment solutions to a large number of customers and at a large proportion of everyday-spend merchants
- Customers’ willingness to relinquish control over payment options (e.g., convenience over control)

**Implications of the scenario on...**

<table>
<thead>
<tr>
<th>Customers</th>
<th>Merchants</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less complex and time-consuming customer experience at check-out</td>
<td>Reduced friction and improved efficiency at check-out</td>
<td>Increased competitive intensity among existing players to become top of wallet</td>
<td>Reduction in the number of credit card providers</td>
</tr>
<tr>
<td>Decreased cognitive effort on payment selection</td>
<td>Issuers seek to incentivize merchants to influence consumers to load their cards</td>
<td>Marginalisation of niche players</td>
<td>Increased stickiness to those surviving card issuing institutions</td>
</tr>
</tbody>
</table>

**Opportunities and risks associated with the scenario**

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development of more personalised rewards programs to attract and retain customers</td>
<td>Over time, potential decrease in the number of available card choices as consumers use fewer cards, leading to decreased competition and innovation</td>
</tr>
</tbody>
</table>
Scenario 2: Fragmentation of the payment market (1 / 2)

The adoption of digital wallets will free consumers from physical limitations on the number of cards they can carry, allowing niche cards to gain popularity, particularly in geographies where customers are value-conscious. This proliferation of cards will encourage the development of decision support systems that interact with digital wallets to help customers choose the best card for each purchase. As a result, owning and using multiple payment cards will no longer hinder the delivery of a seamless customer experience, prompting further proliferation of niche / merchant-issued cards.

Case studies

Currently, customers can add multiple payments cards (credit and debit) to leading digital wallets (e.g., 8 for Apple Pay, unlimited for Google Wallet), and pick and choose a payment card for each transaction with few additional clicks / taps.

While currently not integrated with digital wallets, decision support systems run on mobile and wearable devices to automatically recommend the optimal payment option among payment cards added by the customers to maximise the overall rewards.

Summary of impact

- The successful deployment of digital wallets eliminates the need to carry physical cards and virtually removes the limitations on the number of payment cards customers can carry and use.
- Proliferation of digital wallets also enables decision support systems to help customers optimise card usage by automating card selection based on loyalty points and other benefits.
- This drives a proliferation of niche and merchant-branded cards, optimised for specific purchases, splintering share of wallet across many providers.
Scenario 2: Fragmentation of the payment market (2 / 2)

Necessary conditions for the scenario

- Merchants’ widespread acceptance of smart payment solutions or the solutions’ successful integration with existing acceptance markets
- Development of payment solutions into platforms surrounded by innovative ecosystems (e.g., increased linkage between mobile wallets and merchant apps, location-based check-out experience creation)
- Proven efficiency and impartiality of recommendations engines’ card choice for each transactions, creation of streamlined user experience and differentiated value propositions by smart wallets that will drive consumers to want to adopt the optimisation services

Implications of the scenario on...

| Customers | Able to optimise reward collection without sacrificing seamless experience
|           | Potential increase in debt as it becomes easier to issue multiple credit cards, offset by spending management functionalities of mobile wallets
| Merchants | Potential decrease in total merchant service charges paid as private-label cards are more widely adopted among each merchant’s customer base
| Incumbents | Increased issuance of a greater variety of cards
|           | Increased competition from new entrants, including merchant credit cards
|           | Stronger competitive position for niche players
| Overall Ecosystem | Encourage issuers to improve and innovate their product offerings (e.g., rewards programmes, interest rates)

Opportunities and risks associated with the scenario

Opportunities

- Opportunities for merchants to directly enter the payments ecosystem via private label solutions and gain deeper understanding of their customers’ spending patterns
- Ability for financial institutions to introduce highly specialised rewards programmes to capture specific segments of spend

Risks

- Decreasing opportunities to scale for credit card providers
- Potential decline in the efficacy of rewards programmes if card is only used for most rewarding (lowest margin) transactions
- Displacement of traditional players who are not willing to participate in smart payment solutions
- Potential arms race for rewards and backward optimisation
Scenario 3: Displacement of credit cards (1/3)

Narrative

Today, merchants and payment solutions providers, such as mobile wallets pay higher merchant service charges on credit card-funded transactions than on bank account-funded transactions. To reduce costs, these players will use incentives to encourage customers to switch their funding method from credit cards to bank accounts. At the same time, merchants will adopt data-driven alternative vendor financing solutions that offer customers lower interest rates and provide financing income to merchants.

These innovations will place pressure on credit card transaction volume and interest income; limiting issuers’ ability to offer attractive loyalty programmes and reducing competitiveness in the face of merchants who are able to directly offer their own incentives (e.g., loyalty points, special offers).

Summary of impact

- Credit card usage is eroded on two fronts: payment facilitation and revolving lending / loyalty
- Payment solutions that link directly to bank accounts provide an alternative to customers who previously relied on credit cards for payment facilitation
- Point-of-sale vendor financing schemes and merchant loyalty functionalities within new payment solutions further their appeal to customers who currently rely on credit cards for revolving balances or loyalty accumulation

Case studies

- Leading mobile payment solutions allow customers to fund their purchases with credit cards and bank accounts and generally earn profits only on bank-funded transactions
- Leading mobile payment platforms allow customers to add, manage and use multiple merchant loyalty programmes and enable merchants to directly issue offers to customers
- Emerging point-of-sale vendor financing schemes provide revolving or purchase-specific line of credit to replace the need for credit card financing
### Scenario 3: Displacement of credit cards (2/3)

#### Necessary conditions for the scenario

- Create incentives for customers to switch their funding methods
  - Merchants’ willingness to transfer financial incentives to customers to be more appealing than the rewards offered by card issuers
  - Sufficient trust needs to build with wallet providers, alternative lending providers and loyalty providers
- Development of alternative financing providers that can offer comparable user experience and efficiency as credit cards (e.g., seamless application process at POS and efficient loan servicing)
- Cooperation of bank account providers and payment solution providers to allow a seamless connection of payment vehicle and account, including sufficient data visibility for real-time decisioning and authorisation
- Clearly defined liability rules across all ecosystem participants and payment solutions’ ability to provide zero liability for consumers while offering higher rewards
- Bank account providers’ willingness to take on credit risk
- Fraud monitoring that maintains fraud levels near those of the current payment networks
- Development of wallet solutions and business models that do not impose large adoption costs to merchants and have a strong business case
- Acceptance infrastructure of providers must be ubiquitous enough to build customer use patterns

#### Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Merchants</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shift in financial incentives from card-driven rewards programmes to direct savings from merchants</td>
<td>Cost reduction due to elimination of credit card fees, potentially offset by passing on savings to customers and increased fraud costs</td>
<td>Reduced fee revenues</td>
<td>Potential disintermediation of credit card networks</td>
</tr>
<tr>
<td>Potential savings from lower transaction fees if bank account / wallet providers can adopt security innovations and offer protection at a lower cost than current credit card fees</td>
<td>Exert greater control in the payments ecosystem</td>
<td>Transaction accounts become more important than credit cards in customer retention</td>
<td>Entrance of technology companies as providers of alternative payment networks</td>
</tr>
</tbody>
</table>
Scenario 3: Displacement of credit cards (3/3)

Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Encouragement of more prudent spending patterns by customers as revolving credit lines are replaced by case-by-case loans</td>
<td>▪ Fragmentation of payment solutions leading to proliferation of non-interoperable or nationally exclusive payment solutions</td>
</tr>
<tr>
<td>▪ May increase check-out conversion for merchants</td>
<td>▪ Increased risk of violations against data protection and security of transactions due to replacement of proven credit card infrastructure with immature alternative payment solutions</td>
</tr>
<tr>
<td></td>
<td>▪ Lack of clear liability construct could drive confusion across participants</td>
</tr>
<tr>
<td></td>
<td>▪ De-centralisation of payment transactions could drive increased fraud and lower efficacy than existing models</td>
</tr>
</tbody>
</table>
What does this mean for financial institutions?

### Key implications and remaining questions

<table>
<thead>
<tr>
<th>“Safe Bets” – Likely Implications Under All Scenarios</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced control over customer experience: Financial institutions may lose some or most control over their customers’ transaction experience as digital wallets consolidate digital payment platforms</td>
</tr>
<tr>
<td>Customer targeting: Leveraging data on specific customer segments will become an essential component of strategies to gain a dominant share of wallet among those segments that encourage or drive more frequent usage in a diversified market</td>
</tr>
<tr>
<td>Merchant relationships: Financial institutions’ ability to partner with merchants will become critical component of strategies to drive merchant-specific usage, enable merchant-issued credits, or become a preferred card on merchant platforms</td>
</tr>
<tr>
<td>How will issuers create differentiated customer experience when their control over customer experience is taken over by digital payment platforms?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 1: Consolidation of the payment market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Competitiveness of bank-issuers: Large stand-alone issuers or network issuers may gain competitive edge over bank-issuers using their scale to consolidate the market</td>
</tr>
<tr>
<td>360° view of customers: Issuers that consolidate their customers’ share of wallet will gain visibility into most of their payment activities, leading to valuable data on their lifestyles and preferences</td>
</tr>
<tr>
<td>What will be the characteristics of issuers who successfully consolidate the market?</td>
</tr>
<tr>
<td>To what degree can and should financial institutions leverage the enhanced view of customers to deliver more value?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 2: Fragmentation of the payment market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer retention: As consumers spread purchases over a larger and larger number of cards, the credit card will lose its significance as a key anchor of customer retention for financial institutions</td>
</tr>
<tr>
<td>Distributed credit: It will become more difficult for individual financial institutions to assess customers’ credit worthiness as their credits become distributed over multiple cards</td>
</tr>
<tr>
<td>How will retail financial institutions generate customer loyalty and stickiness in the future?</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 3: Displacement of credit cards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shift in credit business models: As new credit vehicles displace credit card based borrowing the overall profit models of retail financial institutions will be forced to change</td>
</tr>
<tr>
<td>Loyalty programmes: Financial institutions will need to create new ways to promote customer loyalty as lower fees on bank account transactions disrupt the current credit card loyalty models</td>
</tr>
<tr>
<td>How will financial institutions assess their customers’ creditworthiness without traditional payment history?</td>
</tr>
<tr>
<td>What will the future loyalty models look like on direct payments from bank accounts?</td>
</tr>
</tbody>
</table>

Implications | Remaining questions
Payments

How will the evolution of decentralised or non-traditional payment schemes change the role of traditional financial institutions?
Executive Summary

Context / Innovation
- The current value transfer system, built on automated clearing houses and intermediary banks, has made it easier for customers to send money across geographies, but many pain points remain to enabling rapid and inexpensive value transfer between countries.
- Decentralised currencies and mobile money solutions provide compelling alternatives to traditional value transferring systems by streamlining the intermediating processes.

Future of Payment and Settlement Rails
- Driven by competitive pressure from these innovations, the future of value transfer will be more global, faster, more transparent, and cheaper.
  - These non-traditional schemes may compete directly with the existing financial ecosystem as alternative payment networks emerge along with a variety of financial products denominated in network's native currency.
  - Financial institutions may choose to facilitate the growth of alternative payment networks as a complement to existing networks. They might act as a gateway for value into these networks and launch financial products that are connected to non-traditional payment schemes.
  - Alternatively, the non-traditional schemes may act as a catalyst for traditional institutions to develop solutions that fix key pain points in the current value transfer system; potentially by leveraging elements of the non-traditional schemes.

Key Implications
- To bring innovations to the traditional value transfer rails, financial institutions must collaborate to identify top priority areas for transformation solve for regulatory complexity.
While the rails built on automated clearing houses have enabled value transfer across geographies, many pain points are emerging as customer expectations rise.

How do financial institutions facilitate value transfer today?

- While the current “rails” for value transfer between financial institutions are complex and involve many institutions a similar process is used for all transactions; from large institutional transfers to the settlement of retail payments.

1. **Sender Request**
   - Sender asks their financial institution to transfer an amount to a specific address (using BIC or IBAN codes).

2. **Secure Messaging**
   - Sending bank sends a secure message to the recipient bank requesting transfer of the specified amount.

3. **Flow of Funds**
   - The recipient bank responds to the sender bank’s request for funds via a clearing house or correspondent bank.

**Evolution of money transfer schemes**

- The basic elements of the current value transfer process have been in place for over 150 years.
- The concept of “wire transfers” was originated by telegraph companies (e.g., Western Union) who would receive funds for transfer from a sending party and send a telegraph to correspondent branch instructing them to deliver the money to the intended recipient.
- The digitisation of this process throughout the latter half of the 20th century improved the security of messaging services and improved the settlement time of clearing house activities.

**Key pain points with today’s schemes**

- The actual transfer is not instantaneous: funds may take several hours or even days to move from the sender's account to the receiver’s account.
- If the sending and recipient banks do not hold reciprocal accounts the payment must be sent to a clearing house or correspondent bank for the assurance of payment for the recipient, adding costs and delays.
- The complex structure of requesting the recipient bank to demand payment makes the process more vulnerable to fraud using exposed sender credentials.
Decentralised payment schemes leverage cryptographic protocols to transfer value virtually in a secure, low cost, near-instantaneous manner

What are decentralised payment schemes?

- Decentralised networks utilise a common set of protocols to allocate tasks across many individual nodes rather than via a central point
- Email is an example of a decentralised system that uses a common protocol (SMTP) to distribute mail between a vast number of servers
- Decentralised payment systems allow users to transmit value between users, typically secured by a set of cryptographic processes
- Most decentralised payment schemes use a single distributed ledger and denominate payments between users in a native “currency,” often referred to as a “crypto-currency”

How have decentralised schemes developed?

- Digital payment schemes are as old as the internet itself with many notable failures including Beenz, Flooz, and Digicash, and the most notable success being PayPal. However, all of these schemes utilised a centralised network requiring trust by users in a central counterparty
- In 2009 a pseudonymous whitepaper proposed the creation of a distributed ledger where transactions between participants could be processed in a trustless environment via a cryptographic process
- The implementation of this distributed payment protocol is the Bitcoin network and the native currency of the ledger are Bitcoins
- Since 2009 a range of service providers have emerged to support the acceptance of payments via the Bitcoin network
- At the same time, many competing schemes have launched, built on the same underlying concepts but employing different encryption technology or focusing on different use cases

What are some emerging decentralised schemes?

- **Bitcoin**: Digital currency run on decentralised payment network
- **Ripple**: Open-source low-cost (~1 / 1000th of a cent) payments protocol and instant exchange of any form of money or value
- **Litecoin**: Open-source P2P Internet currency enabling instant, near-zero cost payments
- **Namecoin**: Decentralised open source information registration and transfer system

Characteristics of decentralised schemes

- Secured by cryptographic protocols
- Capable of near real-time settlement
- Very low transaction costs
- Frequently open source where changes are governed by a network of participants
- Transparency and traceability of transactions is typically superior to current systems but user identification may be weaker or nonexistent
Payments: Decentralised and Non-Traditional Payment Schemes

Mobile monies and P2P value transfer networks rely on a trusted central party to transfer value rapidly across geographies, even in underbanked regions

What are non-traditional payment schemes?

- Mobile money refers to a network that supports payment from one user to another via a mobile device
- A mobile money service may be launched by any firm, not just a traditional financial institution. Mobile money services have been launched by network operators (MPESA) and online retailers (PayPal)
- Transactions may be denominated in a fiat currency or in a form of value issued by the central intermediary
- In developing countries mobile payment solutions have been deployed to extend financial services to the "unbanked" or "underbanked"

How have non-traditional schemes developed?

- In 2002, researchers noted that individuals in Uganda, Botswana and Ghana were spontaneously using airtime as a proxy for money transfer; transferring airtime to their relatives or friends who would then use or resell it
- In April 2007, Kenya’s dominant mobile network operator, Safaricom, launched a new mobile phone-based payment and money transfer service, M-Pesa allowing users to deposit money into an account that can be accessed on their cell phones and send balances using SMS
- In January 2011, Transferwise launched a P2P cross-border money transfer service to aggregate and facilitate exchange of foreign currency and transfer needs at the interbank rate

What are some emerging non-traditional schemes?

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- In April 2007, Kenya’s dominant mobile network operator, Safaricom, launched a new mobile phone-based payment and money transfer service, M-Pesa allowing users to deposit money into an account that can be accessed on their cell phones and send balances using SMS
- In January 2011, Transferwise launched a P2P cross-border money transfer service to aggregate and facilitate exchange of foreign currency and transfer needs at the interbank rate

Characteristics of non-traditional schemes

- Transactions are completed rapidly and are highly transparent to both senders and recipients
- Transfer costs are very low and fees are highly transparent
- Many schemes are moving towards open systems, as they build in interoperability with other schemes and traditional outlets (e.g., ATM)
- Does not necessarily require a traditional bank account or well established financial infrastructure making them well suited for financial inclusion goals
While non-traditional payment schemes offer a greater level of efficiency than the traditional rails, their usefulness is dependent on the scale of adoption.

How do decentralised and non-traditional schemes differ from traditional money transfer models?

<table>
<thead>
<tr>
<th>Value Chain</th>
<th>Traditional Model</th>
<th>Decentralised Schemes</th>
<th>Other Non-Traditional Schemes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Processing of transfers is handled by correspondent financial institutions, often facilitated by payment schemes (e.g., SWIFT, Visa, MasterCard)</td>
<td>Value transfer is recorded in a distributed ledger</td>
<td>Value transfer is facilitated by a single trusted non-financial 3rd party</td>
<td></td>
</tr>
<tr>
<td>Relies on a central clearing body</td>
<td>Transactions are managed by a distributed network of processors</td>
<td>Relies on the intermediary to keep records and settle the transfer</td>
<td></td>
</tr>
<tr>
<td>Transfer is initiated by recipient bank</td>
<td>Sender initiates the transfer</td>
<td>Sender initiates the transfer</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Key Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Network is scalable and includes most existing financial institutions</td>
</tr>
<tr>
<td>Proven ability to manage large capital flows on a global scale</td>
</tr>
<tr>
<td>Large retail and institutional customer base who are familiar with the model</td>
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<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Advantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limited visibility into value flow for both senders and recipients</td>
</tr>
<tr>
<td>Prone to fraud when the sender’s credentials are exposed</td>
</tr>
<tr>
<td>Transfer can take days and efficiency varies by countries / institutions</td>
</tr>
<tr>
<td>High costs / number of intermediaries</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shortcomings</th>
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</thead>
<tbody>
<tr>
<td>High volatility in the value of the native “currency”</td>
</tr>
<tr>
<td>Anonymity of accounts / irreversibility of transfers creates security issues</td>
</tr>
</tbody>
</table>
Payments: Decentralised and Non-Traditional Payment Schemes

These emerging non-traditional payment schemes will create competitive pressure for the value transfer rails to become faster, cheaper and more borderless

Key characteristics of the future value transfer systems

- **Global**
  Geographical distance as a factor in transferring value will continue to narrow and even under-banked regions will be connected

- **Fast**
  The time it takes to transfer value between two accounts will be significantly reduced

- **Transparent**
  The flow of funds will become increasingly visible and traceable

- **Secure**
  The opportunities for fraudulent activities will be largely reduced

- **Reduced Costs**
  The cost to execute transfers will be minimised with the streamlined and automated rails

In achieving these future state characteristics, how will the evolution of decentralised or non-traditional payment schemes change the role of traditional financial institutions?
How will the evolution of decentralised or non-traditional payment schemes change the role of traditional financial institutions?

Potential changes to the role of traditional institutions:

1. Compete with an alternative network of financial providers
   - A network of innovative financial services providers (e.g., authentication, remittance, savings / lending, insurance, merchant payments) emerge around alternative payment schemes.
   - These services provide customers a meaningful alternative to financial institutions by keeping money entirely within the alternative schemes.

2. Facilitate alternative payment schemes as complements
   - Traditional institutions launch financial products that are connected to alternative payment scheme ecosystems (e.g., Bitcoin savings accounts, mobile money insurance).
   - Financial institutions may also act as a gateway to alternative payment schemes (e.g., authentication).

3. Provide leaner, faster payment options within the existing network
   - Alternative payment schemes act as a catalyst for traditional institutions to develop new solutions.
   - Leveraging elements of alternative schemes, traditional institutions build more streamlined rails for the movement of money.
   - These solutions reduce the advantages of alternative payment schemes and retain the flow of money within the traditional financial network.

The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions.

These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time.
Scenario 1: Incumbent institutions compete with an alternative network of financial providers (1 / 2)

**Narrative**
With new start-ups providing protection against fraud and fluctuation in value, decentralised schemes (e.g., Bitcoin) gain momentum as a set of rails to transfer value between individuals. In less developed countries, alternative payment schemes (e.g., M-Pesa) become the dominant solution for the under-banked population.

New entrants emerge to manufacture and distribute financial products with a compelling value proposition (e.g., savings accounts, insurance policies, merchant solutions) denominated in the native currencies of these alternative payment networks. As the result, customers no longer need to transfer money out of the scheme to consume these products, further reinforcing the network.

**Summary of impact**
- A network of innovative financial services providers (e.g., savings / lending, insurance, authentication, merchant payments) emerge around alternative payment schemes
- These services provide customers a meaningful alternative to traditional financial institutions by keeping money entirely within the alternative schemes
- Traditional rails and alternative schemes will stay mostly separated with limited points of interaction

**Case studies**
- Bitcoin exchanges allow customers to securely and quickly transfer value within the Bitcoin network. Bitcoin financial services providers (e.g., bitpay – merchant processor, Coinbase – wallet), in conjunction with those exchanges, strive to provide a competitive value proposition for customers to retain value within the Bitcoin ecosystem
- Mobile money solutions (e.g., M-PESA) have led to an increase in financial product offerings from innovative new entrants, across various financial services functions from insurance to savings
Scenario 1: Incumbent institutions compete with an alternative network of financial providers (2 / 2)

Necessary conditions for the scenario
- Low volatility in native currency of the alternative scheme(s)
- A strong rationale for widespread consumer adoption of the alternative scheme(s)
- A strong rationale for widespread merchant adoption of the alternative scheme(s)
- Regulatory acceptance of alternative currency products and low friction transfers between alternative currency and fiat currency stores of value
- Provision of sufficient and efficient entry points into alternative scheme(s)

Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>More willing to engage in cross-border commerce</td>
<td>Lower floats as customers shift funds into alternative payment networks</td>
<td>Creation of a parallel ecosystem</td>
</tr>
<tr>
<td>Finances are split between native and alternative currencies, creating undesirable complexities</td>
<td>Price competition with various alternative currency offerings</td>
<td>Development of regulatory institutions or expansion of existing regulatory bodies to oversee financial transactions in alternative ecosystems</td>
</tr>
</tbody>
</table>

Opportunities and risks associated with the scenario

Opportunities
- Competition between established and new ecosystems drives innovation and improvements in both

Risks
- Security of stored alternative currencies is a challenge with a history of significant breaches (e.g., Mt. Gox)
- Regulatory redress in alternative schemes has a number of unsolved challenges
- Unstable alternative currencies lead to “foreign” exchange exposure on domestic transactions
Scenario 2: Incumbent institutions facilitate alternative payment schemes as complements (1 / 2)

**Narrative**

As the popularity of decentralised and other non-traditional payment schemes grows within customer segments, incumbent institutions make it easier for their customers to transfer value into and out of the alternative rails. Gradually, these institutions leverage their current products and capabilities to begin playing a greater role as a gateway to non-traditional payment networks rails and financial products denominated in alternative currencies (e.g., a Bitcoin denominated bank account).

Alternatively, incumbent institutions could adopt non-traditional schemes as an internal settlement rail to improve efficiency and customer experience. Once these rails are in place, it would be easier for financial institutions to offer products for non-traditional schemes.

**Case studies**

- **Fidor**, an online full-service bank, has adopted the Ripple protocol for all internal settlement processes to improve efficiency. If usage of the Ripple protocol were to expand to other banks, it could be easily used for real-time payment and settlement between these institutions with no automated clearing house or correspondent banks required.

- **CIC**, a traditional insurer, launched micro-insurance products (e.g., funeral insurance) that accept payment, and pay out claims in M-Pesa balances to target the under-banked population. These products allow CIC to build loyalty and brand recognition with a future customer base.

**Summary of impact**

- Traditional institutions launch financial products that are connected to alternative payment scheme ecosystems (e.g., Bitcoin savings accounts, mobile money insurance)
- Financial institutions may also act as a gateway to alternative payment schemes (e.g., authentication)
- Traditional institutions are involved in both alternative payment schemes and traditional Rails and in some cases, act as points of interaction
Scenario 2: Incumbent institutions facilitate alternative payment schemes as complements (2 / 2)

**Necessary conditions for the scenario**

- Strong business case for financial institutions to offer products and services connected to alternative schemes (e.g., customer demand vs. reputational risks)
- Trust in reliability, security and sustainability of alternative payment schemes

**Implications of the scenario on...**

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Expands the universe of choice between traditional and alternative schemes</td>
<td>- Shift from higher margin traditional products to low margin alternative products</td>
<td>- Increased focus on cyber security</td>
</tr>
<tr>
<td>- Potential for lower fees to transfer value within the financial system</td>
<td>- Possibility of a higher level of regulatory scrutiny</td>
<td>- Potential for new competition among institutions from different geographies</td>
</tr>
</tbody>
</table>

**Opportunities and risks associated with the scenario**

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Improved direct connectivity among institutions as others adopt same alternative schemes</td>
<td>- Exposure to security and volatility risks associated with alternative schemes</td>
</tr>
<tr>
<td>- Ability to leverage financial institution’s existing core capabilities to provide better services than alternative competition (e.g., KYC, AML)</td>
<td>- Significant regulatory exposure as some alternative schemes are not well understood yet</td>
</tr>
<tr>
<td>- Opportunities for increased efficiency in foreign exchange</td>
<td>- Increased reputational risks in case of alternative schemes’ failure</td>
</tr>
<tr>
<td>- May support financial institutions in providing a more borderless experience for their customers</td>
<td></td>
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</tbody>
</table>
Scenario 3: Incumbent institutions provide leaner, faster payment options within the existing network (1 / 2)

Increasingly perceiving alternative payment schemes as a threat, traditional financial institutions have intensified efforts to transform their payment and settlement rails. Financial institutions may make major upgrades to existing payment and settlement systems or build on top of them, employing existing or proprietary message sets. Alternatively, financial institutions may leverage innovations developed by alternative payment networks (such as the blockchain) to achieve these goals but elect to stop short of using the alternative networks themselves.

As transferring value within the existing financial ecosystem becomes cheaper, faster, more transparent and more global, the incentives for customers to use payment rails from non-traditional providers will decrease in the face of uncertainties associated with these options.

Case studies

A number of national retail financial institutions launched consortiums to provide a P2P money transfer service to their customers. While some of these services still rely on traditional settlement rails, adoption of more streamlined technologies and processes can improve these transfers making them lower cost and near-real-time.
### Scenario 3: Incumbent institutions provide leaner, faster payment options within the existing network (2 / 2)

<table>
<thead>
<tr>
<th>Necessary conditions for the scenario</th>
<th>Implications of the scenario on…</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Sufficient competitive pressure for incumbents to invest in development of new rails or major improvements to existing infrastructure</td>
<td>Customers ▪ Ability to receive higher standard of customer experience without relying on less proven systems ▪ Receive better prices but potentially not as low as under more disruptive solutions</td>
</tr>
<tr>
<td>▪ Incumbents must possess technical capabilities to build and maintain new rails</td>
<td>Incumbents ▪ Limited disruption of operations or customer relationships ▪ Improved efficiency in operations ▪ Introduction of new types of risks and necessary controls ▪ Potential costs to integrate with new networks</td>
</tr>
<tr>
<td>▪ Sufficient cooperation among financial institutions and other infrastructure providers globally to set up widely accepted standards, potentially augmenting existing standards to expedite adoption</td>
<td>Overall Ecosystem ▪ Development of leaner, more efficient global system for transfer of value</td>
</tr>
<tr>
<td>▪ Regulatory comfort with new technologies and standards adopted</td>
<td></td>
</tr>
</tbody>
</table>

#### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Ability to achieve efficiency and improvements without adding uncertainty of introducing new parties and assets</td>
<td>▪ Difficulty implementing new technologies and processes may lead to unforeseen consequences</td>
</tr>
<tr>
<td></td>
<td>▪ Risks of not being able to establish appropriate, widely accepted standards</td>
</tr>
</tbody>
</table>
What does this mean for financial institutions?

Key implications and remaining questions

**Revised margin structure:** Margins on the current payment and settlement transactions will need to be restructured as competitive pressure grows from alternative rails.

**Global implementation:** Global settlement infrastructure and emerging markets may present the largest immediate opportunities for the development of alternative rails of payment and settlement given regulatory complexity of developed local markets.

**Changing role of trusted intermediaries:** As highly accurate and efficient alternative rail designs are implemented, the role of traditional intermediaries (e.g., payment networks) as a trusted party may diminish.

**Loss of visibility into customer transactions:** As more financial transactions are conducted via alternative rails, financial institutions will lose visibility into payment history to asset / loan portfolio aspects of some or most of customers’ finances.

**New sets of risks:** As financial institutions participate in the further development and usage of alternative rails, they will face a new set of risks around reputation, security and compliance that are not under their direct control.

**Importance of industry collaboration:** Due to the network-based nature of payment and settlement rails, working with other financial institutions at a global level will become more critical to ensure seamless connectivity for customers.

**Scenario 1:** Compete with an alternative network of financial providers

- **Implications:**
  - Loss of visibility into customer transactions: As more financial transactions are conducted via alternative rails, financial institutions will lose visibility into payment history to asset / loan portfolio aspects of some or most of customers’ finances.
  - How will financial institutions assess customers’ finance and provide appropriate products when they lose visibility into transactions on alternative rails?

**Scenario 2:** Facilitate alternative payment schemes as complements

- **Implications:**
  - New sets of risks: As financial institutions participate in the further development and usage of alternative rails, they will face a new set of risks around reputation, security and compliance that are not under their direct control.
  - What are the new risks associated with alternative rails for value transfer, and how will they be managed and mitigated by financial institutions?

**Scenario 3:** Provide leaner, faster payment options within the existing network

- **Implications:**
  - Importance of industry collaboration: Due to the network-based nature of payment and settlement rails, working with other financial institutions at a global level will become more critical to ensure seamless connectivity for customers.
  - What is the appropriate participation model for incumbent institutions in establishing new infrastructure and standards for value transfer?
Insurance

How will disaggregating forces across the value chain transform the insurance industry?
Executive Summary

Context / Innovation

- A number of emerging forces are creating pressure across the insurance value chain, with the potential to redefine the structure of the market
- The rise of online aggregators and the potential entry of technology players could disaggregate the distribution of personal and small commercial policies and separate insurers from the ownership of customer relationships
- The development of autonomous vehicles and advanced sensors will inherently reduce risk with home and auto while the proliferation of sharing economies will homogenize risks. These and other forces are standardising and commoditising individual risks

Future of Insurance Value Chain

- New sources of capital and investment management capabilities, such as hedge funds and investment banks, are aggressively moving in to the insurance industry through innovative securitisation products, offering more cost-effective options to fund policies
  - As the insurance value chain is disaggregated and commoditised, the importance of scale as a source of efficiency may increase, leading to market consolidation
  - Increased use of commoditised personal insurance products in cross sell, along with blurring lines of property ownership, may support the rise of extremely broad multi-line policies
  - Disaggregation of the mass personal lines market may also lead to insurers shifting their focus to niche and commercial markets where traditional capabilities like actuarial skill, underwriting and personal relationships can make bigger differences to performance

Key Implications

- In order to remain competitive in the face of a disaggregating value chain insurers will need to reconsider which core competencies they will invest in to maintain a strong competitive position
The industry has been slowly evolving over the past couple decades, adopting customer-centric innovations from other financial services functions.

**What are the core capabilities of insurers today?**

- Insurance is typically considered one of the functions within financial services where the adoption of innovation has been the slowest.
- However, over the past decade, many innovative practices such as digital channels and process automation have been gradually adopted by many insurers. This has been especially true in personal lines of business while large commercial lines have continued to focus on establishing a “personal touch” across the value chain.

- Traditional broker / agent in-person distribution faces significant competitive pressures from digital channels in personal lines.
- Distribution partnerships with banks and retailers through white-labelling and over-the-counter products have become increasingly popular.
- In some geographies, customer-centric high-touch services have emerged to provide differentiated claims experience (e.g., rapid response teams).
- The adoption of digital channels has begun to replace manual time-consuming processes to empower customers and / or workforce.

- Innovation labs within insurance companies are being established to combine brand and product managers with technological and analytical resources.
- New products increasingly require integration with 3rd party data providers.
- Advanced statistical models are being deployed to understand the correlation between measurable factors and risk (actuarial) using historical data.
- A large portion of pricing risks with collected data (underwriting) has been automated over the years to improve accuracy and speed, especially with the advent of out-of-box solutions.
- Insurers traditionally deploy their own capital and premiums collected to reserve funds for future claims and invest the rest in various classes of assets to earn investment income. They also reinsure a portion of their business to reduce exposure to catastrophic risks.
- The amount of reserve capital required and allocation of investment assets allowed are mandated by regulatory bodies and limits insurers’ underwriting capacity.
A number of emerging forces will lead to pressure on the insurance industry across the value chain (1 / 2)

Key pressures across the insurance value chain

Advancing technologies, changing customer preferences and the market landscape are enabling a number of innovations and trends, which create pressure across the insurance value chain

**e-Aggregators**
Online aggregators that allow customers to compare prices and purchase insurance products online may displace traditional distribution channels as customer preferences change and more insurance products are commoditised (e.g., UK P&C market)

**Entry of tech players**
Technology providers with brand recognition and trust surpassing financial institutions may enter the insurance distribution market, leveraging their extensive data and distribution capability. Google acquired a UK e-aggregator BeatThatQuote charging insurers up to $54 per click

**Securitization**
Insurance linked securities such as catastrophe bonds are introducing new pools of capital providing fully collateralised coverage to insurers, outside of traditional re-insurance and insurance pools

**R&D/Product Manufacturing**

**Distribution**

**Underwriting**

**Claims**

**Risk Capital & Investment Mgmt.**

**Self-driving cars**
Fully or partially self-driving cars are emerging leveraging smart sensors, connectivity and machine-to-machine communications. This will considerably reduce the risks associated with driving and may shift the principal of insurance from drivers to manufacturers

**Sharing economy**
As sharing economies emerge from pay-as-you-go rentals to shared vehicles and houses, the concept of ownership may radically change, challenging traditional insurance models developed based on one-to-one ownership structure

**Entry of hedge funds**
Driven by a low interest rate environment and access to premiums, hedge funds and alternative sources of capital are moving closer to the insurance value chain by setting up reinsurers, providing additional funding options for insurers

Impact on all Insurers
Impact on P&C insurers
As the result, the insurance value chain will be increasingly disaggregated in the future, changing the nature of the insurance business

Key characteristics of the future state insurance value chain

- **Disaggregation of Distribution**
  - e-Aggregators and technology providers could disaggregate the distribution of personal and small commercial policies and the ownership of customer relationships from insurers

- **Commoditization of Risks**
  - As properties (home and auto) become safer and sharing economy homogenises risks, individual risks will be increasingly standardised and commoditised

- **Decoupling of Capital**
  - A larger proportion of investment risks will be transferred outside of an insurance company as more alternative providers of capital (e.g., hedge funds) offer cost-effective options

- Customer loyalty to insurers will decrease as aggregators create distance between the individual and their insurer
- Erosion will occur in the competitive advantages from existing retail channels (e.g., agent force, brand)
- The importance of actuarial and underwriting capabilities will grow as other parts of the value chain are disaggregated
- Insurers’ margins on personal and small commercial products will decrease
- Growth of insurers will be less constrained by their access to risk capital
- Increased underwriting capacity, transfer of catastrophic risks and commoditisation of risks may lead to decreased impact of insurance cycles

How will disaggregation across the value chain change the insurance landscape in the future?
How will disaggregation across the value chain change the insurance landscape in the future?

**Potential changes to the insurance landscape**

1. **Consolidation of the market by mega insurers**
   - With increasingly homogenised risk profiles and commoditised personal insurance policies, the importance of scale to drive efficiency will grow, leading to the market consolidation
   - Disaggregation of distribution to technology platforms will enable insurers to scale rapidly in a cost-effective manner
   - Widened access to capital through securitisation and alternatives will generate excess underwriting capacity for insurers to support rapid growth and consolidation

2. **Rise of multi-line policies**
   - Personal insurance products that are commoditised in the future will be increasingly used as a bundle to cross sell other more profitable products
   - As the concept of ownership blurs in the sharing economy, the concept of cross sell may expand so that an insurance policy encompasses all risks associated with the customer, rather than specific asset
   - Increased connectivity may allow “personal” insurance policies to be adjusted frequently to match customers’ usage patterns

3. **Shifting focus to niche market and commercial lines**
   - Disaggregation of the personal lines value chain will lead insurers to shift their focus to niche markets where traditional capabilities (e.g., actuary and underwriting) make bigger differences in performance, or pivot towards an increased focus on commercial lines
   - In these markets, distribution and underwriting will continue to be relatively more manual and the insurers’ expertise will not be easily replicated by other insurers

The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions

These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time
As a homogenisation of risk profiles leads to margin pressures and a price sensitive market (particularly in more commoditised segments such as personal auto) insurers who can achieve economies of scale will be able to provide lower prices and gain market share. In order to gain scale, M&A activities among insurers will proliferate and insurers will partner with non-traditional companies, such as technology platforms, to distribute their products. This will allow customers to compare prices and products more readily and accelerate commoditisation of the market. Insurers may also actively reinsure their businesses using securitisation and alternative capital sources to minimise regulatory burdens and stabilise their margins.

**Scenario 1: Consolidation of the market by mega insurers (1 / 2)**

**Narrative**

Increased transparency via online channels and limited investment returns have put significant pressure on pricing in the US auto insurance industry, driving a rapid consolidation over the past 10 years. Even absent notable M&A activities, large insurers who can afford big marketing and R&D budgets have grown rapidly; leveraging their superior customer acquisition capabilities and a price advantage derived from economies of scale. As a result, the share of top 10 auto insurers in the United States has grown from 59% in 2000 to 71% in 2012.

**Summary of impact**

- With increasingly homogenised risk profiles and commoditised personal insurance policies, the importance of scale to drive efficiency will grow, leading to the market consolidation
- Disaggregation of distribution to technology platforms will enable insurers to scale rapidly in a cost-effective manner
- Widened access to capital through securitisation and hedge funds will generate excess underwriting capacity for insurers to support rapid growth and consolidation

**Case studies**

- **GEICO**
- **USAA**
- **Progressive**
### Scenario 1: Consolidation of the market by mega insurers (2 / 2)

#### Necessary conditions for the scenario
- Regulatory allowance of the consolidation of the market (i.e., resolution of anti-trust issues)
- Ability to realise the benefits of scale, particularly in terms of cost efficiencies and underwriting accuracy improvements
- Personal lines customers continue to perceive insurance as a commoditised products

#### Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Implications of the scenario on...</th>
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<tbody>
<tr>
<td></td>
<td>Reduced choices for and differentiation among insurance products</td>
</tr>
<tr>
<td></td>
<td>Potential for higher prices due to lower competition</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Incumbents</th>
<th></th>
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<tbody>
<tr>
<td></td>
<td>Margins expand for surviving insurers as competition is lowered</td>
</tr>
<tr>
<td></td>
<td>Smaller insurance companies are at risk of becoming takeover targets</td>
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</table>

<table>
<thead>
<tr>
<th>Overall Ecosystem</th>
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<tbody>
<tr>
<td></td>
<td>Decreased impetus for innovation and diversification as smaller players exit the market</td>
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</table>

#### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidation leads to reduced transaction costs due to economies of scale</td>
<td>Oligopolistic structure may lead to potential collusion among large players, leading to price increases</td>
</tr>
<tr>
<td>Cost savings from efficiency gains can be passed on to customers via lower prices</td>
<td>Mega insurers may bear more systemic risk resulting in increased regulatory pressures</td>
</tr>
</tbody>
</table>
Today insurers frequently cross sell commoditised, low margin products with their higher margin peers (e.g., the bundling of low margin auto insurance with higher margin home insurance). As the commoditisation of risks accelerates across various products, multi-line insurers may focus more heavily on bundling and cross selling products to achieve economies of scale and build customer loyalty.

Leveraging the more granular and individualised data available through connected devices, insurers may ultimately be able to take product cross selling to its logical extreme; offering a single insurance policy covering all (or a very wide range) of an individual’s risks.

- Personal insurance products that are commoditised in the future will be increasingly used as a bundle to cross sell other more profitable products.
- As the concept of property ownership blurs in the sharing economy, the concept of cross sell may expand so that an insurance policy encompasses all risks associated with the customer, rather than risks associated with specific assets.
- Through increased connectivity, the “personal” insurance policies may be adjusted more frequently to add, subtract or modify coverages to match the customers’ individual usage patterns.

**Case studies**

Farm Family has introduced the concept of aggregate flexible contract to small / medium enterprises, concentrating on rural and suburban area, and targeting specific risks surrounding certain sectors (e.g., Special Farm Package 10 for agriculture owners). On the personal insurance side, many multi-line insurers offer bundling discounts to customers to promote cross sell across personal auto, home and life policies, with auto and home cross sell being more popular among customers, yet multi-line contracts are still not widely adopted.
Scenario 2: Rise of multi-line policies (2 / 2)

Necessary conditions for the scenario

- Insurance companies need to be able to assess and cover a wide range of risks for individuals
- Insurers need the ability and capacities to modify coverage and pricing in real-time
- Customers must trust in insurers’ ability to evaluate and cover their risks comprehensively and fairly

Opportunities and risks associated with the scenario

### Opportunities

- Shifting from insuring “things” to insuring “people” is more aligned with who is actually exposed to risks
- Mono-line and niche insurers may partner with each other or evolve into product-specific reinsurers with deep product knowledge

### Risks

- Risk of adverse selection by customers is exacerbated by insurers expanding into areas where they have less experience
- Potential for certain individuals to oversubscribe to insurance

Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peace of mind knowing that a broad range of situations are covered by a single contract</td>
<td>Requires a full suite of products offering to participate in the market</td>
<td>Expansion of coverage range for each individual</td>
</tr>
<tr>
<td>Potential loss of control over details and choices around specific insurance coverage</td>
<td>Economies of scale driven by vertical consolidation</td>
<td>Minimum size/capabilities required to participate in the market increases</td>
</tr>
<tr>
<td>Potential premium reduction driven by vertical consolidation</td>
<td>Potential challenges for mono-line and niche insurers regarding their competition with multi-line insurers</td>
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</tr>
</tbody>
</table>

Insurance: Disaggregation of Value Chain
Scenario 3: Shifting focus to niche market and commercial lines (1 / 2)

Narrative

As access to granular data and sophisticated underwriting become necessary conditions for personal insurers to survive, those with insufficient scale to compete may choose to specialise in specific market segments. These segments will tend to require in-depth historical knowledge and niche distribution networks based on factors such as demographics (e.g., cancer patients), sector (e.g., medical SME), or region (e.g., Manhattan). Multi-line insurers who sell both personal and commercial policies today may also choose to exit the commoditised personal insurance market and focus more heavily on the commercial market, where their specialised capabilities can lead to higher margins and growth / customer retention.

Summary of impact

- Disaggregation of the personal lines value chain may lead some insurers to shift their focus to niche markets where traditional capabilities (e.g., actuary and underwriting) can make bigger differences in performance and profitability, or pivot toward an increased focus on commercial lines.
- In these markets, distribution and underwriting will continue to be relatively more manual and the insurers’ expertise will not be easily replicated or replaced.

Case studies

Bought by Many, a UK-based insurance start-up, brings together customers with specific insurance needs (e.g., age, illness, residence location, profession) to represent their needs to insurers and promote the creation and distribution of specialised insurance products designed for them. Bought by Many matches customers who do not fit commoditised insurance policies to insurers who are willing to specialise in certain customer segments.
### Scenario 3: Shifting focus to niche market and commercial lines (2 / 2)

#### Necessary conditions for the scenario

- Niche markets and complex commercial lines must continue to require special capabilities that take time and investment to develop
- Margins for niche markets and complex commercial lines need to be attractive
- Mechanisms for insurers to exit their existing commitments in non-niche markets

#### Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fewer suppliers of commoditised insurance products, potentially resulting in a marginal price increase</td>
<td>Increased competition in the most profitable niche and commercial markets</td>
<td>Bifurcation of the ecosystem into commodity and niche markets with different characteristics</td>
</tr>
<tr>
<td>Proliferation of the niche market results in development of products that meet special needs</td>
<td>Less competitive intensity in commoditised markets as companies exit</td>
<td></td>
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</tbody>
</table>

#### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opportunity to encourage insurers to leverage their sophisticated underwriting capabilities to understand and insure against more complex risks (e.g., unhealthy population)</td>
<td>Greater risks for catastrophic losses as the concentration of insurers around niche risks increases</td>
</tr>
<tr>
<td>Increased need for reinsurance as insurers focus more on specific, concentrated markets</td>
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</tbody>
</table>

Insurance: Disaggregation of Value Chain
What does this mean for financial institutions?

Key implications and remaining questions

“Safe Bets” – Likely implications under all scenarios

1 Reduced customer stickiness: With insurers’ ownership of customer relationship further disaggregated and personal lines products further commoditised, customers will become more fickle and creating customer loyalty will become increasingly difficult.

2 Self-insurance models: The overall revenue for the insurance industry will be reduced as the agents of the commoditising forces (e.g., self-driving car manufacturers, sharing economy platforms) gain scale and begin to self-insure.

3 Competitive benchmarking: Insurers’ ability to scan and benchmark against competitors’ pricing models and strategies will become more important as customers gain visibility into prices from multiple insurers via digital distribution platforms.

? How will insurers create customer loyalty and stickiness going forward as the insurance products become increasingly commoditised and new, digital entrants disaggregate customer relationship?

? What role will insurers play in supporting the self-insuring agents of commoditising forces in response to the erosion of the premium base?

? How can the insurance industry cultivate innovation ecosystem amidst risk-averse culture in order to proactively manage the disaggregating forces instead of reacting to them?

Scenario 1: Consolidation of the market by mega insurers

1 Regulatory complexity: As mega insurers emerge across multiple regulatory jurisdictions, their burden to comply with various regulatory regimes will increase.

Scenario 2: Rise of multi-line policies

1 Acquisition of capabilities: Many mono-line insurers today may face challenges in acquiring expertise and capabilities to effectively provide multi-line policies.

? What capabilities will insurers need to develop in order to quickly and accurately assess and respond to changes in customers’ risks?

Scenario 3: Shifting focus to niche market and commercial lines

1 Relationship-driven distribution: Insurers’ ability to build and closely manage relationships with customers and distribution partners, potentially via human workforce, will become more important again to penetrate niche and commercial markets.

Implications  Remaining questions
Insurance

How will an ever more connected world impact the value delivered by insurance providers?
Executive Summary

Context / Innovation

- Increasing adoption of connected devices in cars, homes and lifestyles presents an opportunity for insurers to expand the use of telematics, i.e., the integration of telecommunication and information processing

Future of Personal Insurance

- Expansion of the telematics insurance models through connected devices and platforms will create channels for insurers to better understand their customers and engage more closely with them
  - Connected devices can allow insurers to track and continuously refine individual risk profiles, enabling more accurate underwriting of individual risks and more personalised products
  - Insurers can also evolve into a risk manager for clients by interacting more frequently with their customers and proactively participating in risk management through their customers’ connected devices
  - Furthermore, insurers could leverage the individualised data gathered through connected devices to gain a fuller view of customers’ identities and lifestyles, and work with retailers and external parties to deliver relevant, and financially beneficial, offers to customers

Key Implications

- To reap the benefits of new business models enabled by connected devices, insurers must work closely with device and service providers and must also define acceptable boundaries in utilising customer data
The business model for property & casualty (P&C) and health insurance has been refined over the centuries, but improvement opportunities still exist

Traditional P&C and health insurance processes

- Traditionally, P&C and health insurance policies have been priced based on predictions made using historical information and best in class statistical models

![Diagram]

1. Risks are priced based on the data customers submitted and some 3rd party data, including historical data and predictive indicators, against loss models and clusters created by insurers based on historical statistics.

2. After binding, insurers and customers do not interact until renewal unless specific events are triggered such as claims (e.g., accidents) or servicing (e.g., address change).

3. Customers' usage and losses are reflected in their risk profile only in the underwriting process during the next renewal cycle.

Improvement opportunities in the traditional P&C and health insurance model

**Backward-looking**

Despite the gradual improvement on the accuracy of loss prediction models, losses are predicted using historical indicators. Most pricing models do not adjust to real-time individual behavioural and usage data.

**Limited interactions**

Profitable, claim-free customers typically do not interact with insurers until renewal, limiting insurers' ability to demonstrate value to them and develop stickiness.

**Passive**

Insurers only react to customers' predicted risk profiles upon binding and at renewal, with little to no visibility into proactive risk management opportunities throughout the policy term.
Telematics offers a promising proposition to P&C and health insurers and customers, but its adoption is slow due to a number of factors

What is telematics?

- First introduced in the mid-2000s, telematics insurance products leverage the GPS technology and wireless communications to enable auto insurers to collect usage and behaviour data of their customers in real time or near-real time.
- Leveraging such data, insurers charge customers’ premiums based on their usage of the vehicles and current driving behaviours instead of typical fixed premiums, given the strong correlation between usage of vehicles and risks.
- Today’s telematics devices have evolved to measure a variety of additional behavioural factors from rapid acceleration to air bag deployment.

Benefits of telematics

- **Pricing Accuracy**: Insurers’ risk models become more accurate as individual, empirical and near real-time data is used combined with historical predictions based on segmentation.
- **Lower Claims**: Telematics products incentivise safer behaviours among customers as premiums are linked directly to the behaviours and reduce the overall claims losses for insurers.
- **Personalisation**: As usage and behavioural data accumulates, the insurance premium becomes increasingly personalised to each customer, resulting in lower premiums for customers and customer stickiness for insurers.

Factors inhibiting adoption of telematics

- Installation of physical tracking devices creates an additional “moment of truth” when customers may abandon adoption of telematics.
- Only predominantly low-risk customers sign up for telematics-based insurance contracts and high-risk customers opt out, deterring insurers’ economics.
- Gathering and utilisation of data is usually delayed due to connectivity, costs and analytical power.
- Discounts often do not serve as sufficient incentives for customers to adopt and share personal data.
Connected devices and platforms emerging across cars, homes and lifestyles present an opportunity to improve and expand the telematics insurance models.

Drivers behind the emergence of connected devices
- Smarter, cheaper sensors
- Internet-of-things
- Communication protocols
- Advanced analytics

Innovations creating potential opportunities for the connected insurance model

1. Connected Cars
- Run on operating systems (apps can be installed) and are connected to the internet
- Gather and transmit information on every part of the vehicle
- Communicate with other cars to prevent accidents

2. Connected Homes
- Monitor key metrics (e.g., temperature) and automatically modify the environment accordingly based on learning
- Identify risk factors (e.g., smoke) and take adequate actions for prevention / triaging
- Communicate with the environment to adapt to surrounding environments

3. Connected Lifestyles
- Quantify, track, monitor and manage daily activities through wearable devices
- Identify trends, patterns and recommendations based on quantified data
- Measure, track and analyse vitals relevant for specific conditions and illness

4. Standardised Platforms
- Increase interoperability; facilitate data gathering, management and utilisation; and improve coordination among connected devices

Key advantages
- Easier utilization of data: Gathered data can be shared easily via connectivity and data-based services can be easily provided as apps through platforms (i.e., a tap to install and opt in)
- Real-time communication: Data from vehicles, properties and individuals are gathered and analysed in real-time to provide timely, relevant insights and information to users
- Mix-and-match of data: Data from multiple sources can be combined and analysed to create more comprehensive and accurate understanding of users
Proliferation of connected insurance models will create channels for P&C and health insurers to better understand and engage more closely with their customers.

Key characteristics of the future connected insurance business model

- **Personalisation**: Increased measurability and availability of personal data will allow insurers to refine their understanding of customers’ risks from cluster-based approach to individualised pricing.

- **Accuracy**: With better understanding of each individual’s risks, the pricing accuracy of insurers will improve and more customers will pay premiums appropriate for their risks (i.e., less cross-subsidisation among customers).

- **Transparency**: As customers’ usage and behaviours become more measurable, insurers will gain greater visibility into the circumstances surrounding claims and the opportunities for fraud will decrease.

- **Data-Rich**: Insurers will become a critical custodian of customer data as they gain access to behavioural data on their customers (e.g., vehicle movement), above and beyond historical and static data available today (e.g., type of vehicle owned).

- **Engagement**: Insurers will be able to access additional channels to engage with their customers through mobile and other connected platforms and generate more relevant content for their customers based on data.

As insurers are enabled with additional data and communication channels from connected devices and platforms, how will the value delivered by insurance companies evolve?
How will increasing levels of connectivity impact the value delivered by insurance providers?

Potential value proposition of connected insurers

1. Personalisation of insurance policies
   - Connected devices allow insurers to track and continuously refine individual risk profiles with empirical data, enabling more accurate underwriting of individual risks.
   - Furthermore, connected devices enable a channel for consumers to purchase event-based coverage to personalise their policies for better protection.

2. Active management of the insured’s risks
   - Connected devices create a bilateral channel for insurers to interact more frequently with their customers and proactively get involved in managing their customers’ risks (e.g., health consultation based on data gathered through wearables).
   - By developing ‘concierge’ functions, insurers can actively manage their client’s risk, lower losses and deliver additional value to customers.

3. Broker of personal data
   - Connected devices allow insurers to gather ongoing behavioural data from their customers to gain a fuller view of customer identity and lifestyle.
   - Working with retailers and other external parties, insurers use the increased knowledge on their customers to deliver relevant, financially beneficial information (e.g., offers).

The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions.

These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time.
Scenario 1: Personalisation of insurance policies (1 / 2)

New processes

- Exploration & Submission
- Underwriting (Quoting)
- Binding
- 3rd Party Data

Narrative

A wider adoption of wearable devices (e.g., wristbands) and smarter home sensors (e.g., smart thermometers), as well as the development of aggregation platforms, allows insurers to expand usage-based offerings to home and health policies. As the result, customers pay premiums that are more customised to their risk profiles and usage.

In the automotive space the adoption of standardised platforms and improved sensors enables insurers to create app-based telematics offerings that customers can easily sign up for. Through these apps, customers can purchase additional coverage for specific events.

Summary of impact

- Connected devices create a real-time stream of more granular, individualised, empirical data, enabling insurers to track, analyse, understand and continuously refine individual risk profiles for more accurate underwriting of individual and organisational risks
- Telematics and usage-based-insurance become readily adoptable through the elimination of the need for physical devices and the development of standardised platforms
- Increased connectivity via mobile creates a channel for consumers to purchase event-based coverage to personalise their policies for better protection

Case studies

- Leading mobile platforms are creating standardised platforms that enable the development of apps that can be installed across many vehicles from different automakers. These apps can enable real-time gathering of granular driving data
- Wearable devices that can track users’ lifestyle data are gaining popularity and a number of portable health solutions to track key vitals are being developed. Mobile OS and device makers have also begun to introduce platforms to connect and aggregate data from these devices
- Smarter sensors and control devices (e.g., fire alarms, thermostats) are gaining popularity in households and aggregation platforms are emerging to establish connection among and provide central management of those devices and sensors
## Scenario 1: Personalisation of insurance policies (2 / 2)

### Necessary conditions for the scenario
- Widespread adoption of personal connected devices
- Sophisticated analytical capabilities to use real-time data streams to constantly update underwriting of risks
- Collaboration between regulators, insurance companies, device manufactures and telecommunications operators
- Customers willing to share additional personal data with insurers

### Implications of the scenario on...

#### Customers
- More customised insurance premiums and coverage
- Premiums that are more reflective of true personal risks – less cross-subsidisation between customers

#### Incumbents
- Increased focus on data ownership
- Need to create partnerships with other ecosystem players
- Complete redevelopment of underwriting models

#### Overall Ecosystem
- Personalised insurance products allow less comparability between insurers

### Opportunities and risks associated with the scenario

#### Opportunities
- More accurate underwriting and premium calculation on the basis of available individual data
- Increased stickiness of customers to their insurers

#### Risks
- Management and protection of sensitive, personal data generated by connected devices
- As cross-subsidisation decreases, accessibility to insurance becomes a concern for high-risk customers
- Red-lining customers who elect not to participate in or are excluded from personalised insurance based on data from connected devices
Utilising driving patterns gathered from connected cars and 3rd party data (e.g., weather), insurers send warnings and advice via in-car applications to support safer driving by their customers.

As health insurers gain more granular data on customers' lifestyles and better understand indicators for future illness, they arrange health consultants to high risk customers via mobile apps.

As a result, customers benefit by avoiding accidents and illness and find their insurance policy more valuable, whereas the frequency and magnitude of losses are reduced for insurers.

Summary of impact

- Collection and analyses of more granular data allows insurers to more accurately understand behavioural risk factors and predict near and long-term increases in risk.
- Connected devices create a bilateral channel for insurers to interact more frequently with their customers and proactively get involved in managing their customers’ risks before events occur.
- By evolving into a manager for their client’s risks, insurers can lower losses while delivering additional value to customers.

Case studies

Marmalade Insurance, a UK based insurance company, targets less-experienced driver segments with its telematics offering by providing feedback and e-learning based on driving behaviour to promote safer driving.

Vitality Health’s app encourages its customers to voluntarily track and share lifestyle data with the insurer. The app then provides analysis and feedback based on the gathered data, and rewards customers for healthier lifestyle choices with gifts and other benefits.
### Scenario 2: Active management of the insured’s risks (2 / 2)

**Necessary conditions for the scenario**
- Development of advanced analytical capabilities to predict future risks
- Clear understanding of liabilities associated with advice
- Customer trust in insurers to manage their risks and provide advice

**Implications of the scenario on...**

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reducing risks and better managing future risks through insurers' advice</td>
<td>The implementation of ‘concierge’ functions becomes a core value proposition</td>
<td>Decrease in the overall risk pool of the participating customers through active management of individuals’ risks</td>
</tr>
<tr>
<td>Increased focus on behavioural indicators of risks (i.e., what matters and when to engage)</td>
<td>Build customer loyalty by becoming partners to customers</td>
<td></td>
</tr>
</tbody>
</table>

### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opportunity for insurers to evolve into a service provider that offers differentiated services to customers (e.g., health consulting)</td>
<td>Dealing with losses resulting from policy holders rejection of advice</td>
</tr>
<tr>
<td>Lower claims due to proactive management of risks and longer-term customer education</td>
<td>Dealing with losses resulting from absence of advice or the delivery of incorrect advice</td>
</tr>
<tr>
<td></td>
<td>Risk of fraud from customers gaming the connected systems</td>
</tr>
</tbody>
</table>
Scenario 3: Broker of personal data (1 / 2)

Narrative

Insurers already gather static data on customers’ properties (e.g., make of car, house location, age). Connected devices will allow insurers to track their customers’ behaviour with sufficient granularity to create a comprehensive picture of their identity and lifestyle. Automotive insurers will be able to predict future erosion of tires and collaborate with auto parts retailers to send discount offers to replace tires based on the make of vehicles. Home insurers could utilise customer data to predict a vacation approaching and offer discounts on travel packages as well as travel insurance. These offers will provide additional financial value to customers, encouraging loyalty and supporting proactive risk management.

Summary of impact

- Connected cars, homes and health devices will allow insurers to gather ongoing behavioural data from their customers, which can be combined with existing asset data to better understand customers’ identity and lifestyle
- Working with retailers and other external parties, insurers can use the improved knowledge of their customers to deliver relevant, financially beneficial information to customers, which can incent them to better manage their risks

Case studies

While many P&C insurers already partner with retailers to offer relevant discounts, the use of behavioural data is still limited.

Insure the Box, a UK auto insurer, leverages telematics devices installed on cars to provide theft recovery services.
**Scenario 3: Broker of personal data (2 / 2)**

### Necessary conditions for the scenario
- Insurers gain customer trust as guardians of personal data by clearly demonstrating alignment of interests with customers and providing sufficient value in exchange for their personal data.
- Compliance with existing and future regulations on usage of personal data.

### Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Financial incentives from individualised offers</td>
<td>- Decrease in claims and losses</td>
<td>- Increased competition for partnerships</td>
</tr>
<tr>
<td></td>
<td>- Potential for partnership revenue</td>
<td>- Early-movers may benefit from locking up partnerships</td>
</tr>
<tr>
<td></td>
<td>- Halo effect with customers based on providing additional value</td>
<td></td>
</tr>
</tbody>
</table>

### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Incentives may support lower risk behaviour by policy holders (e.g., not delaying tire replacement)</td>
<td>- Data might be misappropriated by external parties</td>
</tr>
<tr>
<td></td>
<td>- Risk of losing customers' trust, particularly if relevance of offers is low</td>
</tr>
</tbody>
</table>
What does this mean for financial institutions?

Key implications and remaining questions

“Safe Bets” – Likely implications under all scenarios

- **Real-time data and analytics**: Insurers’ ability to gather and analyse data in real-time will become more essential to enabling and optimising the benefits of connected insurance models.

- **Strategic role of insurance business**: As insurers gather behavioural data from customers and become more sophisticated in understanding risks, the role of insurance within retail financial institutions will become critical in understanding customers’ financial status and needs (e.g., Bancassurance players may benefit significantly from insights generated from the connected insurance models).

- **Importance of customer lifecycle management**: As insurers’ relationships with customers become stickier, it will become more difficult for insurers to steal market share. Capturing desirable customers early in their lifecycle will become critical to building revenue.

- **How will the individual behavioural data generated from connected devices be sourced? What issues will arise related to the aggregation and ownership of this new data?**

<table>
<thead>
<tr>
<th>Scenario 1: Personalisation of insurance policies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reduced cross-subsidisation</strong>: Insurers’ current business model of cross-subsidising across customers will no longer be feasible when a majority of insurance policies and premiums are highly individualised.</td>
</tr>
<tr>
<td>How will insurers successfully demonstrate the value of new offerings to early adopters given their lack of historical data and limited experience analysing these data streams?</td>
</tr>
<tr>
<td>How will less-desirable customers be served as insurers become able to exclude them, particularly considering the public nature of some insurance products (e.g., health, auto)?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 2: Active management of the insured’s risks</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Separation of distribution and customer management</strong>: Insurers will need to develop direct digital channels to interact with customers and manage their risks, regardless of their distribution strategies and channels (e.g., brokers).</td>
</tr>
<tr>
<td>How will the insurers incentivise customers to participate in the connected models of insurance and modify their behaviours as they play more proactive role in managing customers’ risks?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Scenario 3: Broker of personal data</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Merchant relationships</strong>: In order to deliver relevant value to customers, insurers’ ability to manage relationships with merchants will become more critical, which is not a core capability in the insurance industry today.</td>
</tr>
<tr>
<td>Where will the new boundaries lie in selecting desired customers and utilising their data to generate value (e.g., third party offers) while ensuring fairness and privacy?</td>
</tr>
</tbody>
</table>

Implications  Remaining questions
Deposits & Lending
How will emerging alternative models of lending change the market dynamics of traditional lenders?
Executive Summary

Context / Innovation

- Following the financial crisis, lower risk appetites among retail banks have significantly limited access to traditional bank intermediated lending. This is particularly true among sub-prime borrowers.
- Over the same period of time alternative lending platforms leveraging P2P models have experienced rapid growth. These platforms use alternative adjudication methods and lean, automated processes to offer loans to a broader base of customers and a new class of investment opportunities to savers.

Future of Savings & Lending

- As competitive pressures from alternative lending platforms grow, the overall savings and lending industry will be forced to compete.
  - Alternative lenders could successfully move upstream to replace traditional institutions in intermediating prime loans while traditional lenders, restricted by legacy processes and high capital requirements, lose share.
  - Alternatively, traditional institutions and alternative platforms may continue to cater to different classes of investors and borrowers, especially with growing partnerships between smaller traditional institutions and alternative platforms.
  - Traditional institutions could also transform their processes and technologies, potentially absorbing alternative platforms, to adopt the key features of alternative lending business models.

Key Implications

- Emerging alternative lending models create both competitive threats and evolutionary opportunities for financial institutions, making it important for incumbent institutions and alternative platforms to develop more integrated partnerships and learn from and share each other’s capabilities.
In a risk-averse economy, retail banks’ model of intermediating savers and borrowers has reduced accessibility to loans for subprime customers

How do financial institutions facilitate lending activities today?

- Retail banks receive savings from their account holders and provide interest on the savings in return. In most countries, regulators mandate banks to insure and hold minimum reserve on the savings held.
- Using the saved funds, retail banks originate loans to borrowers and receive interest in return. The availability of loans and the interest rates are determined by the adjudication of borrowers’ risk profiles, typically using credit scores.
- Typically, interest received on loans are higher than interest paid on savings to account for default risks and other operational costs.
- The breadth of borrowers served is dependent on each bank’s risk appetite, which is generally related to the size and scale of the banks (e.g., riskier borrowers tend to be served by tier 2/3 banks or balance sheet lenders).

Evolution of traditional lending models

- Following the 2008-2009 global financial crisis, customer trust surrounding financial services quickly dissipated.
- Regulators also mandated increased safety measures around loans (e.g., higher capital requirements) which resulted in many banks tightening loan requirements.
- This mutual loss of confidence created a lending gap, leaving a considerable portion of borrowing needs underserved by financial institutions.
- Furthermore, customer preferences in financial services are rapidly changing, demanding more transparency, efficiency and control over their savings and loans.

Key characteristics of traditional models

**Limited Access**
A growing lending gap limits the availability of loans to individuals and companies with higher risk profiles.

**Slow Speed**
Traditional adjudication processes with multiple layers of approval limits the banks’ ability to process loans in timely manner.

**Margin for Error**
Traditional adjudication models and credit scores tend to miss suitable lending opportunities in a virtual economy.

**Poor Customer Experience**
Highly manual adjudication processes and requirements fall short of increasing expectations on customer experiences.

**Limited Control**
Borrowers have limited visibility and control over the uses of funds and interest rates earned.

**Low Return**
Operational inefficiency and reduced risk appetite of banks result in low returns on savings.
Alternative lending platforms leverage P2P models and lean operations to offer seamless services to a broader base of customers

Description of alternative lending models

- Alternative lending institutions have emerged to fill gaps in the traditional lending model. New industry players are emerging across the globe, showcasing a myriad of value propositions and strategies that are challenging traditional business models.
- Online and P2P (P2P) lending platforms provide customers low-cost, fast, flexible, and more customer-oriented alternatives to mainstream retail banking that traditional financial institutions once dominated.
- While the business models of alternative lenders often differ from one another, most providers directly link borrowers and lenders, employ advanced adjudication methods and streamline processes.

Key characteristics of alternative lending platforms

- **P2P**: Alternative lenders leverage online platforms and legal contracts to provide direct matching of funds between savers and borrowers. By acting as online marketplaces, P2P lenders facing lower funding costs than traditional depository lenders.

- **Alternative adjudication**: Alternative lending platforms assess the creditworthiness of borrowers based on metrics beyond the credit scores used by traditional lenders (e.g., social data). Most alternative lenders also refine their risk engine more frequently than traditional lenders to incorporate feedback based on empirical analysis.

- **Lean, automated processes**: Alternative lending platforms are free of legacy processes and technologies, allowing them to onboard and assess borrowers and lenders in a more streamlined fashion. At most alternative platforms, assessment of borrowers is at least partly automated against predefined rules for fast, transparent processing.
Traditional and alternative lending models differ significantly in their flexibility and allocation of risk

- Traditional lending intermediaries (e.g., retail banks) take risks themselves and leverage their scale to provide stability to lenders (depositors), however their focus is typically limited to low-risk borrowers and they charge high fees (in form of interest spread). Therefore the needs of risk-seeking savers and high-risk borrowers are not fully served by traditional banks
- Alternative lending platforms typically provide an online marketplace where lenders have the flexibility to pick and choose a desired risk portfolio. The marketplace generates lenders’ scores and typically takes a cut of loan originations and ongoing loan revenues but does not directly take risks

<table>
<thead>
<tr>
<th>Description</th>
<th>Traditional lending intermediaries</th>
<th>Alternative lending platforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Savers</td>
<td>Risk-averse, Risk-seeking</td>
<td>Savers</td>
</tr>
<tr>
<td></td>
<td>Retail Banks</td>
<td>Alternative Platforms</td>
</tr>
<tr>
<td></td>
<td>Low-risk</td>
<td>Borrowers</td>
</tr>
<tr>
<td></td>
<td>High-risk</td>
<td>Low-risk</td>
</tr>
<tr>
<td></td>
<td>Stabilization</td>
<td>Stabilization</td>
</tr>
<tr>
<td></td>
<td>Lending processes</td>
<td>Lending processes</td>
</tr>
<tr>
<td></td>
<td>Risk profiles</td>
<td>Risk profiles</td>
</tr>
<tr>
<td></td>
<td>Transparency</td>
<td>Transparency</td>
</tr>
<tr>
<td></td>
<td>Traditionally underserved borrowers gain access to loans and diverse risk appetite of lenders is met</td>
<td>Traditionally underserved borrowers gain access to loans and diverse risk appetite of lenders is met</td>
</tr>
<tr>
<td></td>
<td>Reduction of transaction costs</td>
<td>Reduction of transaction costs</td>
</tr>
<tr>
<td>Limitations</td>
<td>Lenders do not have flexibility to determine the desired level of risk and return</td>
<td>Investments may be more susceptible to individual default risks even with portfolio approach, especially for smaller investments</td>
</tr>
<tr>
<td></td>
<td>Primary focus on low risk loans exclude higher risk borrowers, depending on the market conditions</td>
<td>Guarantees on the investments are limited</td>
</tr>
</tbody>
</table>

- Alternative lending platforms directly match lending needs of borrowers with willing lenders (individuals or institutions)
- Contractual obligations exist directly between borrowers and lenders and platforms provide mere intermediation and adjudication
- Alternative platforms are compensated through origination fees or a percentage of interest payments
- Lending processes and risk profiles are transparent to both borrowers and lenders
- Traditionally underserved borrowers gain access to loans and diverse risk appetite of lenders is met
- Reduction of transaction costs
Alternative lending platforms are creating competitive pressures to savings and lending industry to become more transparent and customer friendly.

Key characteristics of future deposits and lending models

**More Accurate Underwriting**
Adverse selection by lending intermediaries with superior underwriting capabilities will lead to a broader adoption of alternative credit indicators for adjudication and pricing.

**Increased Access**
Use of alternative adjudication and diversification of lenders will provide more lending options to a broader spectrum of borrowers (e.g., “thin file” borrowers).

**Control and Transparency**
Lenders will gain more control over the return on their savings based on their risk appetite and more visibility into the flow of their savings.

**Reduced Costs for Borrowers/Increased Return for Savers**
As the understanding of risk profiles of borrowers is improved, the margins of lending intermediaries may be pressured, resulting in lower cost of obtaining loans for borrowers and increased return for lenders.

**Fast and Customer Friendly**
Streamlined and automated processes expedite loan processing and improve customer experience for borrowers.

While enabling these future state characteristics, how will emerging alternative models of lending change the market dynamics of traditional lenders?
How will emerging alternative models of lending change the market dynamics of traditional lenders?

### Potential roles of alternative lending platforms

1. **Disintermediation of traditional intermediaries**
   - Alternative platforms successfully move upstream to replace traditional institutions in intermediating risk-averse savers and low-risk borrowers
   - Restricted by legacy processes / technologies and reserve requirements, traditional institutions lose their share to leaner and more consumer-friendly alternative lending platforms

2. **Complementing traditional intermediaries**
   - Traditional institutions and alternative platforms continue to cater to different classes of investors and borrowers
   - Some smaller institutions with limited lending bandwidth may partner with alternative lenders through customer referral and capital investments to address the underserved needs of their customer base

3. **Driving change within traditional intermediaries**
   - Traditional institutions transform their processes and technologies or absorb alternative platforms to adopt the key features of alternative lending business model
   - Traditional institutions serve as a lending intermediary for both low-risk and high-risk borrowers, building on their trust and reliability among customers

---

The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions.

These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time.
As the position of alternative lending platforms in the high-risk lending market matures, alternative lending marketplaces will gain sufficient customer trust and reputation to attract more risk-adverse investors and low-risk borrowers. The ability of alternative lending platforms to offer borrowers lower interest rates and a more streamlined customer experience will also help attract and retain low-risk borrowers. As lending marketplaces move upstream to prime lending markets they may evolve to become the primary origination point for consumer lending and an investment destination for a portion of bank’s deposit float.

**Case studies**

**Scenario 1: Disintermediation of traditional intermediaries (1 / 2)**

- **Zopa**: Launched in 2005 as the world’s first P2P lending service, Zopa targets only prime lenders as determined by its adjudication model, and competes with traditional institutions on rates / returns and a more seamless origination process. In 2014, Zopa achieved a default rate of 0.38 percent, significantly lower than traditional institutions.

- **CreditEase**: Launched in 2006, CreditEase started as a Chinese P2P lending service, aiming to bridge urban lenders with excess funds and an underbanked rural population with borrowing needs. Building on its success CreditEase has grown to offer other financial products and services, such as wealth management products for high net worth customers.

**Summary of impact**

- Leveraging alternative adjudication methods, streamlined processes, and lower overhead, alternative lenders successfully move upstream and emerge as a cheaper and faster direct competitor to traditional lending institutions in the low-risk lending space.

- Entrenched by legacy processes / technologies and capital requirements, traditional institutions do not adapt quickly enough and lose share to leaner and more consumer-friendly alternative lending platforms.
Scenario 1: Disintermediation of traditional intermediaries (2 / 2)

### Necessary conditions for the scenario

- Sufficient customer knowledge and trust in alternative lending platforms by both borrowers and lenders
- Relevant authorities need to be comfortable with alternative lending platforms accounting for a significant portion of total loans originations
- Increased liquidity of investments through the development of secondary markets (allowing them to compete with money market funds and other highly liquid savings products)

### Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Customers across the spectrum gain ability to select desired risk / return mix</td>
<td>• Loss of market share to alternative lending platforms</td>
<td>• Loss of savings accounts may lead to losing shares in other products</td>
</tr>
<tr>
<td>• Some investments become more susceptible to default risk</td>
<td>• Reduced ability to cross-subsidise financial products</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Negative impact on capital ratio as deposits erode</td>
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</tbody>
</table>

### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>• Creates a new asset class once critical mass for liquidity is achieved</td>
<td>• Uncertainty around the stability of the ecosystem in a high interest rate environment</td>
</tr>
<tr>
<td></td>
<td>• Overhead costs for alternative lending platforms may increase as their scale grows, eroding their cost advantage</td>
</tr>
<tr>
<td></td>
<td>• Conflict of interest may arise as alternative lending platforms act as rating agencies within their marketplace but also benefit from the origination of new loans</td>
</tr>
</tbody>
</table>
Scenario 2: Complementing traditional intermediaries (1 / 2)

**Narrative**

Unable to build sufficient customer awareness / trust, particularly in the market for low-risk lending, alternative lenders enter into partnerships with existing financial institutions. Traditional financial institutions are able to refer high-risk borrowers who do not meet minimum lending requirements to alternative platforms, thereby helping those customers fulfill their financing needs without the risk of losing other elements of their business (e.g., deposit accounts, credit cards) to another traditional financial institution. Some smaller, and more regional, institutions may also find it beneficial to “park” excess funds with their lending marketplace partners as a mechanism for diversifying their lending portfolios.

**Summary of impact**

- Traditional institutions and alternative lending platforms continue to cater to different classes of investors and borrowers – traditional institutions cater to the low-risk market based on trust, and alternative platforms cater to the high-risk market based on access.
- Some traditional institutions with limited lending bandwidth may partner with alternative lenders to meet the underserved needs of their customer base, by referring customers or investing excess capital.
- Overall, more customers gain access to savings and lending products that best suit their needs as the industry becomes more diversified.

**Case studies**

In 2014, Lending Club (an alternative lending platform) and Union Bank (a U.S. regional bank) formed a strategic alliance. Under the agreement, Union Bank plans to purchase personal loans through the Lending Club’s platform and work with the platform on the co-creation of new credit products. Through the partnership, Union Bank can meet the borrowing needs of its sub-prime customer segments while earning higher interest on its strong balance sheet.
### Scenario 2: Complementing traditional intermediaries (2 / 2)

#### Necessary conditions for the scenario

- Continued regulatory acceptance of alternative lending models serving the sub-prime market
- Alternative lenders do not gain sufficient awareness / trust from the low-risk borrower and investor base
- Banks continue to have a limited appetite for high-risk lending

#### Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customers are more likely to trust alternative lending platforms as they become associated with established financial institutions</td>
<td>The ability to serve high-risk customers without risking losing other business lines (e.g., transaction accounts)</td>
<td>Expansion of credit without disruption of traditional industry structure and lending models</td>
</tr>
<tr>
<td>The ability to earn originations revenue from high-risk borrowers without taking high risks</td>
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</table>

#### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opportunity to create a more inclusive financial ecosystem and mechanisms for customers to build / rebuild creditworthiness without the main financial ecosystem taking direct risks</td>
<td>Reputational risks for traditional institutions who partner with alternative lenders</td>
</tr>
<tr>
<td></td>
<td>Established institutions that refer customers to alternative lending platforms may fuel the growth of those platforms, allowing them to evolve into more direct competitors</td>
</tr>
</tbody>
</table>
Scenario 3: Driving change within traditional intermediaries (1 / 2)

**Narrative**
Responding to the threat of alternative lending platforms, traditional institutions transform their technologies and processes and / or acquire the alternative platforms. This allows traditional institutions to leverage alternative adjudication methods, deliver a more streamlined lending process, and improve efficiency to potentially offer lower interest rates. It will also allow them to selectively cater to more borrowers that traditionally fell in underserved categories.

**Summary of impact**
- Traditional institutions transform their processes and technologies or absorb alternative platforms to adopt the key features of an alternative lending business model, such as alternative adjudication and streamlined processes, to provide compelling value proposition to customers
- Traditional institutions successfully create financial products beyond savings products to cater to the borrowing needs of high-risk borrowers and provide the desired level of return to risk-seeking lenders

**Case studies**
Advanced Merchant Payments (AMP) helps traditional financial institutions transform and supplement their adjudication models with alternative methods to improve underwriting accuracy of small / medium enterprise loans. For instance AMP enables financial institutions to leverage merchant acquiring data in adjudication, which is more accurate indication of a company’s cash flow and readily accessible by financial institutions.
Scenario 3: Driving change within traditional intermediaries (2 / 2)

Necessary conditions for the scenario

- Sufficient pressure from alternative lending platforms on traditional intermediaries to justify significant investments in new business processes and IT infrastructure
- The ability of traditional financial institutions to achieve cost competitiveness with alternative lending platforms by adopting alternative adjudication and process improvements

Implications of the scenario on...

**Customers**
- Significant improvement in customer experience and availability of loans / investment opportunities without customers having to change service providers

**Incumbents**
- Ability to directly serve their customer base's borrowing needs, even for the high-risk customers
- Improved profitability due to adoption of alternative adjudication methods
- Reduced leakage during lending application process due to streamlined straight-through processing

**Overall Ecosystem**
- Incumbents remain dominant with minimal changes to ecosystem but significant improvements are made in the efficiency of the lending process

Opportunities and risks associated with the scenario

**Opportunities**
- Accessibility to the financial system can be extended to more customers without changing the overall ecosystem
- Financial institution’s ability to more accurately understand risks associated with borrowers and loans will improve

**Risks**
- Potential risks might be created by channelling additional credit volume through the traditional financial institutions
- Reputational risks associated with running alternative lending platforms that specialise in high-risk loans
**What does this mean for financial institutions?**

### Key implications and remaining questions

#### “Safe Bets” – Likely implications under all scenarios

<table>
<thead>
<tr>
<th>Scenario 1: Disintermediation of traditional intermediaries</th>
<th>Scenario 2: Complementing traditional intermediaries</th>
<th>Scenario 3: Driving change within traditional intermediaries</th>
</tr>
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<tbody>
<tr>
<td><strong>Erosion of deposits and investment products:</strong> As savers leverage alternative lending platforms as short and medium-term investment vehicles, erosion will occur among traditional deposits and investment products (e.g., money market funds) offered by traditional institutions, ultimately leading to some balance sheet shrinkage.</td>
<td><strong>Distributed credit:</strong> Customers’ savings and credit portfolios could become distributed over a large number of alternative platforms with varying reporting standards, making it difficult for financial institutions to measure each customer’s creditworthiness on a consistent basis.</td>
<td><strong>How will retail banks continue to maintain their ability to serve lending needs of customers as the erosion of deposits to alternative lending platforms leads to a smaller balance sheet?</strong></td>
</tr>
<tr>
<td><strong>How will retail banks continue to accurately and consistently assess creditworthiness as customers’ loan portfolios become distributed and the measurement of creditworthiness becomes increasingly diversified?</strong></td>
<td><strong>Reduction of diversification of customers:</strong> As risk-tolerant savers and high risk borrowers switch to alternative lending platforms, the profiles of customers served by traditional institutions will become increasingly homogenised.</td>
<td><strong>Diversification of products:</strong> In order to compete against diverse lending platforms and serve various needs of savers and borrowers, traditional institutions will need to diversify savings and lending products from today’s one-size-fits-all approach.</td>
</tr>
<tr>
<td><strong>Pressure on spread:</strong> Intensified competition driven by alternative lending models will create pressure on spread earned between interest paid to savers and earned from borrowers, leading to margin pressure on financial institutions.</td>
<td><strong>How will traditional institutions compete against diverse lending platforms and serve various needs of savers and borrowers?</strong></td>
<td><strong>In addition to the adoption of alternative adjudication models and streamlined processing, how will financial institutions meet increasingly diversified needs of savers and borrowers?</strong></td>
</tr>
<tr>
<td><strong>How will traditional institutions offer competitive interest rates to both savers and lenders against the disintermediated business model of alternative lending platforms?</strong></td>
<td><strong>How will traditional institutions participate in the alternative lending market to meet the needs of their customers who are currently underserved (e.g., direct entry, investment vehicle, distribution partnership)?</strong></td>
<td><strong>Implications</strong></td>
</tr>
</tbody>
</table>

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*Deposits & Lending: Alternative Models of Lending*
Deposits & Lending

What will be the future role of financial institutions in response to continually shifting customer preferences?
Executive Summary

Context / Innovation

- Driven by generational shifts and rapid consumer adoption of technology, customers’ channel preferences for financial products and services are shifting rapidly.
- These changing customer preferences have manifested in a number of innovations, from the development of virtual banks to the evolution of mobile banking capabilities, and the development of “banking as platform” movement.

Future of Primary Accounts

- As customer expectations for financial institutions continue to rise, financial institutions will be required to create a fuller virtual experience that is more customer driven, potentially changing the role of primary account providers.
  - Increasing customer demand and growing trust with tech companies may enable non-traditional firms that excel in creating digital customer experiences to assume control of the customer relationship, while traditional institutions focus on manufacturing financial products.
  - Full-service virtual banks could offer a comprehensive suite of financial products by partnering with a range of niche alternative providers (e.g., P2P lenders, automated asset managers); allowing the network of alternative providers to compete directly with full-service retail banks.
  - In the future financial institutions could leverage virtual channels to offer frequent customer interactions and non-financial value-adds above and beyond needs-based transactions to strengthen customer relationships.

Key Implications

- As customers’ demands continue to grow, it will become increasingly difficult for financial institutions to cater to all the needs of customers. In the future – financial institutions should consider what portion of their business they would like to retain and what partnerships can deliver better value to customers.
These changing customer preferences have manifested in a number of innovations emerging across primary account providers.

**Virtual Banks**
- “Direct Banks” first emerged in the 1990s based on telephone banking and have since evolved to become more “virtual,” relying on online / mobile channels.
- Most virtual banks established to date have been subsidiaries of large traditional financial institutions, targeting their price-sensitive customer segments.
- Today, improved technology is allowing virtual banks to offer new and compelling value propositions beyond just lower cost.

**Evolution of Mobile Banking**
- Rapid adoption of mobile devices has led many financial institutions to quickly add digital channels for basic transactions.
- However, these channels often struggle to meet customers’ demands for fully functional mobile platforms.
- Free of legacy systems, non-traditional players are emerging to offer mobile apps that make financial transactions even more effortless for customers (e.g., P2P money transfer, photo bill payment, voice recognition).

**Banking as Platform**
- Legacy systems and competing priorities limit the speed at which traditional players can offer innovative online and mobile tools, particularly for smaller institutions where the cost to deliver a full suite of solutions to meet diverse customer needs can be prohibitive.
- Banking-as-platform movement aims to standardise APIs across financial institutions allowing 3rd party developers to easily build and integrate customer-facing enhancements to the institutions’ core offerings.

**Case studies**
- **Fidor Bank**: Fully virtual “community” bank in Germany, offering innovative products such as game currency wallet and high degree of social media integration.
- **Popmoney**: Provides financial institutions with a mobile / online solution that enables fast, easy and low cost consumer to consumer money transfer via email and text across institutions.
- **Crédit Agricole**: Runs an app store for its customers to download a wide range of additional functionalities to its core online and mobile platform by exposing its API to external developers.

Other Examples:
- **Simple**, **mBank**, **Zuno**, **Mitek**, **USA**
- **Crédit Agricole**
- **Yodlee**
As customer expectations continue to rise, the primary accounts industry will become more virtual and customer-driven

**Key characteristics of the future banking experience**

- **Full Virtual Experience**
  Virtual channels will evolve beyond basic transactions to provide broader functionality such as onboarding and servicing

- **Customer-Driven**
  As customers become more tech savvy, the value propositions and customer experiences of financial institutions will be increasingly shaped by customer demands

- **Higher Expectations**
  Banks will need to cater to heightened expectations of customers who are accustomed to the seamless customer experiences offered by technology providers

- **Segment-based**
  Service offerings will evolve to target and meet the needs of each segment or community, moving away from one-size-fits-all mass market approach

- **Externalised**
  Financial institutions, especially the smaller and newer organisations, will shift away from in-house approach to relying on external providers to deliver online and mobile solutions in a timely manner

What will be the future role of financial institutions in response to continually shifting customer preferences?
What will be the future role of financial institutions in response to continually shifting customer preferences?

### Potential impact of shifting customer channel preferences

1. **Disaggregation of customer relationship ownership**
   - **Today**: Distribution, Manufacturing, Risk Taking
   - **Future**: Distribution, Manufacturing, Risk Taking, Financial Institution, Investors
   - Increasing customer demand and growing trust with technology companies enable non-financial companies that excel in creating digital customer experience to disaggregate distribution of financial services and ownership of customer relationships.
   - Traditional financial institutions evolve to become providers of financial products, focusing on sophisticating the products with excess capacity.

2. **Enabling the ecosystem of non-traditional providers**
   - **Traditional Full Services Bank**: Investment, Lending, Account, Remittance, FX, Payments
   - **Non-Traditional Network**: Alternative Lending, Payment Rails, Account Provider, Automated Investment, Traditional Products
   - “Light” or virtual financial institutions emerge that only focus on account management, offering a comprehensive suite of financial products by partnering with a range of niche alternative providers of financial services (e.g., alternative lending, alternative payment rails, etc.).
   - These partnerships allow a network of alternative providers of financial services to compete directly against incumbent full-service retail banks.

3. **Embedding closer into customers’ daily lives**
   - **Primary Account Institution**: Financial Transactions, Branch Banking, Daily Touchpoints
   - **Customers**: Financial Value-adds, Non-Financial Services
   - Financial institutions leverage virtual channels to offer frequent interactions with customers, above and beyond today’s needs-based transactions, to strengthen customer relationships.
   - Virtual channels enable financial institutions to offer not only financial value-adds but also non-financial services to customers (e.g., concierge services for high value customers) without significantly increasing costs.

The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions.

These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time.
Scenario 1: Disaggregation of customer relationship ownership (1 / 2)

Narrative

A partnership is launched between a financial institution with no retail banking presence and a technology player with existing customer relationships, customer trust, and an expertise in the creation of online experiences. Together these partners leverage their respective expertise in a seamless digital customer experience and manufacturing financial products to create a new kind of online financial experience complete with a full suite of financial products.

The structure of the partnership allows the technology player to increase their access of data and centrality to the lives of their customers with limited pressure on their balance sheet or increased regulatory exposure.

Summary of impact

- In the face of rising customer expectations for a highly flexible, intuitive and personalised service across multiple platforms, new and existing players who are accustomed to providing these sort of solutions disaggregate the manufacturing of financial products from the ownership of customer relationships.
- Traditional financial institutions evolve to become manufacturers of financial products, shifting freed capacity from distribution to focus on manufacturing sophisticated or highly personalised products.

Case studies

Many leading technology players chose to enter the mobile payments space by partnering with established financial institutions and leveraging white-label products. This allowed them to focus on their own expertise in customer interactions (e.g., marketing, UX, offers) while relying on their financial partners’ infrastructure and capabilities. PayPal’s mobile payment solution used Discover’s payment network infrastructure for acquiring, approval, clearing and settlement, while a core component of Google Wallet’s mobile offering involves a virtual pre-paid Visa card issued by US Bancorp.
Scenario 1: Disaggregation of customer relationship ownership (2 / 2)

Necessary conditions for the scenario

- Non-traditional market players must be perceived as highly trustworthy and must provide a sufficiently superior offering to justify a change in financial institutions
- Seamless integration among players involved in the value chain

Implications of the scenario on...

**Customers**
- Significantly improved customer experience
- Changes the ways customers perceive their banks and technology providers

**Incumbents**
- Acceleration of existing shifts in the dominant distribution strategy away from branch based sales
- Pressure on retail banks to cannibalise existing business by creating competing partnerships
- Loss of customer ownership and commoditisation of core services drives decreased bargaining power

**Overall Ecosystem**
- Potential for consolidation of financial service product providers
- Pressure on regional players with limited ability to partner with technology providers

Opportunities and risks associated with the scenario

**Opportunities**
- Financial institutions will be able to develop a broader suite of more sophisticated products as they focus solely on manufacturing
- Potential for financial products and services to integrate more seamlessly with other services offered by technology players
- Financial institutions no longer need to worry about customer experience management

**Risks**
- Financial institutions may lose control over the ownership of customers and become at the disposal of technology providers
- Customer loyalty and stickiness may erode as customers gain more visibility and can more readily compare financial institutions and products
- Technology players may lack regulatory familiarity with requirements on product sales and the emergence of more personalised financial products may create regulatory uncertainties
Scenario 2: Enabling the ecosystem of alternative providers (1 / 2)

Narrative

Alternative providers of niche financial services continue to mature and become reliable alternatives to offerings of traditional institutions. Initially, connections develop among these niche providers through bi- or multi-lateral partnerships. Eventually, some traditional banks shift their focus to managing customer relationships as “depositories of trust” and serve as a central platform for connections to niche providers' products. Alternatively, digital wallets (e.g., Google Wallet, PayPal) or online marketplaces (e.g., Money Supermarket, Amazon) may evolve to become those central platforms.

These network of non-traditional niche providers collectively meet customers’ banking needs and compete with traditional full service banks. They also provide the ability to seamlessly mix and match niche providers that fit the clients needs in a fashion not possible within today’s full service financial institutions.

Case studies

Simple is a low cost, virtual-only bank that provides primary account services to its customers with a focus on improving customers’ ability to save, budget and control their spending. Simple has partnered with a number of traditional and emerging financial institutions to provide fuller functionalities to customers: Visa to facilitate payments (debit cards), Venmo to enable mobile payments, Bankcorp and CBW to deposit savings in FDIC-insured products, and Allpoint to provide a fee-free access to ATM networks.

Summary of impact

- “Light” or virtual financial institutions emerge that only focus on account management, offering a comprehensive suite of financial products by partnering with a range of niche providers of financial services (e.g., alternative lending, alternative payment rails)
- These partnerships allow a network of alternative financial service providers to compete directly with full-service retail banks
- Customers are able to select the products that best fit their needs and pay transparent fees since financial products are not cross-subsidised
### Scenario 2: Enabling the ecosystem of alternative providers (2 / 2)

#### Necessary conditions for the scenario

- Existence of account providers with the ability and incentive to connect with many competing providers of financial services
- Services and products of alternative niche providers must in aggregate fulfill the core requirements of most clients
- The network of alternative niche providers must provide a sufficiently compelling value proposition for customers to consider changing financial institutions
- Account providers must be able to act as a trusted verifier of services offered by alternative niche providers
- Regulatory comfort with significant growth in the use of alternative niche products

#### Implications of the scenario on...

**Customers**

- Creation of market for each product class leads to increased choice and potentially lower prices
- Greater control over the selection of financial products
- Lower loyalty to financial institutions

**Incumbents**

- Increased competition with alternative niche providers who are now able to achieve greater scale
- Challenge to pricing of cross-subsidised products with increased competition from mono-line products
- Pressure to integrate with 3rd parties to deliver cheaper and more customer-friendly solutions

**Overall Ecosystem**

- Alternative niche providers gain access to the main population and form more meaningful pressures for financial institutions to innovate
- Markets for each product become more modular

#### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Decrease in cross-subsidisation will benefit the consumers of those products and services that are currently subsidising other products</td>
<td>- With increased choices, customers may face cognitive challenges to select the right products and providers for them</td>
</tr>
<tr>
<td>- Increased pressure for innovation within each product line</td>
<td>- Liability may be unclear in cases of fraud or service failure</td>
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<td></td>
<td>- Non-bank virtual account providers may lack sufficient understanding of risks associated with niche products</td>
</tr>
<tr>
<td></td>
<td>- Decrease in customer loyalty and stickiness</td>
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</table>
Scenario 3: Embedding closer into customers’ daily lives (1 / 2)

Description of the scenario

To meet evolving customer demands, financial institutions actively explore innovations in mobile and other virtual channels’ transactional services. Empowered by smarter machines that can emulate human-human interactions, financial institutions automate previously high-touch, high-value services and deliver them through virtual channels to increase touchpoints with customers.

Financial institutions also build on their core competencies today and extend them to tangent spaces (e.g., extending secure management of finances to personal data / identity management) to play a bigger role in customers’ lives and improve customer loyalty and retention.

Potential development stories

- Financial institutions leverage virtual channels to offer frequent enriched interactions with customers above and beyond today’s needs-based transactions in order to strengthen customer relationships
- Virtual channels may present an opportunity for financial institutions to evolve their role from providing financial transactional and value-add services to delivering non-financial services to customers (e.g., concierge services for high value customers, custodian of data, identity management) without significantly increasing costs

Case studies

<table>
<thead>
<tr>
<th>Transactional Innovation</th>
<th>New Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voice recognition and command</td>
<td>Augmented reality new home finder</td>
</tr>
<tr>
<td>Cardless ATM withdrawals</td>
<td>Digital lockbox for important documents</td>
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<tr>
<td>Provide instant digital receipts</td>
<td></td>
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<tr>
<td>Location-based reward offers</td>
<td></td>
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</tbody>
</table>
**Scenario 3: Embedding closer into customers’ daily lives (2 / 2)**

### Necessary conditions for the scenario

- Continued competitive pressure from disruptors on incumbent institutions to innovate
- Financial institutions’ ability to understand customers’ unidentified needs and develop competitive offerings to cater to them

### Implications of the scenario on...

#### Customers
- Access to new and better integrated quasi-financial services

#### Incumbents
- Importance of the traditional branch as a source of customer interaction will decrease
- Pressure to acquire or develop new capabilities
- Improved stickiness of customers

#### Overall Ecosystem
- Expansion of the role of financial institutions in customers’ lives
- Non-cost differentiation of product offerings

### Opportunities and risks associated with the scenario

#### Opportunities

- Opportunities to solidify customers’ trust in financial institutions by playing bigger roles
- Opportunities to use 3rd party services to create more literate, better protected clients

#### Risks

- New risks and liabilities may arise as financial institutions expand to offer quasi-financial services
- Potential to leave out customers unfamiliar with / unwilling to adopt technologies as financial institutions’ distribution strategies change
What does this mean for financial institutions?

**Key implications and remaining questions**

"Safe Bets" – Likely implications under all scenarios

**Reduced cross-subsidisation**: Whether they are anchored around non-traditional players or financial institutions, financial products and services will increasingly be offered on a stand-alone basis limiting incumbent institutions’ ability to competitively cross-subsidise.

**Partnership with non-traditional players**: Financial institutions’ ability to work with non-traditional players will become essential to creating new distribution channels, providing competitive product offerings and enabling non-traditional services.

**Redefining the role of financial institutions**: Financial institutions will need to realign their long-term strategy based on how they define their shifting role with varying emphasis on product manufacturing and creation of customer experiences.

*How will the emergence of competitive unbundled products and resulting limits on cross-subsidisation impact the overall structure and business model of retail financial institutions?*

**Scenario 1: Disaggregation of customer relationship ownership**

**Reduced access to customer data**: As customers consume financial services on an a-la-carte basis, financial institutions will no longer own the majority of individuals’ financial data, limiting their ability to independently create more compelling products and services.

*What will be the products and services that anchor customer relationships to retail financial institutions in the future; particularly as customers move toward “shopping” for financial products through technology players (e.g., Amazon, Google)?*

**Scenario 2: Enabling the ecosystem of non-traditional providers**

**Reduced control over customer experience**: Even though financial institutions may still act as a gateway, their ability to control end-to-end customer experience will be reduced.

*What will be the core value proposition of traditional financial institutions to customers compared to technology players, considering traditional institutions’ strengths as perceived by customers?*

**Scenario 3: Embedding closer into customers’ daily lives**

**New set of risks**: As financial institutions evolve their core offerings to stay more relevant in customers’ daily lives, they may need to expand to unfamiliar and less-defined areas, which may generate new risks and compliance issues that are not common to financial institutions today.

*What tangential products and services could financial institutions offer in the future, leveraging their strengths (e.g., custodian of customer data)?*

**Implications**

**Remaining questions**
Capital Raising
How will the evolution of distributed capital raising impact the role of traditional intermediaries?
Executive Summary

Context / Innovation
- Traditionally, capital raising activities have been facilitated by specialised financial institutions, leveraging their deep expertise to identify and support investment opportunities. Access to investments in these intermediaries has been limited to select high net worth and institutional investors.
- In the face of growing interest in start-ups and digital democratisation, a series of alternative funding platforms have emerged, widening access to capital raising activities and providing funding to a greater number of companies and projects.

Future of Alternative Funding Platforms
- While these alternative funding platforms are not likely to replace the traditional capital raising ecosystem in the short or medium term, their growth could change the role of incumbent institutions:
  - Alternative funding platforms may solidify their position as a key capital raising intermediary for higher risk seed-stage companies, which would increase their access to funding and increase the number of new firms eligible for venture capital.
  - Alternative platforms could also evolve to focus on investors with motives beyond financial return. They could help funnel capital to low-return opportunities that would not have qualified for investment from traditional venture capitalists but provide non-financial returns to crowd investors (e.g., alternative energy projects or local development projects).
  - Alternative capital raising platforms could also provide a channel for larger companies to raise capital directly from their customers base, potentially reducing costs while supporting customer engagement.

Key Implications
- The opportunities created by the proliferation of alternative capital raising platforms likely outweigh the risks they pose to incumbent institutions as they enable a more diversified pipeline of investment opportunities to support a richer innovation ecosystem.
Capital raising has been traditionally facilitated by specialised institutions with deep expertise, but individual investors have limited access so far.

How do financial institutions facilitate capital raising activities today?

- While smaller loans for small / medium enterprises are directly issued by retail / commercial banks, larger capital needs of companies are typically fulfilled by issuing equity or debt through a specialised intermediary like an investment bank.
- Unlike lending transactions where loans are issued from the banks’ balance sheet, investment banks facilitate the structuring, marketing and sales of equity or debt capital to potential investors and charge a fee to the issuing company (in certain cases, banks participate as an investor by buying shares / bonds, managing investors funds or providing a lending facility).
- Issuing companies directly pay back principal and interest on debt or pay dividends for equity to the investors.
- Layers of financial institutions, from venture capital to investment banks, specialise in and focus on various stages of businesses to facilitate capital raising.

Emerging pressure on traditional lending models

- Increased connectivity, the success of internet start-ups, changing consumption behaviours and increasingly entrepreneurship-friendly policies have fueled a rapid increase in the number of start-ups, making effective screening and selection processes by traditional funding options (e.g., venture capital) increasingly difficult.
- To maintain control and agility, rapid growth companies continue to delay accessing the public pool of capital via IPOs, aided by policies and regulations permitting widening of investor base without going public (e.g., Jumpstart Our Business Startups Act (JOBS Act)).
- As a result, an imbalance is created between supply and demand for capital in the private market, calling for alternative models to provide the funding required.

Key challenges with traditional models

- **Limited Access**: Access to capital can be limited by the size, history and relationships of a business.
- **Timely Supply of Capital**: Lengthy structuring and fulfillment process may limit timely access to capital.
- **Standardised Measurement**: Appeal to investors is determined strictly by risk / return and funding may be limited for opportunities with alternative propositions.
- **Loss of Control**: Businesses may lose control over key decisions to investors and individual investors do not have direct control over their investments.
- **Potential for Inadequate Funding**: The ability to meet funding needs at a fair price can be deterred by the capability of the intermediating institution.
Alternative funding platforms enable the crowd to play a bigger role in providing capital to investment opportunities

### Description of alternative funding platforms

- Alternative funding platforms provide an opportunity for businesses to interact directly with individual investors to widen options for raising capital
- Instead of providing investment advice or directly marketing investments in equity or debt capital, alternative funding platforms aggregate investment opportunities, provide a standardised view of the opportunities and facilitate legal structuring of equity or debt issued
- The rating of investment opportunities are conducted through the wisdom of the crowd (i.e., minimum target must be met for successful funding) or by allowing more experienced individual investors to lead the investment activities, instead of using credit rating agencies or sell-side analysts

### Key characteristics of alternative funding platforms

#### Crowd Based
- Alternative funding platforms provide a marketplace for individual investors to directly discover and invest in investment opportunities
- Investment opportunities are typically only funded when a pre-determined target is met, to weed out less credible or less promising opportunities through “crowd’s approval”

#### Empowering Individuals
- Some alternative funding platforms leverage the expertise of more experienced individual investors in certain fields (e.g., angel investors) by providing them an opportunity to lead funding for desired investments
- Some platforms allow these “lead” investors to gain additional income through fees, similar to carries paid to general partners of private equity firms

#### Customisation
- Alternative funding platforms provide a number of customisable parameters for businesses to adjust and easily design funding options desirable for them (e.g., term, equity share)
- Moreover, some platforms allow businesses to build in unique clauses, such as rewards, to make them appealing to investor segments

---
While traditional capital raising intermediaries directly structure products or investment money for their customers, alternative platforms act as a marketplace.

### Traditional intermediaries

- **Ecosystem**
  - Investors: High Net Worth, Institutional, Mass
  - Intermediaries: Venture Capital / Private Equity / Investment Banks
  - Investment Opportunities: Seed, Series A-D, Mid-Market, Large

- **Description**
  - Equities and debts are structured and sold through an intermediating institution, mainly to institutional investors.
  - Access to the investment opportunities are limited for individual investors and they indirectly invest through institutional investors instead, without control over where their funds are invested.

- **Advantages**
  - Businesses and investors can rely on the expertise of intermediating institutions to raise adequate funding and select more promising investment opportunities.
  - Aggregation of capital allows intermediaries or institutional investors to effectively represent their interests to the funded businesses’ management.

- **Limitations**
  - Individual investors have limited control over how their funds are invested in businesses and projects.
  - Funding options are limited and stratified depending on the size and maturity of the business.

### Alternative funding platforms

- **Ecosystem**
  - Investors: Institutional, High Net Worth, Mass
  - Facilitator: Alternative Funding Platforms
  - Investment Opportunities: Large, Seed, Series A-B, Mid-Market

- **Description**
  - Alternative funding platforms act as a facilitator providing an online marketplace for individual investors to discover and invest in businesses and projects, relying on the “wisdom of the crowd” or other seasoned investors in selection.
  - Contractual obligations exist directly between individual investors and investment opportunities.

- **Advantages**
  - Individual investors gain direct visibility and control over investment target selection and allocations.
  - Individual investors can gain higher return on successful investments since they are made directly.
  - More businesses and projects gain an opportunity to fund their capital needs.

- **Limitations**
  - Businesses will receive less specialised advice and support than they would from specialised intermediaries.
  - Individual investors’ liquidity is highly limited, especially with pre-IPO equity funding.
The proliferation of alternative funding platforms will make the capital raising market more diversified and accessible

Key characteristics of the future capital raising market

**Increased Accuracy**
As more individual investors get involved in funding decisions, the business’ prospects will be tested from multiple perspectives. This “wisdom of the crowd” may improve the accuracy of overall investment decisions.

**Increased Access**
As more individual investors receive opportunities to directly fund businesses, more businesses and projects will gain access to potential funding options.

**Increased Control**
Individual investors will gain more control over where their investments flow and determine whether they want direct control over investment decisions.

**Reduced Costs**
As individual investors participate directly in funding without going through intermediaries, their cost to invest will decrease, but the impact to overall profitability remains unclear.

**Diversified Options**
Businesses will be able to structure equity or debt more flexibly to meet funding needs and will offer more diversified incentives to potential investors to increase appeal.

In enabling these future characteristics, how will the evolution of distributed capital raising impact the role of traditional intermediaries?
How will the evolution of distributed capital raising impact the role of traditional intermediaries?

### Potential role of alternative funding platforms

1. **Incubator of seed-stage companies**
   - Peer-based funding platforms solidify their position as the capital raising intermediaries for higher risk seed-stage companies.
   - Extending funding opportunities to more seed-stage companies makes the overall capital raising ecosystem richer by increasing the number of investment opportunities eligible for later stage venture capital financing.

2. **Provider of funding to lower return investments**
   - Peer-based funding platforms focus on investors with motives beyond financial return (e.g., sustainability and social responsibility interests) to provide capital to low-return investment opportunities that otherwise would not have qualified to raise capital through traditional intermediaries.
   - Seed-stage companies are funded by traditional angel investors and venture capitalists who can provide appropriate guidance for growth.

3. **Evolution into an alternative funding option for larger companies**
   - Larger companies leverage peer-based platforms as an alternative channel to engage and raise capital from their customer base.
   - In addition to benefiting from implicit marketing and increased customer loyalty, larger companies further reduce costs of capital by providing non-financial incentives to customers (e.g., future discounts).

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*The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions.*

*These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time.*
Narrative

The popularity of peer-based funding platforms grows but remains focused on seed-stage ventures, with later stage firms opting to raise funds through traditional providers, such as venture capitalists, who are able to provide guidance and access to networks.

Within this environment early-stage companies can more easily test their product ideas, and gain exposure to potential customers, while later-stage companies can accelerate their growth through venture capital involvement. Some venture capitalists may partner with peer-based platforms as a sourcing channel for potential deals.

Summary of impact

- Peer-based funding platforms solidify their position as the capital raising intermediaries for higher risk seed-stage companies
- Private equity and venture capital firms move upstream to focus on Series A or later stage ventures, where their networks and guidance matter most and risks of failure are lower
- Extending funding opportunities to more seed-stage companies makes the overall capital raising ecosystem richer by increasing the number of investment opportunities eligible for later-stage venture capital financing

Case studies

Seedrs is an online peer-based capital raising platform for individual investors to discover and invest in seed-stage ventures. Investment opportunities at Seedrs provide equity shares to investors and only those investments that meet their funding target receive funding. Seedrs acts as a custodian for the individual investor’s equity to protect their interests and enable further rounds of investment.
### Scenario 1: Incubator of seed-stage companies (2 / 2)

#### Necessary conditions for the scenario

- Accumulation of a critical mass of investors who are interested in participating in peer-based funding models
- Investors have access to sufficient high-quality and accurate information to conduct due diligence
- Investors have sufficient financial literacy in order to understand high-risk investment opportunities
- Regulators to implement well-defined and well-balanced investor protection rules

#### Implications of the scenario on...

<table>
<thead>
<tr>
<th>Individual Investors</th>
<th>Incumbents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversify their portfolio adding on high-risk and potentially high return investments</td>
<td>Pressure on margin for angel investors and seed-stage venture capitals</td>
</tr>
<tr>
<td>Increased level of engagement throughout the investment process</td>
<td>Increased maturity of investment opportunities</td>
</tr>
<tr>
<td>Increased number of potential investment targets</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>More diversified opportunities are funded fostering economic growth in financial markets</td>
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</table>

#### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
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<tbody>
<tr>
<td>Creates a channel to source investment opportunities for later-stage venture capitals that have been approved by the potential customer base (e.g., VC creating a crowd-funding platform to incubate seed-stage companies)</td>
<td>Many investors may not understand the risks associated with even the most promising seed-stage investments thus increasing the risk and impact of fraud</td>
</tr>
<tr>
<td></td>
<td>Risk of excessive dilution by venture capitals during later-stage funding rounds</td>
</tr>
</tbody>
</table>
Scenario 2: Provider of funding to lower return investments (1 / 2)

Peer-based capital raising platforms that focus on seed-stage investment opportunities lose popularity among mass investors as they realise that the investment horizon is very long and the chance of a successful exit is extremely low.

Instead, peer-based platforms shift their focus to smaller projects that either have a higher chance of generating sustainable profits sooner, or can deliver benefits above and beyond financial return. Examples of non-financial returns include community development (e.g., funding expansion of a favorite coffee shop, funding re-paving local roads) and ideological pursuits (e.g., sustainable energy).

**Case studies**

- **Spacehive** is a peer-based funding platform for civic projects, which enables local residents and businesses to fund community development projects (e.g., playgrounds, parks). Individuals with project ideas can directly pitch ideas to other residents through Spacehive and rally support and capital.

- **Abundance Generation** is a peer-based capital raising platform for local or regional sustainable energy projects that are too small to be attractive to investment banks. The platform raises capital from environmentally conscious investors and facilitates issuance of debentures to create cash flow back to investors sooner.

**Narrative**

Peer-based capital raising platforms that focus on seed-stage investment opportunities lose popularity among mass investors as they realise that the investment horizon is very long and the chance of a successful exit is extremely low.

Instead, peer-based platforms shift their focus to smaller projects that either have a higher chance of generating sustainable profits sooner, or can deliver benefits above and beyond financial return. Examples of non-financial returns include community development (e.g., funding expansion of a favorite coffee shop, funding re-paving local roads) and ideological pursuits (e.g., sustainable energy).

**Summary of impact**

- Peer-based funding platforms focus on connecting lower-return investment opportunities, which would not qualify for capital raising through traditional intermediaries, with investors with motives beyond financial return (e.g., empowering local community, sustainability)

- Seed-stage companies continue to be funded by traditional venture capitalists and angel investors who can provide appropriate guidance for growth

- Peer-based mechanisms are adopted by traditional intermediaries or high net worth individuals to encourage angel investor involvement
## Scenario 2: Provider of funding to lower return investments (2 / 2)

### Necessary conditions for the scenario

- Limited funding opportunities for local start-ups through traditional institutions
- Existence of communities that accept a lower than market return in order to make a project succeed

### Implications of the scenario on...

#### Individual Investors

- Access to investments with low financial return but high social return
- Low cost capital for socially beneficial projects
- The ability for investors to closely identify with their investments

#### Incumbents

- Traditional investors like government funding agencies can re-deploy funds to other investment targets
- Minimal overlap with traditional capital raising intermediaries

#### Overall Ecosystem

- Potential erosion of businesses for commercial banks (e.g., balance sheet lending)

### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provides funding to local and purposeful projects with high social return that would not be properly served by the traditional ecosystem</td>
<td>Potential misallocation of funds to high profile but ineffective projects or over-concentration of funds into certain types of projects</td>
</tr>
<tr>
<td>Institutional investors could get access to investment opportunities they don’t have access to today. This would help them meeting their triple bottom line goals</td>
<td>Potential for higher than expected rate of default on debentures for products unable to meet even the lower than market expectations</td>
</tr>
</tbody>
</table>
Inspired by the ability of peer-based funding platforms to simultaneously raise funding and cultivate new clients, established companies partner with peer-based platforms to fund their growth. By engaging directly with customers, large companies can gain exposure to potential customers and build deeper partnerships with exiting customers. Customers in turn feel that they are participating in the growth of their favourite businesses. Businesses can also further compensate or incentivise their customer-investor base by providing perks that go beyond interest or dividends, such as future discounts.

**Scenario 3: Evolution into an alternative funding option for larger companies (1 / 2)**

**Narrative**

Large established companies utilise peer-based capital raising platforms as an alternative channel to raise capital directly from their customer base.

In addition to benefiting from implicit marketing and increased customer loyalty, larger companies further reduce direct cost of capital by providing non-financial incentives to customers (e.g., future discounts).

Peer-based funding platforms develop into an alternative funding method that exists in parallel with the traditional capital raising ecosystem, potentially reducing traditional intermediaries’ businesses.

**Summary of impact**

**Case studies**

Chilango, a UK-based fast food chain, structured a campaign to raise £1 million for expansion by selling four-year corporate bonds with an 8 percent unsecured, unlisted coupon through peer-based capital raising platform, Crowdcube. In addition to offering a financial return (8 percent coupon), Chilango offered a free burrito every week for the duration of the bond to investors who invested more than £10,000 and a voucher for two free burritos to investors with smaller investments. This campaign raised £2.16 million from 749 investors, exceeding the target as the largest funds raised on the Crowdcube platform.
Scenario 3: Evolution into an alternative funding option for larger companies

### Necessary conditions for the scenario

- Fully loaded cost of funding through peer-based platforms must be lower than the costs incurred in the traditional financial ecosystem.
- Alternative funding platforms should be able to provide equivalent levels of information to mass market investors as institutional investors receive from intermediaries.

### Implications of the scenario on...

#### Customers / Investors

- Feel more personally involved with their favourite businesses.
- Act as partners to investment target’s strategic decisions.
- Gain access to an asset class unavailable to individual investors today (e.g., corporate bonds).

#### Incumbents

- Increased competition and potential margin pressure for commercial loans / investment banks.

#### Overall Ecosystem

- Introduction of new tool to raise capital may induce traditional institutions to innovate.

### Opportunities and risks associated with the scenario

#### Opportunities

- Businesses can achieve non-financial gains (e.g., revealed preference in the market, marketing, customer loyalty) through financial activities.

#### Risks

- Businesses issuing securities without professional advice from capital raising intermediaries risk underpricing and under-subscription.
- Individual investors may lack financial sophistication to properly understand the covenants of financial products or assess a suitable return for the risks entailed.
- Reputational risks for businesses when issues arise with their financial products.
What does this mean for financial institutions?

Key implications and remaining questions

“Safe Bets” – Likely implications under all scenarios

1. **Competition for investments**: While distributed capital raising platforms and traditional intermediaries may have limited overlap in investment opportunities, traditional intermediaries will need to compete for investments, especially from angel investors, against distributed platforms where investors can play more active roles.

2. **Shortening capital raising cycles**: With access to more diverse funding options, new companies will be able to grow at a quicker pace and the average time between funding stages will be shortened.

3. **Alternatives to wealth products**: As individual customers gain access to investment products with potential higher returns and/or better aligned to their interests, their mix of investments in traditional wealth management products will shift over time.

4. **How will traditional institutions, from investment managers to investment banks, participate in distributed capital raising platforms to maximise the benefits from the broadened capital raising market (e.g., direct entry, sourcing partnerships, investment vehicles, valuation model)?

**Scenario 1: Incubator of seed-stage companies**

- **Changes to sourcing strategy**: Advantages of distributed platforms as a sourcing tool, such as testing with future customer base, will create pressure to traditional internally-driven sourcing models.

- **How will traditional intermediaries discover unique investment opportunities and generate exclusivity when most investment opportunities become visible to competition via distributed platforms?**

**Scenario 2: Provider of funding to lower return investments**

- **Channel for new investment opportunities**: Distributed platforms may enable traditional institutions to directly participate in smaller investments without significant efforts (e.g., entry of hedge funds).

- **What are the hurdles that prevent traditional institutions from participating in smaller investments and how may distributed platforms resolve them?**

**Scenario 3: Evolution into an alternative funding option for larger companies**

- **Importance of selection**: Traditional intermediaries' ability to provide value not linked directly to financing will become more important if they wish to maintain their current role.

- **What differentiated value will traditional intermediaries offer to compete against distributed platforms that successfully move upstream?**

**Implications**  **Remaining questions**
Investment Management

How will the empowerment of individuals through automated systems and social networks transform the business of investment management?
Executive Summary

Context / Innovation

- The wealth management industry has suffered from the loss of customer trust since the financial crisis. This trust has been slow to recover in the face of continued economic uncertainties.

- In this environment, a number of disruptors, from automated wealth management services to social trading platforms, have emerged to provide low-cost, sophisticated alternatives to traditional wealth managers. These solutions cater to a broader customer base and empower customers to have more control of their wealth management.

Future of Investment Management

- These innovations will create pressures for the wealth management industry to improve the value delivered while broadening access to more customers.
  - Cheaper and faster online tools and automated services that originally catered to underserved customers may steal share from traditional wealth managers in the mass affluent market, pushing traditional managers to switch their focus to more personalised, relationship-based segments.
  - Alternatively, automated investment management platforms could commoditise traditional high-value services and reduce the value delivered by wealth managers across all customer segments, enabling traditional wealth managers to focus on providing more personalised, bespoke services to a broader customer base.
  - Empowered with intuitive and affordable tools, some individual investors may also gain sufficient level of sophistication to act as investment experts, selling and sharing their investment expertise via social trading platforms that erode the value of traditional wealth management professionals.

Key Implications

- The emergence and growing popularity of automated wealth management services and customer empowerment tools will pose a tangible threat to the traditional practices of the wealth management industry. However, incumbent institutions who can embrace these innovations and streamline their processes will be able to provide higher value services to a broader customer base.
The wealth management industry has suffered a significant loss of customer trust and increased regulatory scrutiny following the financial crisis.

Overview of the wealth management industry

- Offered by variety of financial institutions, including private banks, registered investment advisors, bank brokers/insurers
- Targets higher-end of customers with investable capital, such as ultra high net worth, high net worth and mass affluent customers

Recent developments in wealth management

- In recent decades, wealth managers have begun to expand their focus from high net worth to mass affluent segments
- Increased regulations on consumer protection requires banks to advise customers in a more structured way, raising the bar for new entrants
- Increased transparency into investment performance is allowing individuals to better compare products
- Continued economic instability has left customers uncertain about the economic outlook and reticent to pursue active strategies. This trend toward passive products has placed pressure on pricing

Key challenges in wealth management

- High fees limit access to wealth management services for mass and mass affluent clients
- Customers’ expectations of personalisation, efficiency and low costs continue to grow
- Ability to meet customer needs is limited by organisation structures and technology infrastructure
- Customer trust has been slow to recover following the financial crisis
A number of disruptors are emerging to provide low-cost and sophisticated alternatives to traditional wealth managers to a broader customer base.

Key innovations democratising wealth management

**Automated Management and Advice**
- Offers high-value advisory services on portfolio allocation and money management at low costs based on automated analysis
- Automates the management of a personalised investment portfolio based on individual needs
- Provides aggregated view and analysis of multiple accounts

**Social Trading**
- Empowers individual investors to build and share investment strategies and portfolios with other investors
- Empowers individual investors to share their opinions and gain market insights from the opinions shared by the crowd

**Retail Algorithmic Trading**
- Enables investors to easily build, test and execute trading algorithms with limited technical knowledge and infrastructure
- Provides platforms for sophisticated investors to share trading algorithms with others

Common characteristics of wealth management disruptions

<table>
<thead>
<tr>
<th>Lower Barriers</th>
<th>Algorithm-Driven</th>
<th>Customer Empowerment</th>
<th>Reliance on the Crowd</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allow customers with fewer assets to receive financial advice by reducing the minimum investment threshold and management fees by leveraging automated algorithms</td>
<td>Commoditises previously high-value, manual-intensive services at a low cost via automation. This minimises the need for manual intervention</td>
<td>Improves the financial literacy of customers by readily providing analysis of their financial position and empowering them with tools to easily create and execute investment strategies</td>
<td>Leverages the capabilities existing within the crowd to create more accurate understanding of the market and provide low-cost alternatives to investment funds to customers</td>
</tr>
</tbody>
</table>
Disruptive innovation in wealth management pressures the industry to improve the value delivered to more customers

Key characteristics of the future of wealth management

**Accessibility**
More sophisticated wealth management services will become available to a broader customer base, including the mass affluent and mass market customers

**Transparency and Control**
Customers will gain greater visibility into their financials and how their money is invested and will be able to make adjustments to their financials more readily as more wealth management options become available

**Convenience**
Online and mobile channels will be increasingly leveraged to interact with customers and deliver higher value services, providing access to financial information on demand

**Personalised**
As algorithms used in managing wealth become more sophisticated, the degree of customisation and individualisation will increase for services delivered to mass affluent and mass market customers

**Low Cost**
The cost of receiving advisory and management services will decrease as automation lowers the operating costs and new disruptive entrants spur competition in the market

As these disruptive innovations create pressures for the wealth management industry by empowering individuals, how will the wealth management landscape evolve?
How will the empowerment of individuals through automated systems and social networks transform the business of investment management?

Potential impact to investment experts

1. Erosion of the mass affluent market
   - Cheaper and faster online tools and automated services that originally catered to underserved customers steal share from traditional wealth managers in the mass affluent market
   - Wealth managers, who have been expanding their focus to the mass affluent market, shift their focus back to more personalised and relationship-based high net worth individuals

2. Revamping the value proposition of wealth managers
   - Automated investment management platforms commoditise traditionally high-value services (e.g., tax loss harvesting) and reduce the value delivered by investment managers even to high net worth customers
   - Services provided by physical wealth managers evolve to more personalised, bespoke space, such as financial concierge services and the management of inter-generational wealth transfers

3. Lowering bars to act as an investment expert
   - Empowered with intuitive, affordable and accessible tools, some individual investors gain sufficient level of sophistication to act as investment experts without the technical knowledge or infrastructure traditionally required
   - The next generation of retail and social trading platforms offer effective means for individuals to share or sell their investment expertise, directly competing with traditional investment managers

The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions.

These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time.
As automated wealth management services and online tools establish a solid track record they continue to develop their service offerings to encompass functionalities desired by the mass affluent segment.

Traditional wealth managers find their market share eroding as a growing number of mass affluent customers defect to lower cost automated options. Traditional wealth managers are forced to either develop their own automated solutions, accepting lower margins, or move upstream to higher new worth clients seeking a highly personalised experience.

- Cheaper and faster online tools and automated services that originally catered to underserved customers move upstream and steal share from traditional wealth managers in the mass affluent market.
- Wealth managers, who have been expanding their focus to the mass affluent market, shift its focus back to more personalised and relationship-based high net-worth individuals, intensifying the competition and improving the services offered to those customers.

Scenario 1: Erosion of the mass affluent market (1 / 2)

Launched in December 2011, Wealthfront offers an automated investment service that consists of managing a diversified, continually rebalanced portfolio of index funds, along with tax loss harvesting, via fully automated algorithms. Unlike traditional wealth management companies, the minimum account size is small ($5,000) and fees are extremely low; which reduces the hurdles for entry for the Millennial generation. Since inception, Wealthfront has penetrated above and beyond Millennial customers to gather $1.5 billion in assets under management within three years.
Scenario 1: Erosion of the mass affluent market (2 / 2)

Necessary conditions for the scenario

- Customer trust and awareness of new market entrants
- New players’ offerings must cater to sufficient portion of customers’ needs to replace traditional wealth managers

Implications of the scenario on...

Customers
- Access to more personalised and sophisticated services at a lower price
- Extended services for high net worth and ultra high net worth customers as incumbents move upstream
- Increased transparency into and control over their wealth

Incumbents
- Revenue and margin pressure as the mass affluent market is eroded
- Intensified competition in high net worth market as incumbents move upstream

Overall Ecosystem
- Competition will increase and pricing for advisory services will adjust accordingly
- Shift into low-fee, passive investment

Opportunities and risks associated with the scenario

Opportunities
- Customers may make better, more educated choices based on a more holistic view of their financial situation
- Potential increase of market size as more customers get access to investment management services
- Mass consumers have access to different level of services which suits with their respective needs

Risks
- Lack of personal relationship means customers may make irrational financial choices in extreme situations (e.g., market crash)
- Risk of not receiving sufficient customer information to offer a suitably customised portfolio
- Shift to passive investment may increase market volatility and amplify losses during extreme events
- Potential impact to retail banks as their ability to cross sell wealth management products is reduced
Scenario 2: Revamping the value proposition of wealth managers (1 / 2)

Narrative
Automated investment management platforms commoditise a large portion of the wealth management transactions by automating standardised activities (e.g., asset allocation) and formerly high-value services (e.g., tax loss harvesting). However, the demand for in-person interactions and other specialised transactions continues to exist across the customer segment spectrum.

In order to remain competitive against automated platforms, traditional wealth institutions adopt and further develop automated functionalities, which in return free up capacity for in-person wealth advisors. Leveraging freed capacity, wealth managers can now offer more specialised, high-touch services to a broader customer base, improving the overall quality of services received by customers.

Summary of impact
- Automated investment management platforms commoditise services once considered high-value and reduce the value delivered by investment managers even to high net-worth customers.
- Services provided by physical wealth managers evolve to be a more personalised financial concierge and expand to provide specialty in areas such as intergenerational wealth transfer.
- As incumbent institutions adopt improved automation, traditional wealth managers can free up capacity to expand their customer base.

Case studies
Facing the threats of new automated investment services like Wealthfront, Charles Schwab announced the launch of its own automated investment service “Intelligent Portfolios” based on ETFs, featuring competitive capabilities like automatic rebalancing and tax loss harvesting, at no charge and with low minimum account threshold.
# Scenario 2: Revamping the value proposition of wealth managers (2 / 2)

## Necessary conditions for the scenario

- Incumbents must be able to acquire and implement new capabilities or be comfortable with partnering with automated service providers.
- Incumbents must successfully identify and deliver on high-value services that can only be delivered through personal relationships.

## Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced price for commoditised services and access to more sophisticated services</td>
<td>Pressure to differentiate from other institutions</td>
<td>Market structure will remain largely similar as existing players evolve</td>
</tr>
<tr>
<td>Access to more differentiated offerings among financial institutions</td>
<td>May face challenges in redeploying workforce to deliver different services than today</td>
<td>Increased focus on non-price differentiation</td>
</tr>
</tbody>
</table>

## Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opportunity to leverage freed capacity from automation to serve more clients</td>
<td>Customers may not find additional, “personal” offerings valuable, eroding institutions’ value proposition</td>
</tr>
<tr>
<td>Ability to scale automated service offerings in new markets once developed</td>
<td>Incumbents risk not being able to successfully transform their workforce to adopt new business models</td>
</tr>
<tr>
<td></td>
<td>Evolution of mass affluent-focused institutions to offer more bespoke services may create competitive pressure to upstream institutions</td>
</tr>
</tbody>
</table>
Scenario 3: Lowering bars to act as investment expert (1 / 2)

**Narrative**

Since the advent of online discount brokerages, the ability for individual investors to develop sophisticated strategies and participate in investment activities has grown continuously. Next generation tools (e.g., retail algorithmic trading platforms) are leveraging advanced algorithms, visualisation and cloud computing to eliminate traditional barriers like a need for programming skills.

These innovations are narrowing the gap between individual and professional investors and facilitating the emergence of marketplaces for trading strategies and algorithms, enabling some of these empowered individuals to steal share from traditional investment managers.

**Summary of impact**

- The next generation of retail and social trading platforms offer effective means for individuals to share or sell their investment expertise to other individual investors.
- Sophisticated individual investors directly compete with traditional investment managers and aspects of the market for active retail investment management experience margin compression.

**Case studies**

- **Quantopian**
  Quantopian allows sophisticated individual investors to build, test and execute algorithmic trading strategies with limited development knowledge and infrastructure, and manage other investors’ investments for a fee.

- **Estimize**
  Estimize gathers stock-performance opinion from professional and individual investors (buy-side) to create price estimates that would mimic the market reaction, without relying on sell-side analysts.
Scenario 3: Lowering bars to act as investment expert (2 / 2)

Necessary conditions for the scenario

- Sufficient track record of performance by investment experts to gain customers’ trusts and overcome reputational barriers
- Competitive value proposition offered by investment experts in terms of return, risk and costs
- Regulatory control to ensure that accountabilities and disclosure standards are well understood by all parties

Implications of the scenario on...

| Customers                  |  |
|----------------------------|  |
| Access to more diverse investment strategies at lower costs |  |
| Ability to expand financial knowledge |  |

| Incumbents                 |  |
|----------------------------|  |
| Erosion of market share to investment experts and DIY customers |  |
| Need to develop differentiated offering from individual investment experts |  |
| Increased reliance on brand as a differentiator |  |

| Overall Ecosystem          |  |
|----------------------------|  |
| Creation of “prosumer” environment where consumers participate in production |  |
| Increased churn of entries and exits into investment advisory roles by individual experts |  |

Opportunities and risks associated with the scenario

| Opportunities |  |
|---------------|  |
| Room for misalignment of interests by incumbent advisors is reduced due to increased competition |  |

| Risks |  |
|-------|  |
| Risk of less sophisticated customers overlooking tail risks associated with seemingly well-performing investment strategies |  |
| Interests of marketplace platforms may not be aligned with the interests of investors, making it easier for fraudulent behaviour from investment experts |  |
| Customers may feel overly confident or lose long-term view resulting in investment portfolios unsuitable to their needs |  |
| Due to lower tolerance to short-term poor performance, customers may switch too frequently between investment strategies, leading to suboptimal return and incentivising bad behaviour among advisors |  |
What does this mean for financial institutions?

Key implications and remaining questions

“Safe Bets” – Likely implications under all scenarios

1. **Decoupling of advisory and products:** As more customers switch to automated advisors for more streamlined and cost-effective advisory services, the “one-stop” model of distributing financial institutions’ wealth products primarily via their advisory channels will become less effective.

2. **Eroding advantages of scale:** Traditional wealth managers’ scale-based advantages will erode as once manual processes are automated, virtual channels are utilised and core infrastructure become available at a low cost to new entrants.

3. **Increased competition:** The commoditising forces generated by new entrants will make more segments and services less profitable for traditional wealth managers and intensify competition among traditional players in more specialised segments or services.

4. **How will wealth managers that used to distribute their own products via advisory channels change their distribution strategy as new entrants providing automated digital solutions erode their customer base?**

5. **What are the differentiated services provided by traditional wealth managers that will remain difficult to automate and replicate by new entrants?**

**Scenario 1: Erosion of the mass affluent market**

1. **Erosion of deposits:** New entrants will begin to compete for mass or mass affluent customers’ deposits with retail banks.

2. **Importance of relationship:** As competition intensifies among traditional players in relationship-driven high / ultra net worth market, the role of in-person managers will become more critical.

3. **How will retail financial institutions prevent the erosion of deposits to new wealth products that now offer lower threshold for entry?**

**Scenario 2: Revamping the value proposition of wealth managers**

1. **Empowering retail banks:** More retail banks will be able to meet most needs of wealth management customers through automated services.

2. **Organisational change:** Traditional players may face challenges in redeploying workforce to deliver different services and customer segments than today.

3. **How will traditional institutions capture customers early on in their lifecycle as younger, mass affluent customers enter the wealth management market earlier through automated advisors?**

**Scenario 3: Lowering bars to act as an investment expert**

1. **Benchmarking challenge:** Benchmarking the performance of traditional wealth products will become increasingly difficult as distributed, constantly-changing group of prosumers become a source of competition.

2. **Importance of brand and trust:** In competing against prosumers who can generate similar return on investment, traditional institutions’ brand and customer trust will become a critical differentiator.

3. **How will traditional investment managers change their competitive and workforce strategy as emerging platforms empower sophisticated individuals to compete directly with professional investors?**

Implications

Remaining questions
Investment Management

How will the externalisation of key processes transform the financial ecosystem?
Executive Summary

Context / Innovation

- Many processes within investment institutions are considered as “core” to their business operation. However, a new breed of process externalisation providers are using highly flexible platforms (typically based in the cloud) to provide financial institutions with increased efficiency and new levels of process sophistication / excellence.

Future of Process externalisation

- As service providers externalise and consolidate processes previously considered core capabilities, the core competencies that differentiate winning financial institutions shift from process execution to more “human” factors (e.g., synthesis, decision making).
- External service providers could enable small and medium-sized organisations to better compete with large incumbents by providing them access to top-tier processes that were once unreachable due to lack of scale.
- Some external providers that consolidate regulatory compliance capabilities may also create an opportunity to centralise communications to regulatory agencies. This would improve the speed at which financial institutions are able to respond to regulatory changes and ensure a higher level of compliance.

Key Implications

- By exploring options to externalise a large number of redundant processes across institutions, firms will benefit from efficiency gains and increased sophistication.
- However, financial institutions must consider which capabilities they should continue to focus on as a source of competitive advantage.
Many processes within investment management institutions considered as core to their business today are facing various pressures

Core capabilities of investment institutions today

- Over the past few decades, externalisation of non-core processes (e.g., HR, finance) has been a major trend in the financial services industry to drive efficiency and operational excellence
- Despite this trend many processes, such as transaction monitoring, regulatory compliance and risk management continue to be perceived as mission critical or competitive differentiators and have remained in house

Evolution of landscape impacting core processes

- The notion of core internal processes can change when external providers emerge with the ability to complete the process more efficiently and with more sophistication than individual institutions
  - The ability to access and collect market data was once considered a critical internal competency for equity investments firms until external providers emerged to provide more standardised and comprehensive set of data (e.g., Bloomberg, Thomson Reuters)
- A number of issues are arising that impact the institutions’ ability to excel across today’s core processes:
  - Increased regulatory burden as a result of the 2008 financial crisis (e.g., the Dodd-Frank Act) and the introduction of stricter compliance requirements (e.g., anti-money laundering) has taken up a large amount of institutions’ capacity
  - Legacy processes and systems built based on the physical computing environment continue to limit institutions’ flexibility and agility in adapting to the rapidly changing market conditions and continuously evolving regulatory requirements

Key challenges faced by institutions

- Capacity Constraints
  - Lost capacity on updates and maintenance limits the ability to invest in core capabilities

- Limited Flexibility / Agility
  - Timely update of the processes and technologies is limited due to costs and efforts required

- Scale-driven Barriers
  - Sophistication of capabilities is not feasible due to the institutions’ scale and size

- High Cost of Maintenance
  - Updating and maintaining processes and technologies are costly and time-consuming

- Inconsistency
  - Fragmented, local legacy processes and technologies impede connectivity across the organisation

- Complexity
  - Inflexible systems designed for past market environments result in added complexity to adapt to the current environment
The new breed of process externalisation providers are built on the technologies and philosophies behind Web 2.0

### Key innovations enabling the new breed of process externalisation

<table>
<thead>
<tr>
<th>Advanced Analytics</th>
<th>Cloud Computing</th>
<th>Natural Language</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Utilise advanced computing power, algorithms and analytical models to not only automate existing manual processes but also provide a new level of sophistication</td>
<td>• Leverage cloud technology to improve connectivity with and within institutions to facilitate data sharing, streamline implementation and maintenance of processes, and enable real-time processing</td>
<td>• Integrate natural language technology into processes to make them more intuitive for end users, reducing the need for deep technical backgrounds</td>
</tr>
</tbody>
</table>

### Common models of the new breed of process externalisation providers

<table>
<thead>
<tr>
<th>Platform</th>
<th>As-a-Service</th>
<th>Capability Sharing</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Technology platforms, such as real-time databases and expert systems, that leverage automation to help users complete tasks faster and with fewer resources</td>
<td>• Provide full externalisation of an entire capability, including automated and manual processes, as a service to institutions to minimise infrastructure investments required</td>
<td>• Facilitate institutions to work with one another to share capabilities or easily integrate with new providers by constructing legal and technical standards and vehicles</td>
</tr>
</tbody>
</table>
For each capability within investment institutions that are considered “core”, process externalisation can effectively resolve key pain points experienced today.

<table>
<thead>
<tr>
<th>Current State Pain Points</th>
<th>Benefits Offered by External Providers</th>
<th>Examples of New External Providers</th>
</tr>
</thead>
</table>
| Collection from multiple sources required for certain assets | Aggregating data collection from multiple sources and automating extraction not only improve efficiency, but allow greater influence over the sources of data | **Novus**
Novus aggregates performance and position data of funds from regulators and participating funds to provide a single point of access to fund of fund managers |
| Reliance on manual modelling leading to human errors, lengthy turnaround time and capacity constraints to support more prudent decision making | Utilisation of advanced analytics and automation make analyses instant and more accurate, and allow institutions to test a greater number of opinions to support decision making | **Kensho**
Kensho automates the modelling of investment scenarios to support decision makers with real-time projection of performance under various outlook assumptions |
| Trading strategy starts with hypotheses, requiring trial-and-error process | Advanced analytics support automated data-driven trading strategy formation | **Ayasdi**
Ayasdi utilises topological data analysis to draw out correlations and outliers from big data to inform hypothesis and trading strategy development |
| Increasingly dynamic and complex trading landscape requires increased costs to achieve best execution | Automated execution providers improve the efficiency and quality of execution through connectivity with multiple venues | **RedKite**
RedKite monitors erroneous trading patterns in real-time (e.g., layering) to help organisations deal with noncompliant transactions instantaneously |
| Transactions are monitored post-trade in a batch process, focusing on coping with erroneous behaviours rather than preventing them | Transactions can be monitored in real-time to ensure erroneous trades are identified and addressed in real-time | **OpenGamma**
OpenGamma provides an open source platform for real-time market risk mgmt. and analytics, allowing front office resources to control and manipulate calculation |
| Risk modelling and analysis is conducted by middle and back office functions with periodic reporting to front office, limiting its visibility on risk in real-time | Automation of risk modelling and monitoring with user-friendly interfaces allows front office to directly engage in understanding and analysing risk in real-time | **FundApps**
FundApps organises regulatory information and delivers a cloud-based managed service to automate shareholding disclosure and monitor investment restrictions |
| Constantly evolving regulations across geographies mean significant resources must be expended to ensure compliance processes are up to date and properly monitored | | |

Illustrative transformative potential of process externalisation across core capabilities
The next generation of process externalisation not only brings efficiency, but also enables institutions to gain the level of sophistication unattainable by themselves.

Key characteristics of the future state enabled by process externalisation:

- **Automation**: More processes will be automated and commoditised to free up capacity to invest in differentiating core capabilities.

- **Flexibility / Agility**: Updating and maintaining processes and technologies to adapt to the changing landscape will become quicker and more effortless.

- **Sophistication**: Leveraging scale, externalised processes will become more sophisticated than was possible within a single organisation.

- **Consistency**: Increased standardisation of processes, technologies and their interfaces will bring consistency across various operations and facilitate sharing of data.

- **Reduced Costs**: The costs to update and maintain processes and technologies will be reduced as they are shared among a number of institutions.

Empowered by these benefits, how will the externalisation of key processes transform the financial ecosystem?
How will the externalisation of key processes transform the financial ecosystem?

**Potential impact of process externalisation**

1. **Redefined core capabilities of financial institutions**

   - Service providers use advanced technologies to **externalise, consolidate and commoditise** processes that were previously considered core capabilities, in a more efficient and sophisticated manner.
   - As a result, **core competencies** that differentiate winning financial institutions shift from process execution to more “human” factors (e.g., synthesis, decision making).

2. **Level playing field for newer, smaller financial institutions**

   - External service providers give small and medium-sized organisations access to sophisticated capabilities that were not previously attainable due to lack of scale.
   - By enabling small and medium-sized organisations to access top-tier processes, **barriers to entry are lowered** for new players and smaller existing players are able to compete with large incumbents on a more level playing field.

3. **Centralised communications with regulatory agencies**

   - These providers improve the **speed** at which financial institutions are able to respond to regulatory changes, ensure a **higher level of compliance** via automation, and empower regulators to receive **consistent inputs** from financial institutions.
   - As more regulatory compliance and monitoring processes are outsourced to a small number of service providers, these firms can act as **centralised communication touch points** for regulators.

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The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions.

- These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time.
Narrative

Financial institutions begin to outsource select processes to specialised external firms who leverage advanced technologies to provide improved outcomes at a much lower cost. Efforts previously spent on managing these processes in-house can be deployed toward higher value activities that provide competitive differentiation.

As this pattern repeats over multiple processes, a financial institution’s competitive position ceases to be defined by core operational excellence and instead is defined by which higher value activities they have chosen to focus on.

Summary of impact

- Service providers using advanced technologies provide options for financial institutions to externalise processes once considered core capabilities
- Competitive advantages derived from excellence in process execution will disappear as high quality process execution becomes a commodity available for purchase
- Financial institutions are required to redefine what capabilities differentiate them from other institutions with process execution taking a backseat to more “human” factors

Case studies

The ability to quickly and accurately model market projections and hypotheses through large quant teams has traditionally been a key advantage of large financial institutions. Kensho threatens that advantage by offering a next-generation analytics platform for the investment industry with massively-parallel statistical computing, scalable analytics architectures and user-friendly visual interfaces. By leveraging Kensho’s platform, any investment institution can now rapidly model projections without an army of quantitative analysts; instead focusing more “human” capabilities like hypothesis generation and market insights.
### Scenario 1: Redefined core capabilities of financial institutions (2 / 2)

#### Necessary conditions for the scenario

- External service provider’s ability to demonstrate a clear business case for financial institutions to outsource many core functions
- Clear definition of accountabilities and liabilities between financial institutions and their service providers
- Securing regulatory comfort by demonstrating financial institutions’ control over the externalised processes

#### Implications of the scenario on...

<table>
<thead>
<tr>
<th>Customers</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>High quality service levels across most financial institutions</td>
<td>Need to reallocate resources to develop new core capabilities</td>
<td>Emergence of a class of institutions specialising in externalising specific processes</td>
</tr>
<tr>
<td>Access to increasingly differentiated services / product offerings among financial institutions</td>
<td>Increased pressure to identify and develop new differentiating capabilities</td>
<td>Increase in the average level of sophistication of processes across institutions</td>
</tr>
</tbody>
</table>

#### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fewer process failures as they are externalised to more focused and specialised providers</td>
<td>Centralisation of processes creates larger implications of process failures including continuity risks for banking in the case of a failure of an external service provider</td>
</tr>
<tr>
<td>Emergence of institutions competing to excel in specific processes drives deeper specialisation</td>
<td>Risks resulting from potential lack of clarity surrounding accountabilities</td>
</tr>
<tr>
<td>Increased capacity for financial institutions to be innovative due to reduced focus on resource intensive core processes</td>
<td>Loss of deep process knowledge within financial institutions may have unforeseen spill-over consequences in other areas of the business</td>
</tr>
</tbody>
</table>
Scenario 2: Level playing field for newer, smaller financial institutions (1 / 2)

**Narrative**

Once an external service provider has developed the tools for a financial institution to externalise a process, the cost of extending that service to additional financial institutions is typically very low and not dependent on the institution’s size.

Small and medium-sized financial institutions capitalise on these economics to both improve their efficiency and radically increase the sophistication of their processes across the board. As process sophistication ceases to be a source of competitive advantage for large financial institutions, small and medium-sized institutions are able to increase their focus on differentiating capabilities.

**Summary of impact**

- External service providers provide small and medium-sized organisations access to sophisticated capabilities, which were previously unattainable due to lack of scale.
- Barriers to entry into the market will be lowered and the playing field will be leveled with small and medium-sized organisations increasingly able to compete with large institutions.

**Case studies**

Open Gamma uses an open source platform to provide real-time market risk management analytics to buy-side, sell-side and clearing institutions. While Open Gamma provides the platform free of charge, they offer support, consulting and training services to help institutions configure and modify the platform and select appropriate risk models. The platform includes a number of advanced functions not normally available to small institutions.

Through services like Open Gamma, new and small institutions no longer need to set up extensive support functions in middle and back offices to attain sophisticated capabilities and compete with larger institutions.
**Scenario 2: Level playing field for newer, smaller financial institutions (2 / 2)**

### Necessary conditions for the scenario
- Externalisation providers must be able to provide suitable options for both small and large institutions
- Clear definition of accountabilities and liabilities of financial institutions and their service providers
- Securing regulatory comfort by demonstrating financial institutions’ control the externalised processes

### Implications of the scenario on...

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<thead>
<tr>
<th>Customers</th>
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<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wider universe of options for financial services as customers’ choice of institutions is no longer restricted by their scale</td>
<td>Increased competition as smaller institutions gain a stronger competitive position</td>
<td>Wider distribution of market share</td>
</tr>
<tr>
<td></td>
<td>A need to re-evaluate business models that are based on economies of scale</td>
<td>Increased monitoring burden to regulators as the number of players increase</td>
</tr>
</tbody>
</table>

### Opportunities and risks associated with the scenario

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</tr>
</thead>
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<tr>
<td>Potential increase in diversification of strategies as smaller financial institutions are empowered to pursue innovative strategies</td>
<td>Risks to small and mid-sized players that their externalisation service providers will be acquired and internalised by large financial institutions</td>
</tr>
<tr>
<td>Increased competition might lead to reduction of transaction costs for customers</td>
<td>Systemic benefits of scale, such as visibility into the market, may erode as the average size of institutions decreases</td>
</tr>
</tbody>
</table>
Scenario 3: Centralised communications with regulatory agencies (1 / 2)

**Narrative**

A number of niche service providers are emerging who are able to externalise processes related to specific regulations (e.g., restricted holdings, KYC). These firms are able to interpret regulatory changes and translate them into rules that can be applied across various financial institutions, improving regulatory compliance and the speed at which financial institutions can respond to regulatory changes.

As regulatory compliance within financial institutions becomes more closely integrated with these service providers, some regulators may choose to collaborate directly with them even to the point of issuing regulations in code rather than as policy documents.

**Summary of impact**

- More regulatory compliance and monitoring processes are outsourced to a small number of service providers with better connections to and understanding of regulations, reducing the compliance burden for financial institutions.
- These compliance service providers can act as centralised communication touchpoint for regulators.
- By solidifying their connections with regulators, these providers improve the speed at which financial institutions are able to respond to regulatory changes, ensuring a higher level of compliance.

**Case studies**

FundApps organises regulatory information and delivers a cloud-based managed-service to automate shareholding disclosure and monitor investment restrictions across 100+ regulatory regimes on a daily basis. FundApps partners with a global legal service provider to monitor and translate changes in relevant regulations into rules on a daily basis.

If regulatory agencies partner with FundApps in the future, they could ensure consistent compliance across financial institutions, make dissemination of regulatory changes in disclosure regimes faster, and reduce the compliance burden faced by the industry.
### Scenario 3: Centralised communications with regulatory agencies (2 / 2)

#### Necessary conditions for the scenario

- Buy-in from multiple regulators to collaborate with external service providers regarding regulatory topics will be necessary. Dealing with emerging risks like cyber security might be a good starting point.
- Solid track record of performance and reliability demonstrated by externalisation business models.
- Full accountability and liability for actions remain with financial institutions.
- Critical mass of financial institutions externalise regulatory processes to a manageable number of service providers.

#### Implications of the scenario on...

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<tr>
<td></td>
<td>Increased trust in financial institutions as overall compliance level increases.</td>
<td>Ability to respond faster, more easily and more cheaply to regulatory shifts.</td>
<td>Higher, more consistent level of regulatory compliance.</td>
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<tr>
<td>Opportunities to improve the clarity of regulations across jurisdictions</td>
<td>Unclear how risks of regulatory capture will be influenced by externalised compliance models.</td>
</tr>
<tr>
<td>Cost for compliance and regulation, which tends to be very high in global institutions, potentially will be reduced.</td>
<td>Amplification of non-compliant activities and unclear liabilities when centralised externalisation providers fail.</td>
</tr>
<tr>
<td>Standardised data simplifies supervision for regulators</td>
<td>Decreased internal compliance expertise within financial institutions may have unintended consequences.</td>
</tr>
</tbody>
</table>
What does this mean for financial institutions?

Key implications and remaining questions

“Safe Bets” – Likely implications under all scenarios

1. **Loss of negotiating power and continuity:** As more capabilities, technologies and processes are externalised, financial institutions will become increasingly dependent on 3rd parties for continuity.

2. **Skill loss of workforce:** Even though externalising less valuable capabilities will create efficiency, it may result in workforce skill loss over the long term and employees’ ability to develop a holistic view of financial services operations.

   - How will financial institutions participate in capability sharing with other institutions to balance efficiency with control (e.g., utility creation, co-development, 3rd party providers)?

   - How will financial institutions prevent the loss of negotiating power and continuity as the next generation of process externalisation providers are often built on managed services models as opposed to today’s vendor models?

### Scenario 1: Redefined core capabilities of financial institutions

1. **Organisational agility:** As innovative providers continue to streamline and commoditise previously high-value capabilities, creating an agile organisation will be critical to adapt to the changing landscape and realign core competencies.

2. **What capabilities and processes will financial institutions focus investments on to create competitive advantages that cannot be replicated through the new process externalisation providers?**

### Scenario 2: Level playing field for newer, smaller financial institutions

1. **Higher turnover of new entrants:** Externalisation of processes will make it easier for new players to enter the market without significant infrastructure, increasing the turnover in the industry.

2. **Imperative for direct participation:** In order to sustain scale-driven advantages, large financial institutions will actively participate in creating, funding, and acquiring innovative externalisation providers.

3. **What are the advantages that larger financial institutions may continue to benefit from when externalisation levels the playing field?**

### Scenario 3: Centralised communications with regulatory agencies

1. **Limited regulatory interpretation:** When regulatory compliance is centralised and automated, regulatory models may shift from today’s interpretation-based approach to more measurable, “black-and-white” approaches, reducing the room for regulations to be flexibly interpreted.

### Implications

1. Organisational agility: As innovative providers continue to streamline and commoditise previously high-value capabilities, creating an agile organisation will be critical to adapt to the changing landscape and realign core competencies.

2. What capabilities and processes will financial institutions focus investments on to create competitive advantages that cannot be replicated through the new process externalisation providers?

### Remaining questions

1. How will financial institutions participate in capability sharing with other institutions to balance efficiency with control (e.g., utility creation, co-development, 3rd party providers)?

2. How will financial institutions prevent the loss of negotiating power and continuity as the next generation of process externalisation providers are often built on managed services models as opposed to today’s vendor models?

3. What capabilities and processes will financial institutions focus investments on to create competitive advantages that cannot be replicated through the new process externalisation providers?
Market Provisioning

How will smarter and faster machines transform capital markets?
Executive Summary

Context / Innovation

- As the popularity and profitability of high frequency trading declines, the next evolution of algorithmic trading may be dependent on smarter machines, allowing a broader class of trades to reap the benefits of automation and sophistication.

Future of Smarter Faster Machines

- The proliferation of smarter machines will further shift the focus of machine-based trading to rapidly respond to real-life events.
  - As the race for speed transitions to the development of strategies responding to real-life events, market makers’ trading strategies may become more diversified as they access a vast amount of different data sources and infer different market conditions from that data.
  - When trading algorithms become more intelligent by incorporating machine learning, the breadth and accuracy of their analyses will expand, and could result in convergence toward a single view of the market.
  - Growing public discontent with algorithmic trading may lead to regulations on the use of automatic data feeds or smart machines in executing trades, reverting some parts of market-making activities to manual processes.

Key Implications

- The development of smarter, faster machines in algorithmic trading will have varying implications on the market structure in terms of volume, liquidity, volatility and spread – the future of algorithmic trading must be approached with a new lens with respect to the benefits it can deliver to the ecosystem weighed against the new types of risks it might create.
As the popularity and profitability of high frequency trading declines, the next evolution of algorithmic, machine trading remains in question

Overview of algorithmic trading and high frequency trading

- The use of algorithms in trading activities has proliferated in lockstep with the evolution of computing power since its initial application for optimal portfolio determination in the 1970s and the emergence of fully automated algorithmic trades in the early 1990s
- Since then, the key focus of algorithmic trading has been on exploiting arbitrage opportunities in time and/or across venues by leveraging low latency access to the exchanges (i.e., high-frequency trading, autonomous market makers) and thereby providing liquidity to the market
- These high frequency traders largely replaced the market-making activities traditionally performed by broker dealers, who provided liquidity and made prices by manually coordinating offers and taking on the risks of buying and selling shares in return for spread
- While some trading firms and hedge funds use algorithms to achieve faster processing times for analysis of large datasets; price discovery and order execution remain the most active areas of high frequency trading

Focus of algorithmic trading by HFTs

Declining popularity and profitability of high frequency trading

- High frequency trading reached its peak in 2009-2010, where those trades accounted for over 60 percent of all U.S. equities traded in volume
- However, the popularity and profitability of high frequency trading has significantly decreased due to lower volatility, improved liquidity, rising costs of trading infrastructure, and regulatory scrutiny
Smarter, faster machines will allow broader types of trades beyond high frequency trading to reap the benefits of automation and sophistication.
Proliferation of smarter and faster machines will further develop traders’ capabilities and transform the capital markets

Key characteristics of the future of trading

**Agility**
Real-life events will be reflected in the market price at a much faster speed as traders gain access to and act on news from new and traditional sources more quickly

**Accuracy**
The room for human error will decrease as more aspects of trading activities are automated. The quality of trading decisions will also improve as the machines used in researching, hypothesising and decision making self-learn

**Privileged**
The gap between trading institutions and individual investors will increase as the increased infrastructure costs to compete in collecting, analysing and acting on information create barriers for individual investors

As smarter, faster machines improve the capabilities of traders, how will the capital markets transform?
How will smarter and faster machines transform capital markets?

Potential scenarios enabled by smarter, faster machines

1. **Diversification of trading strategies and tactics**
   - **Data Sources**
   - **Traders**
   - **Market**
   - Reacts to real-time events from diverse data sources
   - Takes different actions on different set of stocks

2. **Convergence of trading strategies and activities**
   - **Data Sources**
   - **Self-learning machines**
   - **Market**
   - Analyses various data and predicts market outlook in similar ways
   - Takes a similar action on any stock

3. **Reverting to manual processes**
   - **Data Sources**
   - **Traders**
   - **Market**
   - Regulations require access to external data and/or trade execution to be intervened manually

- The race for speed transitions from responding to price movements to the development of strategy **responding to real-life events** through big data analysis and machine readable news
- **Algorithmic trading strategies become diversified** as they access different data sources and infer different market outcomes
- As trading algorithms become more intelligent and are able to access more complete sets of market data, their analyses **converge toward a single view** of the market
- As trading and market-making strategies converge, volume decreases and spreads tighten
- Growing public discontent with algorithmic trading leads to **regulations on the use of automated** data feeds and/or smart machines in executing trades
- Some parts of market making activities **revert to old, manual processes**, tangibly reducing the trade volume and the liquidity of the market

The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions

These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time
As the benefits that can be earned from incremental investments in high frequency trading decrease, algorithmic traders will shift their focus to real-life events by connecting to new data sources available from social media feeds to machine readable news. Due to the vast amount of data available, most algorithmic traders will focus on different events and triggers. Unlike most high frequency trading strategies, the market reaction to real-life events is not certain and traders with different views, skills and analytical tools will make different decisions in face of the same data. As the result, the trading strategies and tactics of algorithmic traders will vastly diversify.

The focus of a race for speed moves from chasing price movements to responding to real-life events through big data analysis and machine accessible news. Market makers’ trading strategies become diversified as they access different data sources and infer different market outcomes. Diversification leads to increase in intraday volatility and wider ask-bid spread.

New innovative services like Dataminr and SNTMNT enable traders to gain access to events and news that may trigger market movement (e.g., breaking news, M&A speculation) faster than the competition by utilising non-traditional data sources like social media / market sentiment and real-time analytics. Leveraging these platforms, algorithmic traders can leverage their infrastructure to shift focus from reacting to stock price movements to monitoring and reacting to real-life events faster than other traders and investors in the market.
Scenario 2: Convergence of trading strategies and activities

**Narrative**

As access to a universe of real-time data feeds becomes essential to the execution of successful algorithmic trading strategies, the set of data used by traders converges with every trader using almost every available data source. At the same time algorithms become smarter incorporating machine learning and improving the accuracy of projections.

With algorithmic traders connected to similar data sources and smarter machines generating similar projections from those data, the variances among algorithmic traders’ activities will decrease.

**Case studies**

- **AYASDI**
  Ayasdi leverages topological data analysis to process big data sets to unveil patterns within the network of data. In capital markets, Ayasdi’s technology can be used to understand the relationships between various real-life events and market performance to derive trading hypotheses. Over time, additional historical data and trading outcomes can be added back to the analysed big data to continuously sophisticate and automatically correct the trading hypotheses.

- **Neuro Dimension's TradingSolutions** combines technical analysis with artificial intelligence using neural networks and genetic algorithms to learn patterns from historical data and optimise system parameters.

As these types of systems become more sophisticated, algorithmic traders will simultaneously predict the market performance with a greater degree of accuracy and their trading activities will converge.

**Summary of impact**

- Accuracy of market projections by trading algorithms gradually improves as market makers gain access to broader sets of big data and more sophisticated machines
- Since each market maker’s system accurately predicts the market movement, differences among various market makers’ projections and trading strategies are eliminated
- As trading strategies converge, volume decreases and arbitrage opportunities effectively disappear
Scenario 3: Reverting to manual processes

Narrative
The utilisation of new data sources like machine readable news and advanced computing in trading activities increases the gap in the level of sophistication between professional algorithmic traders and individual, retail investors. The public may perceive some of these innovations to be an “unfair” advantage; similar to how infrastructures costs associated with high frequency trading have been scrutinised.

Reacting to public sentiment, policy makers and regulatory agencies may impose restrictions on what automated data streams and trading machines can and cannot be used for various activities. Potential misinterpretation of data by smart machines triggering systemic losses might accelerate such movements toward regulation.

Summary of impact
- Growing public discontent with algorithmic trading leads to regulations on the use of automated data feeds and / or smart machines in obtaining information or executing trades
- At least some parts of market-making activities revert to old, manual processes, tangibly reducing the trade volume and the liquidity of the market
- As a result, the liquidity of the market will decrease. As traders cannot react to fact-based price arbitrage as quickly, they may also increase their spread to mitigate their risks, resulting in unfavourable price formation for both buyers and sellers

Case studies
On 23 April 2013, a false report of explosions at the White House was posted on the hacked Twitter account of Associated Press. With many algorithmic traders’ systems linked to key Twitter feeds, algorithmic trades caused a selling spree nearly immediately after the posting. As the result, $136 billion was wiped out from the S&P 500 index within two minutes of the tweet’s posting. While the market quickly recovered three minutes after the correcting announcement, many industry experts and regulatory agencies perceive the event as something that would not have been caused by human traders as humans would have second-guessed the validity of the tweet.
What does this mean for financial institutions?

Key implications and remaining questions

“Safe Bets” – Likely implications under all scenarios

**Reduced role of humans:** As the adoption of smarter and faster machines accelerates the competition for speed in gathering, analysing and acting on data, the role of humans in trade execution will diminish and intelligent machines will replace largely human activities today, such as trading strategy development.

**Larger impact of errors:** Even small errors in data integrity, trade strategy, and trade execution will lead to much larger impact as end-to-end trading activities are automated via smarter, faster machines, with limited human intervention.

What role will human traders play as end-to-end trading activities become automated through smarter, faster machines?

How will financial institutions effectively sort out erroneous data, algorithms and execution to avoid resulting in enormous losses, while maintaining execution speed?

### Scenario 1: Diversification of trading strategies and tactics

**Competition for data sources:** Competition to discover new data sources and gain exclusivity will intensify as the focus of algorithmic trading shifts from price movements to real-life events.

**Increased specialisation:** Traders with a deeper understanding of specific companies, sectors and real-life events will gain advantage over firms with broader approaches as trading strategies diversify.

How will financial institutions gain exclusive or faster access to data without appearing as having an unfair advantage?

### Scenario 2: Convergence of trading strategies and activities

**Marginalised returns:** As trading strategies converge through big data and machine learning, competition for each trade triggered by real-life events will intensify and marginal returns will diminish.

**Competition for speed:** When most players in the market rely on similar trading strategies, the basis for competition will shift again from discovery of new insights to faster execution via infrastructure investments.

How will each institution differentiate from one another as the convergence of trading strategies via smarter, faster machines lower the margin?

### Scenario 3: Reverting to manual processes

**Competitive uncertainty:** Capabilities required to be competitive in the market (e.g., faster computation, faster access, advanced analytics) will change drastically and rapidly depending on regulatory changes, leading to uncertainty in traders’ long-term strategies.

**Impetus for agility:** In order to react timely to those competitive uncertainties generated by potential regulations, traders’ organisational agility will become critical amidst the current shift toward replacement of workforce with smarter, faster machines.

**Implications**

**Remaining questions**
Market Provisioning

What impact will better connected buyers and sellers have on capital markets?
Executive Summary

Context / Innovation

- Many illiquid financial assets remain highly dependent on intermediating institutions to discover and connect buyers and sellers, often based on networks of pre-existing relationships with other institutions.
- However, following the financial crisis, traditional capital market intermediaries’ risk appetite has been reduced while their capital requirements increased, limiting their ability to take positions on financial assets to create liquidity; this has resulted in reduced liquidity mainly for non-exchange traded assets.
- Leveraging automation and standardisation of information flow, a number of platforms (information/connection platforms) have emerged with an aim to redefine how buyers and sellers are connected in a variety of markets.

Future of Market Making / Intermediation

- As these platforms proliferate, the market landscape may change for many financial products and assets.
  - New information/connection platforms will allow demand and supply represented by smaller intermediaries to be more readily and objectively discovered by counterparties, levelling the playing field between them and larger institutions.
  - Alternatively, these platforms could be developed for a “group” of larger institutions to improve connectivity among themselves, reducing their need to connect with smaller intermediaries and stabilising the current market framework for existing institutions.
  - Information/connection platforms may also choose to extend the connections to individual investors, acting as a market for specific assets and products and opening doors for sellers to easily broaden their buyer base to the broader public.

Key Implications

- Improving information flow among market participants through new information/connection platforms will create tangible benefits to the industry by empowering intermediating institutions to optimise their ability to make the best decisions for their clients; however, it will also require behaviour changes within those institutions.
Over-the-counter activities depend on intermediating institutions to discover and connect buyers and sellers

How do financial institutions facilitate financial markets liquidity today?

- For a wide range of assets and financial products, financial institutions play a role as an intermediary to connect and act on behalf of buyers and sellers
- For some assets (e.g., public stocks, liquid bonds), formal markets exist to facilitate the connection between buyers and sellers, typically in the form of exchanges
- For less liquid and less standardised assets and products, demand and supply is often dispersed, making direct discovery and connection among buyers and sellers highly inefficient
- For these assets and products, financial institutions aggregate demand and supply, and build relationships with one another to effectively create a market, the so called over-the-counter (OTC) market
- As an intermediary, financial institutions sometimes take positions in the assets traded to provide liquidity or offer advisory services to the buyers and sellers they represent

Evolution of OTC driven activities

- Over the years, the markets for standardised assets with high transaction volume have greatly improved their efficiency by adopting technologies to improve connectivity among buyers and sellers
- However, OTC markets still rely on relationship-based intermediaries and non standardised processes to connect buyers and sellers
- Since the 2008 financial crisis, increased capital requirements and reduced risk appetite among intermediary institutions have limited the desirability of acting as a market maker, reducing liquidity for many financial assets and products

Key limitations of today’s model

- **Operational Inefficiency**
  - Highly manual discovery process for the counterparties makes transactions time consuming, costly and complex
- **Suboptimal Pricing**
  - No intermediaries, regardless of their size, have a full view of the demand and supply, making the best price discovery difficult
- **Limited Liquidity**
  - Not all buyers and sellers at a given moment are discovered by one another, limiting liquidity
- **Limited Visibility**
  - Buyers and sellers have imperfect visibility into the market supply, demand and counterparties, limiting their ability to exert control over transactions
- **Limited Access**
  - Buyers’ ability to access assets is limited by their intermediaries’ connections with sellers’ intermediaries

![Diagram showing connectivity between buyers, intermediaries, and sellers](image-url)
New platforms are emerging to connect intermediaries of buyers and sellers to facilitate the flow of market information and the discovery of counterparties.

**What are the new platforms?**

- Leveraging technological innovations, a number of platforms have emerged to redefine how buyers and sellers are connected for various financial assets and products, improving the efficiency of those markets.
- These platforms automate and standardise collection of demand/supply data from intermediaries or buyers and sellers to create an aggregated view of the market and facilitate discovery of the most suitable counterparties.
- Some platforms provide additional analyses on the data collected to better inform buyers/sellers and their intermediaries in choosing their counterparties.

**Examples of platforms improving connection between buyers, sellers and intermediaries**

- **Algomi** - Fixed Income
- **Novus** - Funds / Fund of Funds
- **Bison** - Private Equity / Venture Capital Shares
- **Liquity** - Private Company Shares
- **SecondMarket** - Private Company Tenders
- **ClauseMatch** - Commodities & Derivative Contracts

**Key characteristics of the platforms improving connection between buyers and sellers**

- **Social**: These platforms embed the elements of social networks to facilitate the interaction among buyers, sellers, and intermediaries and improve how buyers and sellers are evaluated.
- **Standardisation**: These platforms typically standardise what data points are collected and analysed through a set of sophisticated metrics to allow buyers to evaluate sellers more critically.
- **Automation**: These platforms automatically collect and analyse data to help buyers and sellers make more informed decisions and make the discovery process less relationship-driven.

Buyer 1, Seller 2, and Seller 3 connected through new platform can exchange information.

Result: All transactions are likely to be executed at an optimal price.
How do market connection platforms differ from traditional models of market making?

<table>
<thead>
<tr>
<th>Value Chain</th>
<th>Traditional Model</th>
<th>Market Information/Connection Platforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyers</td>
<td>Intermediaries</td>
<td>Buyers</td>
</tr>
<tr>
<td>A</td>
<td>D</td>
<td>A</td>
</tr>
<tr>
<td>B</td>
<td>E</td>
<td>B</td>
</tr>
<tr>
<td>C</td>
<td></td>
<td>C</td>
</tr>
<tr>
<td>Intermediaries</td>
<td>Sellers</td>
<td>Intermediaries</td>
</tr>
<tr>
<td>D</td>
<td>F</td>
<td>D</td>
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<tr>
<td>E</td>
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<td>E</td>
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<tr>
<td>F</td>
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</tr>
</tbody>
</table>

**Key Characteristics**
- Information about buyers and sellers (e.g., current inventory / demand, historical performance) is distributed via relationships / awareness existing among their intermediaries
- Intermediaries collect, analyse and act on the information about the counterparties and the market

**Advantages**
- Reduced chance of counterparty failure by transacting through established, trusted intermediary relationships
- Reduced exposure to arbitrage attempts as demand and supply is only visible to a small number of intermediaries

**Shortcomings**
- Highly manual, relationship-based discovery and assessment of demand and supply leading to inefficiency
- Potential to overlook the best price available due to the limitation in the scale of each intermediary's network
- Limited visibility of the transaction process to buyers and sellers

- Intermediaries of buyers and sellers in some cases are directly discovered and connected via a central platform
- Information on counterparties and the market is aggregated and analysed by the central platform for all constituents in the market
As buyers, sellers and intermediaries become better connected via these platforms, the overall efficiency of the market will improve

**Key characteristics of the future markets enabled by improved market connections**

**Increased Liquidity**
More intermediaries, and buyers and sellers, will be connected with one another to enable more accurate assessment of demand and supply in the market, leading to improved liquidity in the market

**Improved Price Accuracy**
As the aggregate demand and supply can be assessed more accurately, intermediaries and buyers / sellers will be able to determine the best price more accurately without revealing undesired information to the market

**Transparency**
Buyers and sellers will gain more visibility into the transaction process and therefore will be able to exert greater control over the transactions and reduce the opportunities for suboptimal transactions by intermediaries (e.g., agent conflict of interest)

**Improved Access**
The ability to buy / sell financial assets and products will be less dependent on the scale or the size of the intermediaries' network, improving access to the market by more buyers, sellers, and intermediaries

**Faster, Cheaper Transactions**
As the discovery and assessment of counterparties become more streamlined and automated, the efficiency of intermediaries will improve, leading to faster turnaround and lower cost to complete transactions for buyers and sellers

**How will the market landscape change for various financial assets and products as buyers and sellers are better connected in the future?**
Levelling the playing field for newer, smaller institutions

Unlike relationship-driven market making, where larger institutions have an advantage over smaller institutions, new platforms will allow demand and supply represented by smaller institutions to be more readily discovered by counterparties.

These platforms will also provide fact-based measures to make counterparty comparison and selection to be more objective, enabling smaller institutions with less developed networks of relationships to compete.

Stabilising market framework for existing institutions

Platforms are developed and used by larger institutions to improve connectivity and efficiency among a “group” of large players.

As connections among larger intermediaries are strengthened by information/connection platforms, the need for larger institutions to connect with smaller intermediaries to generate liquidity will decrease, effectively building barriers of entry for smaller, newer institutions.

Opening the doors to individual investors

As platforms grow, they may choose to extend connections to individual investors (e.g., acting as brokerages).

When sufficient volume from individual investors can be aggregated, these platforms can act as a market for specific assets and products and open doors for sellers to easily broaden their buyer base to the broader public.

The following scenarios illustrate potential outcomes generated by the innovations discussed in this topic, particularly in response to the key question above – they are not meant to be future predictions.

These scenarios are illustrations of particular aspects of the potential future and are not meant to represent a complete view of the market and competitive landscape – in many cases, some or all scenarios could be realised at the same time.
Market information / connection platforms open their doors to intermediating institutions of all sizes. Smaller institutions are particularly incentivised to join such platforms as the platforms significantly expand the intermediaries’ access to market information and connect them to a universe of potential counterparties.

As these platforms grow in scale, so will the pressure for greater trade transparency and the use of more quantitative metrics for best execution. As large intermediaries yield to client pressure to adopt these metrics, they will be more likely to interact with smaller intermediaries with whom they may not have previously established working relationships.

**Case studies**

Novus is a portfolio intelligence platform that automatically gathers and analyses data on various funds’ performance to provide visibility and transparency to fund-of-funds managers. Traditionally, fund-of-funds managers discovered and researched investment opportunities manually by contacting target funds. As a result, the ability of fund-of-funds to source investment opportunities was dependent on their scale, reputation and network. Through Novus’ automated platform, nearly all funds operating across the world and their performance are catalogued and analysed based on an automated collection of regulatory reporting data. This allows smaller fund-of-funds to independently identify lucrative investment opportunities without being limited by their reputation and the size of their networks.
**Scenario 1: Levelling the playing field for newer, smaller institutions (2 / 2)**

<table>
<thead>
<tr>
<th>Necessary conditions for the scenario</th>
<th>Implications of the scenario on...</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Top-level and line-level buy-in from large and small institutions for adopting the information/connection platforms</td>
<td>▪ Higher chance of achieving the best execution of trades</td>
</tr>
<tr>
<td>▪ Intermediating institutions’ are comfortable with managing the risks associated with transacting with less familiar, less pre-defined counterparties</td>
<td>▪ Customers’ ability to achieve optimal results is no longer constricted by the size of their intermediaries</td>
</tr>
<tr>
<td></td>
<td>▪ Sources liquidity from the broadest group of counterparties without risking discovery of demand / supply</td>
</tr>
</tbody>
</table>

**Opportunities and risks associated with the scenario**

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Incentivise deeper specialisation of intermediaries by creating higher returns to specialization</td>
<td>▪ Transparency of counterparty selection is dependent on the transparency of the information/connection platforms</td>
</tr>
<tr>
<td>▪ Potential increase in systemic resilience as the result of diversification of related parties</td>
<td>▪ Increased counterparty risks when dealing with newer, smaller counterparties without standing reputation or relationships</td>
</tr>
</tbody>
</table>
Scenario 2: Stabilising market framework for existing institutions (1 / 2)

Narrative

As standardised information/connection platforms gain popularity, a “group” of large intermediaries may explore adopting the techniques behind these platforms to create a streamlined, exclusive network among themselves. These large institutions may acquire or partner with standardised platforms to set up artificial barriers against smaller and newer institutions. As these exclusive networks grow, it will become more difficult for smaller institutions to find trading counterparties or compete with the efficiency delivered by those networks.

Summary of impact

- As connections among larger intermediaries are strengthened by platforms, the need for larger institutions to connect with smaller intermediaries may decrease, effectively building barriers of entry for smaller, newer institutions.
- Smaller companies lack economies of scale to set up their own liquidity network and may lose their customers to the larger institutions.
Scenario 2: Stabilising market framework for existing institutions (2 / 2)

Necessary conditions for the scenario

- Regulatory tolerance of exclusive networks (e.g., no collusion or anti-trust concerns)
- Large institutions participating in exclusive networks do not experience significant loss in liquidity by excluding smaller institutions
- Continued customer confidence in large institutions to fulfill their orders at a reasonably fair price

Implications of the scenario on...

**Clients**
- Liquidity may increase relative to the current state, but could be less than under an open platform

**Incumbents**
- Large institutions retain strategic advantages over smaller institutions

**Overall Ecosystem**
- Increased concentration of trades among a small number of intermediaries
- Increased difficulty for small intermediaries to compete outside of niche specialties
- Creates barriers of entry for new intermediaries

Opportunities and risks associated with the scenario

**Opportunities**
- Opportunities for large institutions to continue to be highly influential in the market landscape
- Shifting transactions from obscure internal execution facilities to more transparent standardised platforms

**Risks**
- Encouraging concentration of transactions among few large institutions
- Public and regulatory agencies may perceive exclusive networks as an unfair, colluding activity
Scenario 3: Opening the doors to individual investors (1 / 2)

Under the current market structure, individual investors cannot directly participate in markets for many assets because information about supply and demand is disparate and disorganised. As the growth of information/connection platforms improves visibility into these asset classes, the platforms may choose to expand their offerings to provide access for qualified individual investors.

Using these platforms, individual investors are able to transact directly with one another or can aggregate their demand/supply to interact with institutional investors. As engagement with individual investors grows, some platforms may choose to evolve to play the role of a broker.

- As platforms grow, they choose to extend their connections to individual investors, enabling them to bypass traditional intermediaries and transact with one another.
- These information/connection platforms may help individual investors represent their aggregate demand and supply more effectively to institutional buyers and sellers.
- If sufficient volume can be aggregated from individual investors, these platforms can effectively act as a market for specific assets and products, and open doors for sellers to broaden their buyer base.

Case studies

Liquity provides private company directors with a comprehensive suite of shareholder and equity management services and match investors with private company shareholders who want to sell some or all of their equity. Liquity facilitates complete deals, from introduction to transaction completion including escrow and custodial services.
### Scenario 3: Opening the doors to individual investors (2 / 2)

#### Necessary conditions for the scenario
- Appetite for individual investors with high degree of financial sophistication to directly participate in trades
- Development of execution infrastructure to facilitate trades with individual investors who do not possess over-the-counter capabilities
- Ability to aggregate sufficient demand and supply volume among individual investors to transact with institutional investors

#### Implications of the scenario on...

<table>
<thead>
<tr>
<th>Implications</th>
<th>Clients</th>
<th>Incumbents</th>
<th>Overall Ecosystem</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ability to make direct connections with trade counterparts</td>
<td>Access to new asset classes for individual investors</td>
<td>Erosion of market shares to brokers and groupings of groups of high net worth individuals</td>
<td>Increased liquidity on standardised platforms</td>
</tr>
<tr>
<td>Improved transparency and control over the transaction process</td>
<td></td>
<td>Impetus for intermediaries to strengthen values they provide to clients beyond transaction facilitation</td>
<td></td>
</tr>
</tbody>
</table>

#### Opportunities and risks associated with the scenario

<table>
<thead>
<tr>
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<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opportunities to separate transactional services from high-value, advisory offerings</td>
<td>Potential for sophisticated individual investors to make errors due to lack of specialised knowledge (relative to professional intermediaries)</td>
</tr>
<tr>
<td>Opportunities to engage new buyers and sellers in the market, increasing liquidity and diversifying the needs and opinions of market participants</td>
<td>Increased burden on regulatory agencies as more parties are directly involved in the market</td>
</tr>
</tbody>
</table>
What does this mean for financial institutions?

### Key implications and remaining questions

#### “Safe Bets” – Likely implications under all scenarios

<table>
<thead>
<tr>
<th>Scenario 1: Levelling the playing field for newer, smaller institutions</th>
<th>Scenario 2: Stabilising market framework for existing institutions</th>
<th>Scenario 3: Opening the doors to individual investors</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Less differentiation among intermediaries:</strong> As the ability to fulfill the transaction needs of customers become commoditised by market connection platforms, financial intermediaries will be less differentiated by their capabilities.</td>
<td><strong>Direct investments by established institutions:</strong> Established intermediaries will become more active in investing, implementing, and acquiring market connection platforms to stabilise the current market framework.</td>
<td><strong>Reduced value proposition to institutional customers:</strong> As some institutional customers choose to directly discover and transact with counterparties via market connection platforms, their stickiness on other institutional services, such as asset management and investment banking, may decrease.</td>
</tr>
<tr>
<td><strong>Redistributed negotiating power:</strong> With both counterparties and their intermediaries gaining improved visibility into market demand and supply, negotiating power will be redistributed based on actual demand and supply resulting in more efficient pricing.</td>
<td><strong>How will established intermediaries gain exclusive access to market connection platforms while avoiding conflict-of-interest (i.e., best execution) and anti-trust issues?</strong></td>
<td><strong>How will larger financial institutions continue to maintain advantage over smaller players when economies of scale are eroded and smaller players can gain access the same information and counterparties?</strong></td>
</tr>
<tr>
<td><strong>Shift to advisory models:</strong> As the financial intermediaries’ role in counterparty discovery and negotiation diminishes, their ability to build customer relationships based on advice will become more important to their competitiveness.</td>
<td><strong>How will financial intermediaries differentiate from one another as improved information flow and trading connections reduce the gaps in institutions’ ability to find counterparties for their customers?</strong></td>
<td><strong>Direct investments by established institutions:</strong> Established intermediaries will become more active in investing, implementing, and acquiring market connection platforms to stabilise the current market framework.</td>
</tr>
</tbody>
</table>

### Implications

- Reduced fee structure: As the cost of fulfilling transactions falls, the fee structure of intermediation services, as well as actual products themselves (e.g., carry on funds), may be reduced regardless of client size.

### Remaining questions

- How will larger financial institutions continue to maintain advantage over smaller players when economies of scale are eroded and smaller players can gain access the same information and counterparties?

- How will established intermediaries gain exclusive access to market connection platforms while avoiding conflict-of-interest (i.e., best execution) and anti-trust issues?
Contact Details
For additional information please contact:

**World Economic Forum Core Project Team**

**R. Jesse McWaters**  
Project Manager, Financial Services – Project Lead  
World Economic Forum  
Jesse.McWaters@weforum.org

**Giancarlo Bruno**  
Senior Director, Head of Financial Services  
World Economic Forum  
Giancarlo.Bruno@weforum.org

**Abel Lee**  
Director, Head of Insurance and Asset Management  
World Economic Forum  
Abel.Lee@weforum.org

**Matthew Blake**  
Director, Head of Banking and Capital Markets  
World Economic Forum  
Matthew.Blake@weforum.org

**Professional Services Support From Deloitte**

**Rob Galaski**  
Deloitte Canada  
Rgalaski@deloitte.ca

**Hwan Kim**  
Deloitte Canada  
Hwankim@deloitte.ca