The 6 megatrends: What concerns unite our global executives?

Financial Institutions 2025 Risk Index
Index methodology

This index has been compiled through telephone interviews with 150 C-suite individuals from financial institutions. Interviews were completed by an independent surveying organisation on a pre-qualified but random sample.

All respondents were provided with relevant contextual information, and the questions that were asked, in advance of the interviews.

The interviews investigated the respondents’ perception of risk in relation to six megatrends that had been pre-defined after independent, qualified research. The analysis of the output from the interviews was conducted by an independent analyst.

The individuals that participated in the survey covered a broad spectrum of both sub-sectors of the finance industry and global geographies.

Additional trends

Respondents were given the opportunity to state any broad megatrends that they felt had been overlooked in the survey. The two megatrends that emerged clustered around sustainability and customer retention but neither was significant in number.

Digitalisation and technological advances

Technological advancement is impacting the finance industry as new challengers are emerging and growing customer expectations drives significant IT infrastructure investment.

Business Operating Model pressures

Regulation and the increasing cost of capital is exerting pressure on business operating structures, driving segmentation and disintermediation in the financial sector.

Demographic and behavioural changes

The changing demographic, geographical and behavioural profile of customers is forcing financial institutions to deal with divergent customer expectations, and new customer bases and workforces.

Regulatory changes and complexity

Regulatory pressures arising from the financial crisis have increased the cost of capital, prompted large-scale divestment, reshaped attitudes towards risk and redrawn the boundary between retail and wholesale banking.

Global talent and skills race

Talent capable of navigating a rapidly evolving financial landscape will be required to respond to increasing regulatory pressures, a changing approach to risk management and the emergence of new markets.

Changes in investment, capital sources and returns

Non-bank financial institutions, fintech companies and new investors are bringing fresh capital into the sector while banks meet capital requirements, manage stress tests and spend on compliance upgrades.

Demographic

Participation by sub-region

By business description

- Asset manager/Alt investment
- Insurance/Reinsurance
- Retail banks
- Investment/Wholesale banks
- Hedge funds
- Financial technology

By job title

- CEO
- CFO
- CIO
- CRO
- CMO
- CTO
- COO
- Partner
- Managing Director
- Regional Director
- Executive Vice President

By size of business

- Under 100
- 101 - 500
- 501 - 1,000
- 1,001 - 5,000
- Over 5,000

Number of employees
Risk is everywhere. Corporates, lenders, insurers, even revolutionaries crave it in qualified doses. Without it, there is literally no reward. As the celebrated American cowboy and actor Will Rogers once drolly noted: “Why not go out on a limb? That’s where all the fruit is.”

Yet, risk appetite and reward needs to be understood and measured. The firms who master risk will gain a competitive advantage, as they will be able to develop robust growth strategies, deploy capital optimally and invest strategically in the future.

Unlocking this growth potential is the reason that Willis Towers Watson created the Financial Institutions Risk Index, to identify, highlight and understand the principal risks facing the financial sector today, and in the years to come. This is the first in a series of risk indices that Willis Towers Watson plans to publish for the financial institutions sector on an annual basis.

We have conducted exhaustive interviews with C-suite executives and financial industry leaders from across the globe, including chief executives, chief risk officers, chief information officers and financial regulators. These thought leaders have identified six standout megatrends, ranging from regulatory changes and new technology, to global skills and demographic changes. Within those trends sit a number of specific and associated risks, each carving the future of the financial sector. We believe these trends and associated risks will have a seismic impact on financial services firms between now and 2025.

Among its findings, the Willis Towers Watson Financial Institutions Risk Index reveals that 40% of the C-suite executives surveyed believe the financial sector’s ability to manage risk has materially changed for the better between 2014 and 2015. However, wider concerns remain with respect to the continued pace and number of regulatory changes, geopolitical turmoil, and currency issues.

The index demonstrates that the financial sector is being squeezed between two types of risk: on one side, the growing demands of governments, regulators and clients; on the other, unparalleled economic volatility and instability.

Drilling down, C-suite executives highlighted the threat of future recessions, mature customers moving against intermediaries and falling returns on capital due to more stringent regulatory demands as specific areas of concern.

The Willis Towers Watson Financial Institutions Risk Index offers an invaluable repository of data and strategic insight for those working across the financial sector. It will also assist firms in setting risk appetites, identifying, understanding and mitigating risk, thereby helping them to build resilience to face the risks of today and the challenges of tomorrow.

Mary O’Connor
Co-head of Financial Lines, Head of Financial Institutions, Willis Towers Watson

“40% of the C-suite executives surveyed believe the financial sector’s ability to manage risk has materially changed for the better between 2014 and 2015.”
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Section one

The megatrends

In our first annual Financial Institutions Risk Index, we identify six megatrends concerning global executives
The world is full of risk. It’s always there, shifting shape to each event. It lies in bank vaults and government treasuries, in corporate balance sheets and business models. It hides in the flickering screens of stock traders and in the minds of the people we hire, and even the technology we buy to keep us secure.

We will never fully control it. In fact, in our complex, interconnected world, it’s folly to try. If the 2008 financial crisis proved anything, other than the dangers of light-touch regulation and truly freewheeling capital markets, it’s that the ingredients for the next recession are already blended into the operating models of leading funds, banks and corporates. The logic has long been that the seeds of future crises must always exist in the present. But the better we understand and measure risk, the easier it is to build and protect a firm’s brand, manage its assets, develop a robust growth strategy, deploy capital optimally, and invest strategically to gain a crucial competitive advantage and develop resilience to face the future.

Corporations and financial institutions, facing greater scrutiny from regulators, clients and governments have all been forced to learn new skillsets. Technology protects valued databases, compliance defends against human slips, checks and balances moderate the more extreme effects of financial innovation. Sometimes this tidal wave of regulations threatens to overwhelm everyone from pension funds to retail lenders. Costs rise as companies buy better technology, radically revise operating models and reassess their entire product range.

To help understand this sometimes daunting new world, we developed the Financial Institutions Risk Index. It captures the consensus view of senior C-suite executives charged with running global banks, insurers, reinsurers, asset managers, hedge funds and fintech firms, and measures how these corporate leaders perceive risks both now and years down the line. In short, the index tells you what boardrooms are thinking about risks and which risks are causing sleepless nights, as can be seen here in the top-ten risk ranking.

The data is broken down simply. C-suite respondents from large and mid-sized financial firms, spanning everyone from chief executives, operating and finance officers, to corporate chiefs in charge of risk, information, marketing and technology, are asked to gauge the significance of risk impact and ease of risk management of half a dozen megatrends to their line of business, on a scale of one to ten. Follow-up questions relating to whether that megatrend is falling or rising in importance are graded respectively on a scale of one to five.

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<th>Composite Risk Score</th>
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<td>Increasing costs associated with IT infrastructure investment</td>
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*Composite risk score reflects the addition of severity of risk and ease of risk management (/20)
To further aid the reader, a clear distinction is made between broader megatrends and narrower risks. The former are collective themes that drive longterm corporate thinking, from changes in technology and regulations, to the global hunt for talent. More precise, but no less of a threat, are the risks caused by the megatrends; risks are omnipresent, embedded in supply chains, new capital requirements or rising IT costs.

Each megatrend is distinct in its own way. Some are viewed by C-suite executives interviewed for the index as more inherently perilous and important than others. To Wences Casares, founder and chief executive of bitcoin vault and wallet specialist Xapo, the most important megatrend is digitalisation and technological advances. Robert Pozen, senior fellow at the Brookings Institution in Washington, highlights the challenge to snap up the best young global talent. Here are the six megatrends identified in this year’s Financial Institutions Risk Index:

**Regulatory changes and complexity**

The big beast in the jungle. Regulations are like the daily commute – unpleasant but necessary. Since the financial crisis, new rules have piled on the cost of capital, forcing banks to divest risky assets or entire portfolios, while more loosely regulated nonbank institutions boost lending to grateful clients. This megatrend scores highest among C-suite executives across the board, from the short and long-term impact of the megatrend on the financial services sector, to companies’ ability to manage its impact on their business. Retail banks typically view it in a slightly less important light than hedge funds and insurers.

**Business Operating Model pressures**

Financial services firms face increasing pressure upon their traditional banking models. Online start-ups offer peer-to-peer lending, crowdfunding and mobile services, segmenting the market and squeezing margins. Traditional financial intermediaries are falling out of the chain, bypassed by customers attracted to new entrants and ways of conducting business. Overall, this megatrend scores relatively low in the index, meaning that it is perceived as less important by C-suite executives, but that simple fact conceals nuances. The more complex the financial provider – investment banks, hedge funds and so on – the higher the score tallied, while results vary between region, with a lower score recorded in the Americas than in Europe and Asia.

**Changes in investment and capital sources and returns**

This is the middle-manager of megatrends. C-suite executives fear its impact, scoring it third highest, but worry more about technology and crushing regulation. There is reason to fret: banks face seemingly never-ending rounds of asset quality reviews and stress tests in Europe and the United States. Many are being undermined by nimbler non-bank peers or fintech ventures. The megatrend tends to score far higher in Europe, the Middle East and Africa than the Americas, and is prominent among insurance companies and investment banks, in contrast to financial technology firms.

**Global talent and skills race**

The real action starts here. This megatrend tallies second highest in terms of its overall impact on the financial services sector and almost tops the rankings in terms of its long-term significance. That’s hardly a surprise. Technology is changing the way people interact with financial firms. Banks are adapting, but often too slowly; threats to the old order emerge online and through low-cost fintech service providers. Data shows that the financial sector believes it’s more prepared for the challenges of this megatrend than any other.

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Global talent and skills race

The megatrend that everyone always underestimates, even though financial institutions desperately need highly qualified graduates who can identify, understand, and target opportunities and emerging risks. It ranks third lowest in terms of outright importance in the index, yet curiously has greater significance attributed to it when executives are queried about its direct impact on their business. Insurers and investment banks are more concerned about the challenge of securing and retaining talent; asset managers, inversely, far less, as they are the beneficiaries of the flow of talent away from the traditional financial powerhouses.

The past five years have provided a daunting and sometimes overwhelming challenge to traditional financial services institutions and the professionals who run them. New pressures have emerged in the form of specialist financial providers targeting infrastructure, and small and medium-sized business lending. Mobile banking is changing the way a new generation interacts with its financial provider. Fintech firms are using online digital platforms to slash overheads and offer cheaper alternatives to traditional banking clients. Many in traditional financial institutions have felt their resilience tested as they spend more time on compliance matters than banking solutions. Financial regulations weigh heavily on incumbent banks while non-bank financial institutions and fintech firms have flourished under ‘light-touch’ regulation.

And where risk lies can change overnight and in any manner of ways. Hackers could break into your system and steal passwords, compliance failures could open a firm up to charges of system and control failings, and place the C-suite under investigation by the financial regulator. But the core risks that keep leading financial services executives up at night have either been with us forever, or will cloud our thinking for years to come.

This list is led by macroeconomic factors such as the impact of deflation and ongoing European-style stimulus, which scored 12.96, when the severity of risk score was added to the ease of risk management score. Next on the list are the risks posed by rising IT costs and the flood of new rules driving talent to less highly regulated corporates, which achieved composite scores of 12.36 and 12.32 respectively. These risks, like death and taxes, are likely always to be there. We can’t always change the world we live in, but we can seek to understand it better.

That’s why the Financial Institutions Risk Index is here – to help you navigate the storms and squalls of financial and business life.
New normals beyond the horizon

Within a generation the world has been transformed by unprecedented economic and political developments – a new world order is shaping up right before our eyes, says Joe Nellis, professor of global economy at Cranfield School of Management.

The globalisation of trade and finance has brought about fundamental changes in the patterns of demand and supply, enabling the rapid development of many emerging economies, such as India and China, as well as the so-called frontier countries, including Turkey, Indonesia and Mexico. In tandem, we are witnessing major social trends, for example the ageing of populations in many of the most developed economies. This contrasts sharply with the rapid growth of populations, urbanisation and educational investment in a growing number of emerging countries and those at the “base of the pyramid”.

Innovations in information communications technology have connected people in radically new ways, and provided access to an almost infinite volume and range of information and knowledge through freely accessible open-source systems. The internet has killed distance. Many successful businesses have creatively adapted to the changing business environment by establishing new business models and structures, including partnerships and interlinked supply chains.

The world has become even more diverse and complex – and riskier – making it increasingly challenging for organisations from all sectors to respond appropriately. In this rapidly changing and challenging new world, what are the likely “new normals” that will have the greatest impact on business, society and government?

North to south?

The development of emerging and frontier economies has led to a fundamental shift in the balance of economic and political power from the West to the East to the extent that it is estimated the aggregate economic weight of developing and emerging economies is about to surpass that of the countries that currently make up the so-called “advanced” world.

Consequently, many of the most mature, high-cost developed nations have been challenged to respond to the rapid growth of high-quality manufacturing capacity in the lower-cost developing countries and regions. For example, Apple has had to outsource hundreds of thousands of manufacturing jobs to Mongolia, China, as well as to Korea and Taiwan, to remain competitive. Some countries, such as India, have also been investing heavily in the growth of their service industries, competing head to head for business with some developed economies while at the same time forming new partnerships through the provision of a wide range of outsourced service operations.

The next wave of change in the global distribution of economic power and wealth is likely to be from the northern to the southern hemisphere as global demand for increasingly scarce commodities and resources continues to grow. As a consequence, it is expected that manufacturing and IT services will shift even more dramatically in the coming decades – at an even faster pace.
Demographic changes

Demographic change manifests itself in different ways across the world. In the developed world, population levels have almost reached a peak and it is estimated they will start to decline slowly from around 2030 onwards. In the developing world, however, populations are still growing; the highest growth rates are in Africa, but Asia will provide the highest numbers in absolute terms until about 2050. In the developed world, the population is ageing: the number of people aged over 65 now exceeds those under 15, with the gap increasing.

In the developing world, however, the number of young people still exceeds those over 65, although this gap will close during the coming decades. As the general standard of living continues to rise for hundreds of millions of people, it is inevitable there will be increasing demands for greater access to a wide range of services including, for example, healthcare, welfare, air, road and rail transport, housing, security and so on. The consumer landscape will change and expand. A new global “middle class” is materialising, with a dramatic rise in purchasing power, in China, India, Latin America and Africa. Some forecasts suggest the rising middle class could result in at least one billion new consumers entering the world's marketplace over the next decade to demand internationally traded goods and services. Spending patterns will be transformed.

Globalisation

The development of new information communication technology is transforming the way that we all live and interact with each other. ICT changes behaviour in terms of the way people access information, and in the way they make and maintain relationships. Geography is no longer a constraint on global communication. For the first time in history, almost everyone on the planet can communicate in some form with each other – location is no longer relevant.

The decline in manufacturing industry in many developed countries and the shift in emphasis towards service industries, particularly the growth of knowledge intensive industries, are now clear trends. Such trends, in turn, increase the demand for highly skilled workers. In the developed world, companies face a demographic landscape dominated by the looming retirement of the baby-boomer generation and by a dearth of skilled young people. Companies will increasingly be forced to look towards the growing global talent pool of highly motivated, educated young people from emerging and developing countries to satisfy their needs for talent.

According to United Nations population forecasts, by 2025 the number of students in higher education worldwide is expected to double to more than 260 million. Nearly all this growth will be in the developing and emerging economies, and more than half of the increase is expected to be in China and India alone. For many companies and governments, global labour and talent strategies will become as important as global sourcing and manufacturing strategies.

There will continue to be a need for new technologies to improve efficiency in the use of natural resources and to stimulate the development of new sources of energy to replace fossil fuels. Ultimately, demand shifts in human behaviour will be required to protect the scarcest natural resources. Such shifts will, inevitably, involve changes in regulations and taxation alongside innovations in technology.

“For the first time in history, almost everyone on the planet can communicate in some form with each other – location is no longer relevant.”
Universal access to knowledge, enabled by ICT, is changing the economics of knowledge. Freely accessible open-source approaches mean communities as well as individuals are generating knowledge and innovation on a scale never experienced before. Recent annual global patent filings now rank China second only to the United States. But, at the same time, it is becoming more difficult for knowledge generators to protect their intellectual property rights.

Businesses, particularly those that are knowledge based, will need to learn how to develop and retain competitive advantage in this environment. And companies will have to learn how to leverage this new knowledge universe – or risk drowning in a flood of too much information.

Evolution or extinction?

Finally, let us remember the words of Charles Darwin when he wrote a long time ago: “It is not the strongest species that survive, nor the most intelligent, but the ones most responsive to change.” The dinosaurs became extinct because of their failure to evolve in a slowly changing environment. Today, the global business environment is changing at breakneck speed. It is becoming increasingly more complex, and organisations and management will have to acquire new resources and techniques to respond, survive and prosper. Those who fail to identify the implications of this growing complexity and adopt new approaches will find themselves facing extinction, sooner than previously thought possible.

The winners of the future will be those organisations and leaders who evolve and rise to the challenge, embrace complexity, and identify and adapt to the new normals that lie beyond the horizon.

Of the world’s disposable household income will be accountable for by the emerging markets in 2025, compared to just 40% today

Source: Oxford Economics

Top 20 largest economies in 2030 ($ Trillion)

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<th>GDP in 2015</th>
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55% of the world’s disposable household income will be accountable for by the emerging markets in 2025, compared to just 40% today

21% of worldwide disposable household income will be from China by 2029

Source: Oxford Economics
Section two

Regulatory changes and complexity

“Nothing is certain”, said Benjamin Franklin, one of America’s founding fathers, “except death and taxes”.

Add regulation to that list. It increasingly circumscribes and defines everything financial services firms do.
Since the 2008 financial crisis, regulation has become the watchword of the financial industry, from the ring-fencing of UK banking operations to endless rounds of eurozone stress tests. The effects on a once lightly regulated industry are profound. Regulators are more assertive, while Basel III requirements, notes Robert Pozen, senior fellow at the Brookings Institution in Washington, have led to “requirements for financial institutions to hold… pots of cash”.

Regulatory changes and complexity is by far the most important megatrend identified by C-suite executives in the Willis Towers Watson Financial Institutions Risk Index, beating the digitalisation and technological advances and changes in investment and capital sources and returns megatrends. The megatrend scored 7.42 out of 10 in terms of the significance of its impact on financial services as a sector, the highest of any in the index. This primacy was also evident when the C-suite were asked to consider the megatrends in relation to their business. It scored 7.39 and 7.0 out of 10 for significance of its impact and ease of risk management respectively, giving a composite score of 14.39, more than a point above the next highest ranked megatrend, digitalisation and technological advances.

Those heavyweight numbers are reflected in the Financial Institutions Risk Index chart on pages 58 and 59, where the megatrends are arranged in descending order. Participants view it as the most impactful megatrend both in the short term of the next 12 months and over a ten-year period, with financial institutions fretting about their ability to manage current ongoing demands and risks.

Little wonder, given the difficulty in predicting the future whims of rule-makers. David Yates, chief executive of payment systems firm VocalLink, points to the increasing prevalence of regulators cracking down “even on historic failures”.

Risk perception

Drilling down into the regulatory megatrend, C-suite interviewees singled out specific themes that prey on their mind, both now and for the future. Risk perception rose sharply when it came to doing business in countries where political interference was more the norm than exception, though fewer worried about their ability to handle the cost of dealing with multiple regulatory regimes. That risk factor sits lowest within this megatrend, as can be seen in the graph overleaf. This is recognition, perhaps, of increasing regulatory convergence, and confidence in the considerable capital investment lavished in recent years by financial providers on forming world-class internal compliance and risk assessment divisions.

Participants covering the entire gamut of the financial sector, from insurance and asset management to retail and wholesale banking, were far more relaxed about the threat posed by new and nimble-footed market entrants.

Despite the rise of assertive and more lightly regulated non-bank financial institutions, this risk factor tallied 11.64, the second lowest composite score across the megatrend, in part a reflection of the sheer range of services offered by large financial institutions and, by extension, the narrower portfolio of services provided by newer entrants.

There was also a marked deviation by region, as there was across the entire index. In Europe, the Middle East and Africa (EMEA), C-suite executives saw the regulatory environment in a far bleaker light. Take the threat of rising compliance costs. In EMEA, this metric scored 7.1 out of 10 in terms of the severity of the risk posed to a business and 6.4 in terms of the relative ease with which financial institutions viewed their ability to tackle that threat. Those numbers were far lower in the Americas, at 6.1 and 5.6 respectively. Perhaps reflecting the developing nature of the Latin American countries, Gerardo Hernandez Correa, head of financial supervision in Colombia, believes that in his country the regulators’ focus will be as much on education as on rules.

“We need to enhance the financial skills, not only of the general population, but also of the people who work in the industry,” he says.

“Significant uncertainty hangs over EU requirements for bank structural reform”.

Dr John Lee
Group Chief Risk Officer,
Malayan Banking Berhad (“Maybank”)
More regulation

This megatrend shows how much the financial world has changed and continues to change, with more rules continuing to carpet the landscape. And the regulators aren’t finished yet, with industry players set to face new restrictions on what they can and cannot do in the future.

Dr John Lee, group chief risk officer at Malaysia’s largest lender, Maybank, says: “Financial institutions will be keeping pace with a number of regulatory requirements”, from UK ring-fencing to US demands for foreign lenders to submit plans for implementation of the intermediate holding company structures. He also points to “significant uncertainty” hanging over new European Union requirements for structural banking reforms, with the European Central Bank insisting in May that it would continue to impose stress tests on 123 lenders across the eurozone in the years ahead, in an attempt to ward off any future banking crises.

Regulation will continue to shape what financial institutions can do, and the different levels of regulatory sophistication will create further challenges that might prompt simple and direct regulatory actions. “I don’t think we are ready to use these kinds of instruments which seem to create larger risks for most people,” says Hernandez Correa. “Therefore Colombia’s Central Bank said, for example in the case of bitcoin, it was not allowed to be used as a payment between the country’s citizens.”

A note of caution is added by Rodney Baker Bates, chairman of Willis Ltd, who notes that “greater regulatory requirements being placed on banks could stifle innovation, so we must ensure that stringent regulation doesn’t become over-regulation”.

Summary

- Regulations define the financial services landscape, posing the greatest threat to industry players.
- The impact of rule changes, seen and unforeseen, are viewed as the biggest drivers of risk.
- C-suite participants spotlight the importance of capital optimisation under new Basel II and III, and Solvency II reforms.
- Regulations are viewed as less of a threat to the industry in the Americas, but more in Europe.

*composite risk score reflects the addition of severity of risk and ease of risk management
“Greater regulatory requirements being placed on banks could stifle innovation, so we must ensure that stringent regulation doesn’t become over-regulation”.

Rodney Baker Bates, Chairman, Willis Ltd.
Trust: The new battleground for financial services
The public’s trust in the financial sector is low. A 2013 YouGov-Cambridge report found that 58% of interviewees agreed that the industry was “at best unprofessional, and at worst dishonest”. It’s not difficult to understand why. Many ordinary customers were affected by the financial crisis. Jobs and homes came under threat or were lost, whilst savings and investments declined or became worthless. Financial regulators have since unearthed egregious examples of misconduct.

Co-ordinated regulatory action by regulators may have resulted in record breaking financial penalties, but this has hardly restored trust in financial institutions. The decline in trust along with the impact of megatrends which are changing the financial landscape, has proven to be a toxic combination for banks but fertile ground for FinTech firms.

Is FinTech the solution?

In the last few years, FinTech entrants have revolutionised the financial space. Crowdfunding and Peer-2-Peer firms have mushroomed from small niche providers to global game changers.

Lending Club achieved a $5.4 billion Initial Public Offering on the New York Stock Exchange, whilst the UK’s Funding Circle is now supported by the British Business Bank, a development bank wholly owned by the UK Government.

Robo-advisors are challenging the wealth management sector by using algorithms and data to improve portfolio returns, whilst improving transparency over fees. Online only banks look set to change the retail banking landscape and proponents of crypto-currencies believe that the underlying technology, blockchain, has the potential to render the traditional banking system altogether irrelevant.

Even established “household” technology names are disrupting the financial sector. Apple has integrated its “ApplePay” service into its product range, whilst Amazon has extended credit to some of its business users.

Trust – the new battleground

FinTech appears to have demonstrated that whilst we need banking and banking services, there is less of a need for traditional banks. Although banks seem to be losing the fight to FinTech firms, there is a new battleground left to fight: Trust.

The Edelman Trust survey showed declines across all technology-based industries. A series of high profile stories have raised significant questions about privacy and personal data. Information leaks about spying and state surveillance revealed intelligence services using technology companies to gather user data without knowledge or consent.

Personal data continues to be compromised. TalkTalk suffered a cyber attack which affected over 150,000 customers as personal details were leaked online. The company lost about a third of its value and spent approximately £30m dealing with the fallout. The Ashley Madison adultery website hacking left over 30m accounts dumped onto the dark web. According to press reports some of those having extra-marital affairs became blackmail targets and two people committed suicide.

The public is also concerned about how personal data is stored and used. As more people move “online”: whether it’s for work, shopping, socialising or dating, the privacy, protection and commoditisation of personal data has become a mainstream concern.
When RadioShack declared bankruptcy it tried to sell 67 million customer emails and addresses to the highest bidder to ward off creditors.

Social media platforms are regularly in the press for selling customer data and web browsing habits. Apps may be free to download but often require users to give up some form of personal data, whether it’s access to personal information such as contacts lists, or “full network access”.

Concerns over trust have already pushed customers towards alternatives. Duckduckgo, a web browser launched 4 years ago exclaiming, “Google tracks you. We don’t!” Today it carries out over 10 million searches a day. There is no sign that the need for trustworthy institutions is abating or that FinTech is the solution.

Rebuilding trust
Technology has disrupted business models including the traditional model between client and service provider. Customers now realise that once they have registered their details online, they have ceased to be the client and have become the product. Customers are unwilling to accept this inversion.

Traditional banks can win this battle against FinTech firms. There are three ways in which financial institutions can differentiate themselves from FinTech firms and rebuild their relationship with customers.

Conduct risk
The banking sector is moving away from thinking of the customer as a commodity; regulatory pressures will simply not tolerate this. Conduct risk helps build an organizational culture that places the customer at the heart of the firm’s business. The authors of a recent report, “Ethical Banking”, published by Cambridge Judge Business School, discussing product design and ethics, stated:

“Being ethical is not about doing charity on the side, but in the first place about selling products that make sense and actually benefit customers and society.”

The report cites the example of a bank’s decision to end credit card teaser rate deals and offer a single interest rate to all consumers. The single interest rate proved to be simpler and more transparent and helped earn customer trust.

Use technology positively
Banks should be clear and transparent with customers about what use is (and is not) made of data and personal information. Banks should always act with the customers clear and informed consent and demonstrate the value to customers of collecting information and data. For example, telematics requires the collection of driving data but can lead to a reduction in insurance premiums and promote safer driving. As firms improve their IT systems and harness big data they will be able to provide bespoke offerings for their customers. Cambridge Judge Business School Professor Jaideep Prabhu notes the:

“Capacity for more innovative data collection, analysis and application also gives banks the capacity to identify and meet individual customers’ needs.”

Go public
Trust is a live issue and banks should take the lead. They should be open about what they will and will not do with client information and be unashamed about stating they want to re-earn the public’s trust. Apple’s CEO, Tim Cook, has been tackling the issue of trust and privacy. Apple has issued a privacy statement: “At Apple, your trust means everything to us.” He has publicly opposed FBI requests that Apple produce a backdoor to the iPhone.

The fight has just started but banks have an advantage - they were once trusted advisors and occupied the moral high ground. They might have lost some territory, but now is the time to regain their position by reconnecting with their customers, using technology positively and reverting to a banking culture which puts the customer back at the heart of business.
Memories of the light-touch regulatory regime enjoyed by the banking sector before the 2008 financial crisis have faded. Today’s C-Suite is focussed upon responding to regulatory demands for financial institutions to hold more capital, improve solvency, reduce systemic risk and improve customer service. These regulatory pressures have reduced the profitability of the traditional banking model, whilst regulators have also reduced regulatory arbitrage opportunities and closed loopholes. The cost of regulatory compliance has been enormous as firms have invested heavily to up-skill and recruit new risk and compliance teams. In a 2014 letter to shareholders, JPMorgan Chase said that it added 13,000 employees from 2012-14 to support regulatory, compliance and control efforts, at a cost of $2 billion. Not a compliance team, but an army.

Increasing compliance costs have been accompanied by increased regulatory supervision. Yet whilst traditional financial institutions have been fulfilling regulatory obligations, new and innovative FinTech entrants have taken advantage of their less onerous regulatory requirements to sweep into an uneven regulatory playing field and take market share and customers.

Technology: The problem and solution

Traditional financial institutions have found themselves on the back foot from technology enabled financial innovation. However, Regulatory Technology, or RegTech, the technological solution to issues which are within the regulatory sphere, looks set to help financial institutions make up some of the ground lost to FinTech by providing firms with innovative technologies to facilitate the delivery of regulatory requirements. In many ways, RegTech is the logical step; it melds innovative technology companies and financial institutions to ease regulatory burdens.

RegTech frequently utilises the Cloud to provide a cheaper technological solution to specific regulatory requirements. It aims to help make meeting compliance obligations and regulatory requirements, cheaper, more efficient and swifter. It can also automate some of the more tedious aspects of compliance.

Financial services firms are collecting greater amounts of information and data points for a variety of regulatory and compliance reasons. Regulatory supervisors want to see metrics as evidence of the firm’s controls in relation to its key risks; Customer information and sales data might increase in importance if there is a subsequent question about how a product was sold and to whom; the C-Suite and INEDs are frequently presented with increasingly detailed and complex management information to help inform their decision making. Firms are generating vast amounts of structured and unstructured data, from different IT systems, for different purposes, which must be managed and maintained ever more effectively.

Automation of compliance

In some instances, RegTech firms can provide a relatively low cost and co-ordinated solution to basic compliance requirements. KYC may seem an unglamorous part of compliance but given the role it plays in money laundering, identifying PEPs and preventing sanctions violations, its importance cannot be underestimated. In recent years, regulators in the UK, US and Switzerland have levied million dollar fines against financial institutions in connection with AML failings. KYC Exchange, a RegTech start-up based in Switzerland, has created a secure communication platform for KYC and customer due diligence purposes to facilite the delivery of regulatory requirements. In many ways, RegTech is the logical step; it melds innovative technology companies and financial institutions to ease regulatory burdens.
Bitcoin, the crypto-currency which has facilitated anonymous, untraceable, irreversible financial transfers, has been the subject of criticism for facilitating money laundering and terrorist financing. Tradle, a RegTech firm, is now seeking to use blockchain, the underlying distributed ledger for Bitcoin, to store and facilitate KYC requirements by creating a unified system which shares KYC information across an organisation and reduces costs. The company proposes to extend this to include AML rules.

RegTech firms are not just limited to KYC compliance processes. They can also offer existing financial services players the data-handling capabilities they might otherwise lack, due to cumbersome legacy systems. Whereas traditionally compliance data has been in a paper form, stored within bulky lever arch files subject to periodic file reviews, RegTech firms can help financial institutions extract clean, precise, safe and organised data which can be dissected and analysed without the need to update legacy systems. Tableau, for example, is a data visualisation tool that allows the user to look at data in new ways to help identify trends from a regulatory perspective.

Other RegTech firms are offering technical solutions to specific regulatory requirements. Silverfinch helps insurers and asset managers comply with Solvency II. Pursuant to the directive, insurers must request their asset manager partners to provide look-through on their fund and fund-of-fund investments. Asset managers must respond to the look through requests and provide relevant information. Silverfinch creates connectivity between asset managers and insurers through a fund data utility in a secure and controlled environment. Its data model meets all the data requirements of Solvency II.

RegTech is also facilitating the management of risk. AlgoDynamix is a risk analytics company that detects disruptive events in global financial markets and anticipates price movements hours or days in advance of the event. Its software monitors data flows from the world’s major financial exchanges. Sophisticated deep data algorithms analyse the information and identify anomalies. An early warning system notifies the user of a disruptive event enabling asset managers to better manage portfolios, volatility and returns.

Regulators are not immune to the allure of RegTech. Vizor provides software to support the full supervisory lifecycle. It claims to be “trusted by Central Banks and Financial Regulators from around to globe for the collection and validation of highly complex data from financial institutions”. It lists as clients the Bank of England, Prudential Regulatory Authority, Central Bank of Ireland and Bank of Canada.
Judgement led regulation

As RegTech develops we can expect to see more firms offering embedded compliance and risk evaluation tools. These have the potential to reduce costs, increase efficiency and improve a firm’s operational effectiveness. It’s likely the development of RegTech will also create better outcomes for consumers, whether in the form of faster processing, better assessment of customer risks or improved product design and development. There will likely be some bumps in the road. According to press reports, a series of managers working within a large investment bank resigned last year in protest at automated AML programs. The managers were concerned the firm was sacrificing quality for quantity in an attempt to reduce compliance costs. One manager resigned and sent his resignation letter, which set out his concerns, to his (former) firm’s regulator.

It remains to be seen whether the move from compliance professionals to RegTech solutions will achieve the desired outcome. The automation of compliance and risk seems to lose the critical component of assessment and judgment traditionally made by compliance officers. Similar concerns have been raised in the robo-advising wealth management space.

RegTech institutionalised

The UK government acknowledged the need to embrace RegTech in the 2015 Budget when it stated that the FCA and PRA would work together to “identify ways to support the adoption of new technologies to facilitate the delivery of regulatory requirements.” As part of its work the FCA launched Project Innovate, which seeks to foster competition and growth in financial services by supporting innovative businesses. Following this, the FCA issued a “Call for Input: Supporting the development and adoption of RegTech” paper, whilst announcing its Regulatory Sandbox; a safe space in which businesses can test innovative products and services without immediately facing regulatory consequences.

The acceptance of RegTech by established regulators marks the start of its institutionalisation; from a disruptive outsider to an establishment figure. Rob Gruppetta, Head of the Financial Crime Department at the FCA, recently speculated on the future capabilities of RegTech:

Could the wealth of information on social media, or the use of biometrics, transform how customer due diligence is done, or how anti-fraud measures work, or how banks filter the wheat from the chaff when deciding whether to make a suspicious activity report... Regulators are not always clever enough to imagine this future. But technologists in financial firms and elsewhere will be brimming with ideas.

Regulators will always stress the importance of meeting regulatory obligations but they also recognise the enormous potential and disruptive force of technology. They acknowledge that the key to adapting to this change lies within, rather than outside of, this technological disruption; and this may well create new ways of complying with the rulebook.
Section three

Changes in investment and capital sources and returns

Business Operating Model pressures

Remember when everything was simpler and cost a little less? The world’s leading financial providers do. These two megatrends highlight how much the world has changed since the 2008 crisis, and how financial providers are adapting to a slew of new hidden dangers and risks.
The first megatrend in this chapter examines changes in investment and capital sources and returns. Retail and investment banks, along with a raft of other financial providers, notably insurers, thanks to the Solvency II Directive, have been forced in recent years to stock up on capital. As lenders retrenched, divesting risky assets, nimbler non-bank financial institutions stepped into the fray.

The C-suite perceives the big threat here to be macroeconomic factors. No other single threat scores higher in the entire Willis Towers Watson Financial Institutions Risk Index, in terms of the severity of risk it poses to business. It scores 6.75 out of 10, with the Europe, Middle East and Africa (EMEA) region giving it an outsized tally of 7.1. When combined with the ease of risk management score of 6.21, we arrive at 12.96, the highest composite number in the index. On the Financial Institutions Risk Index chart, this risk factor is a clear outlier.

Global vision

Yet this shouldn’t be a surprise. Economies are now integrated. “In the past we have been very cautious, but globalisation of the capital markets is a fact, so we have to see this issue in a global vision,” says Gerardo Hernandez Correa, head of the Financial Supervisor of Colombia and a member of the board of directors of the Association of Supervisors of Banks of the Americas. Flagging growth and endless rounds of quantitative easing, which have reduced the yield paid out to investors, have also left financial providers trawling the world for better returns. No wonder so many C-suite leaders fear the prospect of financial providers again pushing into riskier products promising higher returns.

Another point to note is the gap between the significance of this megatrend on the financial services sector and how easy or hard it was for corporate leaders to manage in their business.

The former scored 6.4 overall and as high as 6.9 in the EMEA region, while the latter scored 5.8, marking the biggest gap between these two comparable metrics in the index. This paradox is also visible in the global talent and skills megatrend, where corporate leaders consistently worry about the impact of an overall trend, yet believe in the long term they can successfully manage any risk associated with its impact.

Changes in investment and capital sources and returns is a megatrend that is likely to become increasingly relevant and important to the life of financial providers. The hunt for yield and higher returns on capital has in recent years become almost Sisyphean. “Colombia, Peru, Mexico and Chile have been working on the idea of creating an extended capital market system that takes investments from all the eastern Latin American states and pools them into a single capital market,” says Mr Hernandez Correa. “We are really trying to have only one financial market for the different countries.”

As the eurozone returns to growth, financial players from retail and investment banks to insurers and asset managers appear set to undergo yet more wrenching internal and external reform as they seek their ideal shape and form. This forecast is borne out in the index results, where C-suite respondents were asked to consider the impact of this megatrend on the financial sector as a whole. Respondents from Europe gave a score of 6.9, which is in stark contrast to the corresponding score of 5.8 from the Americas.

Risk analysis by region: Changes in investment and capital sources and returns

*composite risk score reflects the addition of severity of risk and ease of risk management
Business Operating Model pressures

The second megatrend, business operating model pressures, identifies pressures weighing on business operating models, such as disintermediation and segmentation. Traditional financial providers, caught between more demanding consumers, regulatory pressures and the rise of specialised lenders, are being squeezed. The dream of a universal banking model is fading as banks shrink, focusing on traditional lending channels. At the edges, lithe young start-ups corral technology to offer crowdfunding, peer-to-peer lending and mobile banking services.

Of all the megatrends in the index, this is probably the most unthreatening. C-suite executives place it joint last alongside demographic and behavioural changes in terms of its significance of impact, scoring it 5.8 out of 10 in terms of its impact on the financial sector as a whole. Concerning the ability of businesses to manage this megatrend, corporate leaders give it a score of 5.4 out of 10, while this falls to 5 in the Americas, rising to 5.9 in the Asia-Pacific region, where the higher number denotes an extremely hard-to-manage risk.

That’s not to say this megatrend is entirely devoid of hazard. Threats lurk in the minds of leading C-suite executives. Two perceived dangers are a potential loss of clients and markets as businesses focus efforts on restructuring rather than clients, and the emergence of new intermediaries creating risks in the value chain.

These two risks garner composite scores of 11.8 and 11.9 respectively, with greater significance attributed to the risks in EMEA than the Americas. David Paige, non-executive director of Yorkshire Building Society, recognises the pressures, but believes banks will change. “Though disintermediation seems to be a growing trend, I’m sure the banks do have a role – just not the one we currently see,” he says.

Summary

- Burdensome new regulations and the need to hoard cash continue to crimp returns on capital at traditional financial providers.
- Financial institutions fret about pushing into riskier products or markets in their desperate hunt for higher returns.
- The state of the global economy is the biggest single risk factor facing C-suite executives.
- Pressures weighing on business operating models present relatively less risk, but threats lurk in the potential loss of clients as financial firms restructure, and in the emergence of new intermediaries.

“...In the past we have been very cautious, but globalisation of the capital markets is a fact, so we have to see this issue in a global vision”.

Gerardo Hernandez Correa
Head of the Financial Supervisor of Colombia
Risk analysis by sector: Changes in investment and capital Sources and returns

**Average composite risk score**

- Sector with the lowest risk
- Sector with the highest risk

**Risk analysis by sector: Business Operating Model pressures**

**Average composite risk score**

- Sector with the lowest risk
- Sector with the highest risk

**Ranking**

1. Macroeconomic factors: QE and inflation/deflation
2. Drag on returns caused by regulatory capital requirements
3. Search for yield encouraging riskier products or behaviours
4. Lower returns on capital versus new entrants with lighter regulatory burdens

**Composite risk score**

9. Investment/wholesale banks
   - Asset manager/alternative investment companies
   - Insurance/reinsurance companies

14. Financial technology companies

**Ranking**

1. New intermediaries creating risks
2. Focus shift causing loss of clients and potential markets
3. Loss of intermediaries
4. Technological advances prompting new challengers
5. The rise of specialist competitors
6. Profitability pressure under traditional business model

**Average composite risk score**

- Sector with the lowest risk
- Sector with the highest risk
InsurTech: The uberisation of insurance
Technology has impacted many traditional industries to create an “uber moment”; a paradigm shift prompted by technology. Are we now witnessing the uberisation of insurance?

Whilst the “uberisation” of finance has introduced new ways of banking, lending and investing for customers, the insurance industry has proved more resistant to change. Increasingly stringent regulation and capital adequacy requirements have formed significant barriers to new InsurTech players entering the market. However, with $2.65 billion of VC money invested in InsurTech in 2015, peer-to-peer insurance, microinsurance, blockchain and big data innovators are disrupting the traditional insurance market.

**Peer-to-peer insurance**

Peer-to-peer (P2P) insurance is gaining traction. Companies such as UK motor insurance start-up Guevara allow drivers to enter groups in which their premiums are pooled. Any remaining cash at the end of the year goes towards lowering renewals for pool members. The safer the group drives, the lower the claims, the more money left in the pool to reduce renewals the following year. Drivers can even select or create their own groups, containing friends and family. Guevara expects this to change policyholder behaviour when it comes to making fraudulent or exaggerated claims, as each individual will feel responsible for others in their group.

The biggest name in P2P insurance is Lemonade, which plans to offer online property and casualty insurance when it launches this year. As with Guevara, premiums will be pooled and members reimbursed from the pool at the year’s end. However unlike Guevara, Lemonade has been working with New York regulators to ensure it will be a fully-approved insurance carrier, rather than a broker. Lemonade is collaborating with global reinsurance firms such as Berkshire Hathaway, Munich Re and XL Catlin, which may mark the start of traditional insurance firms partnering with InsurTech innovators to offer new solutions.

**Microinsurance: A small step**

Demographic and behavioural changes are driving change and challenging traditional models throughout the financial sector. The sharing economy model which permits P2P based sharing, renting or borrowing of goods, assets and services, reflects the Millennial lack of enthusiasm for the possessions valued by their parents, such as holiday homes or motor vehicles. Technology is facilitating the sharing economy through sites such Peerby, AirBnB, and TaskRabbit. It is estimated that by 2025, the sharing economy will generate global revenue opportunity worth $335 billion. Yet this new model is causing problems for consumers and underwriters. For example, those who share rooms or properties through online platforms may not be covered if their property or room is damaged or vandalised. Traditional insurance must also respond to the news ways in which smaller assets are being shared. Historically insurance was bought to cover an asset owned by the policyholder, now consumers are demanding short term insurance for things that they are simply borrowing; calling into question the most basic notions of insurable interest.
One solution for sharers is microinsurance, which offers small, swiftly underwritten protection over a short period of time. Motor InsurTech start-up Cuvva has recognised the demand for such short term insurance, and allows customers to arrange comprehensive cover down to the hour in just a few clicks via a smartphone app. Car sharers can easily switch their insurance on or off as and when it is needed. If a car owner happens to exceed the alcohol limit on a Friday night, another (sober) member of their group can arrange instant protection in order to drive their drunken colleague home safely.

San Francisco based start-up Trōv currently allows users to store information on their possessions within a mobile app, and track their value over time. The company plans to roll out a microinsurance programme in the UK in the coming year, whereby users can purchase micro-duration insurance policies for valued belongings such as cameras or watches. Their “swipe to protect” function would allow cover to be activated with one simple finger movement, letting the user instigate insurance cover as and when it suits their lifestyle.

Whereas traditional insurance companies must maintain adequate reserves to cover long term liabilities, such as anticipated future claims, microinsurance exposures are short-term, therefore mitigating the need for more substantial reserves. Microinsurance looks likely to further disrupt the insurance industry by offering start-ups a way to enter the market rapidly whilst providing insurance and protection to a broader group of customers.

**Blockchain: Smartening claims**

According to the World Economic Forum, “the BlockChain protocol threatens to disintermediate almost every process in financial services.” The insurance industry is starting to realise the technology’s potential. Everledger is one start-up utilising the blockchain for insurance purposes. The company works as a global ledger that monitors and safeguards high value diamonds. Everledger calculates 40 data points relating to each stone and using this information it is able to track who owns which diamond at any one time, and where it is located. It can also follow diamonds as they pass through platforms such as eBay or Amazon therefore preventing fraud and theft.

“Microinsurance looks likely to further disrupt the insurance industry by offering start-ups a way to enter the market rapidly whilst providing insurance and protection to a broader group of customers.”
The ability to securely store information within the blockchain could have valuable uses across insurance. Work has already begun on “smart contracts” – contracts which are created and stored on the blockchain, which automatically execute provided certain pre-determined conditions are met. For example, insurance cover for flights would be connected to real time flight data.

A pre-determined delay time would trigger a compensation payment. The insured would not need to remember to make a claim. Similarly, a beneficiary to a life insurance policy could receive a payment without having to undergo the emotional pain of “proving” the death of a loved one. The life insurance contract would instead be linked to an online death register.

These proposals seek to reverse the traditional “claims” model – the insured would receive the benefit without needing to make a claim. The hope is that blockchain based smart contracts will reduce costs for insurers, create benefits for customers within an efficient system which reduces large claims processing and provides additional protection for personal data. This should also help reduce fraudulent claims.

Blockchain could also have significant implications for customer data. US start-up Genecoin allows individuals to turn their DNA into data which is then uploaded into the blockchain network to protect it for future genetic engineering. Whilst this may sound like the premise for a dystopian horror movie, the blockchain could allow health insurers to securely store medical records. As wearable technologies and telemedicine are adopted by insurers, there is certainly a space for blockchain in the protection of the ever-growing highly personal data pool.

Data pools, lakes and warehouses

A recent survey by KPMG found that 40% of companies currently operating within the insurance market see increased competition from known competitors as one of their organisation’s biggest challenges over the next two years. However, only 28% see competition from new entrants in the same light. Such sentiment may be misguided, as insurers face formidable competition from digital giants such as Google, Facebook and Amazon. Analysts have even suggested that Alphabet, Google’s parent company, should purchase AIG to expand into financial services. Although the probability of this occurring is very low, the comment symbolises a broader point that the traditional insurance sector is ripe for deep technological disruption and significant innovation.

The data giants’ unparalleled access to a wealth of personalised, individual data points means they are able to analyse customer needs in a way that insurers currently struggle to do. In contrast, less than 25% of current insurance market participants use big data and data analytics to drive their innovation. If the data giants decide to push their own insurance products, they would have access to a potentially large base: two thirds of insurance customers would consider purchasing insurance products from organisations other than insurers.

Future generations might not utilise traditional insurers and firms that form today’s insurance landscape, but from digital names that are held in high esteem. The insurance industry looks like it is ready to embrace technology and utilise data to achieve more consumer-centric products and services. If the insurance industry can realise the potential of InsurTech, be this through financial investment or partnerships with innovators, it can harness the very technology that threatens to cause disruptive waves within the sector and create significant opportunities for itself, its employees and, of course, its customers.
Alternative capital: Sovereign wealth funds

Since the onset of the global financial crisis in October 2008, sovereign wealth funds have nearly doubled in value and hold a significant share of world investment capital.

At the end of 2014, sovereign wealth funds (SWFs) were worth more than $7 trillion globally. Though small in comparison to the $30 trillion of investment capital managed by the insurance sector and the $30 trillion of pension fund assets in the largest 13 pension fund markets, the Sovereign Wealth Fund Institute’s figure is far from insignificant.

SWFs, combined with the $46 trillion held by high-net-worth individuals (HNWIs) – according to Capgemini’s 2013 World Wealth Report – and the vast state-owned entities (SOEs) of Asia, mean a new class of non-traditional investor is occupying a prominent position in the global economy. State capital actors, including SWFs and state-controlled corporations, are playing an increasingly important role in both capitalist and emerging economies.

These new, non-traditional players take on a greater role indirectly through investment in traditional financial services organisations, and directly through providing equity and debt to sovereigns and corporations. The position that the Qatar Investment Authority took in Deutsche Bank in May 2014 was just the latest addition to its European banking portfolio alongside shareholdings in Credit Suisse and Barclays.

New restrictions

These transactions are becoming more common as traditional financial services firms struggle with new regulatory requirements in the wake of the financial crisis, the need to shore up capital reserves and pass new capital adequacy tests. Even six years after the financial crisis, most Western banks still trade at levels well below their pre-financial crisis highs. The same can be said of the insurance sector. The banks need quick cash, and the most ready source is from cash-rich SWFs, SOEs and ultra-high-networth individuals (UHNWIs).

In some corners, the rise of proactive state-driven investment, whether through SOEs, SWFs or even government-linked UHNWIs, is seen as malign. State capitalism versus the traditional model of liberal capitalism is considered by some a crude tool that the sponsors of these investment vehicles use to extend political power.

Often these sponsors come from antidemocratic regimes and the origin of their capital is unclear. The traditional financial services sector is calling foul, claiming that state capital actors must negotiate fewer regulatory hurdles, creating an uneven playing field.

Nick Brainsby, of Pemberton Capital, a London-based boutique investment firm backed by a number of HNWIs, concedes that in some cases, such as the Chinese SOEs’ investments in Africa and Asia, state-capital operations are structured around guaranteeing the security of strategic raw minerals, as well as expanding the political and economic position of the Chinese state and Chinese industry.

However, the Chinese SOEs are following a historical tradition that dates from the days of the East India Company, a vehicle used to extend the influence of the British Empire between the 17th and 19th centuries.
Filling lending void

On the flip side, in the current climate, state-sponsored investors and HNWIs have filled a void as traditional banks have constrained lending, Brainsby says. In Pemberton's case, developing nations' HNWI capital is being recycled to support small, stressed UK businesses that have had credit lines from their traditional banks withdrawn.

"Without this capital injection, denied to them by the traditional banks, these British businesses would fail," says Brainsby. "There is some opacity in this sector, but this new type of investor gets deals done quickly, efficiently, and has a much higher appetite for risk and understanding of an entrepreneur’s challenges than traditional lenders."

It is unlikely these new players wish to supplant traditional lenders and there is evidence they are acting to support the sector. For instance, SOEs in China are helping the state diversify from manufacturing to develop a domestic financial services industry. The Gulf nations are also keen to build financial services sectors to attract investment expertise and credibility to the region.

The insurance sector is key to this development. As emerging economies take a significant place on a global stage, their economic growth requires products such as commercial property and casualty insurance to insure them from risks associated with the creation of new wealth. Reinsurance can help insurers manage the new risks they absorb.

“There is some opacity in this sector, but this new type of investor gets deals done quickly, efficiently, and has a much higher appetite for risk and understanding of an entrepreneur’s challenges than traditional lenders.”

Nick Brainsby, Pemberton Capital
Section four

Digitalisation and technological advances

Not all progress is welcome. To old-fashioned main-street lenders, recent rapid advances in digitalisation and technology present as many risks as opportunities. Challenger firms and start-ups are disrupting traditional business models, in part by imposing transparency on a once-opaque system.

Younger customers bank on their smartphones, while fintech firms slash the cost of online trading.
The megatrend of digitalisation and technological advances pervades the thinking of any financial services firm, young or old, big or small, in myriad and often conflicting ways. Technology brings the customer closer, “changing how traditional financial institutions conduct their business,” said Ismail Dawood, whilst chief financial officer, investment services at US lender BNY Mellon. “This is a global phenomenon that is growing exponentially.”

Technological advances also offer hackers the chance to crack open once-impregnable systems, forcing up IT and infrastructure costs. “Cyber threat is currently a major concern,” notes David Yates, chief executive of payment systems firm VocaLink. “When Sony or even the US Government can suffer an attack, it makes people realise how sophisticated hackers have become.” Meanwhile, new payment services have emerged, from Google Wallet to Tencent’s Tenpay, while bitcoin and its peers offer a glimpse into an alternative future dominated by rival virtual currencies. Technology and its impact on the financial industry is also perhaps the most fascinating megatrend in the Willis Towers Watson Financial Institutions Risk Index.

C-suite executives place it second in importance behind the shifting demands of regulators, scoring 6.8 out of 10 in terms of its impact on the financial sector as a whole. When respondents were asked the same question in relation to their own business, a similarly high score of 6.75 was attributed. This score, combined with the 6.56 given to the ease with which this megatrend can be managed, creates a composite score of 13.31, which places it second only to the regulatory changes and complexity megatrend.

Emerging threats
To Mike McGavick, chief executive of XL Catlin, the dynamic complexity and quick-changing nature of technology goes hand in hand with the need to manage existing and emerging threats. “With the advancement of technology, risks can mutate rapidly,” he says. “Many modern risks are fundamentally different from the types of risks the industry has been used to dealing with in the past. The insurance industry has always been very good at pricing and insuring physical things. It is not quite as good yet at dealing with very technical risks or a number of interconnected risks.”

Look a little harder at the figures though and another picture emerges. Quizzed about the bearing of changing technology on their firm, and its importance as a megatrend compared with others, executives hand it a score of 3.7, where 1 denotes a decreasing impact over the next 12 months and 5 an increasing impact. Regulatory change garners a score of 4, highest in the class. But stretch that to a ten-year window and those numbers narrow, to 3.8 for the technology megatrend and 4 for the regulatory megatrend. Clearly, senior leaders within financial services firms of all sizes see these as twin challenges over the coming decade.

Another curious discrepancy emerges when the index drills down into specific threats. C-suite executives take the threat of cyber-attacks against their firms seriously, giving it a score of 6.1, where 1 denotes an insignificant risk, rising to 10 for very severe risks.

Risk analysis by region: Digitalisation and technological advances

*composite risk score reflects the addition of severity of risk and ease of risk management
The threat posed by rising IT costs, due to the need to update legacy systems, install security patches and weed out bugs, scores 6.3, higher than any other risk associated with this megatrend and second highest across all six megatrends.

The mean of all the composite scores of the perceived risks and threats associated with this megatrend comes in at 11.97 against 11.84 for the regulatory megatrend. This contrasts with the scores attributed to the megatrends prima facie, where the regulatory megatrend was given the composite score of 14.39 compared with 13.31 for the technology megatrend. This suggests that, while C-suite executives may well be haunted by the spectre of burdensome regulations, there is a tendency to underestimate the long-term implications of technological change. Roy Amara, a former president of the Institute for the Future, a Palo Alto, California-based think-tank set up to help corporates and organisations plan for the future, summed up this myopia when he noted that humans “tend to overestimate the effect of a technology in the short run and underestimate the effect in the long run”.

Unknown and unknowable

This is in large part because the rate of technological advancement means the future is both unknown and unknowable. No one predicted the emergence of M-Pesa, co-created by Vodafone and Kenya-based Safaricom, a service that has vastly increased intra-regional trade in sub-Saharan Africa. During interviews with C-suite executives across the Financial Institutions Risk Index, hyper-connectivity, aided by innovations such as smartphones and mobile banking, has emerged as a virtual megatrend in itself.

Wences Casares, founder and chief executive of bitcoin vault and wallet specialist Xapo, draws a comparison with the telecoms sector, which was transformed by high-speed internet. Financial services is, he adds, facing the same impending, wrenching revolution. Another unknown is the fate of cryptocurrencies. Some question whether bitcoin will come to be endemic to our financial systems or a where-are-they-now afterthought. Dawood believes it is “difficult to see cryptocurrencies gaining long-term traction”, while Xapo’s Casares hails the emergence of virtual currencies that “allow someone for the first time to perform financial transactions without involving a third party”. Yet for all the confusion surrounding bitcoin’s future, many believe that it is here to stay. On 7 May 2015, itBit Trust Company, a bitcoin exchange, was handed a licence to operate under New York State’s banking law; other regulators are expected to follow its lead.

Summary

- Financial services face wrenching change as technology alters the way firms do business, direct lending and interact with customers.
- C-suite executives say this megatrend presents a greater risk to operations over the long term.
- Among the greatest perceived threats are cyber-attacks, and the cost of continually weaving in new IT programmes and patches.

“Many modern risks are fundamentally different from the types of risks the industry has been used to dealing with in the past”.

Mike McGavick
Chief Executive of XL Catlin
“With the advancement of technology, risks can mutate rapidly. Many modern risks are fundamentally different from the types of risks the industry has been used to dealing with in the past.”

Mike McGavick,
Chief executive of XL Catlin
New relationships, new opportunities

Technology continues to challenge many traditional financial sectors. Yet this force of change might become opportunity for some traditional financial institutions to consolidate their position and maintain the status quo.

Traditional finance and banking has most strongly felt the impact of technology. Some might recall the rolling out of chip and pin cards in the UK in 2006. In little over a decade, the 4 digit pin has become an inconvenience. Today’s customers are increasingly making contactless payments; “tapping in” on payment points in shops and stores. According to the UK Card Association, a total of £929.8m was spent using contactless cards in October 2015.

But why reach into your pocket to remove your card from your wallet or purse, when you can pay with the smartphone you’re already holding? There has been a steady release of mobile phone payment providers. The most hyped has been Apple Pay and although awareness of Apple Pay is high, adoption rates are sitting at between 10%-20% of iPhone users. Despite the apparent ubiquity of Apple Pay points, a recent survey shows that the two primary reasons for not tapping with Apple Pay were either users forgot (30.1%) or did not know the store offered the service (30.1%). With new iPhones released every 6 months, Apple has little to worry about; adoption rates are likely to increase as smartphone payments become embedded into shopper behaviour.

Technology has also disrupted the English language. We all “like”, “friend” or “follow” people we’ve never met. Some will “swipe left” or “swipe right” depending on who they’re looking at. For decades, London Underground users have known to “mind the gap”. They now avoid “card clash” and remember to “touch in and out” as contactless payments, in the form of contactless cards or smartphones are used in over a quarter of journeys. Research from the Transport Network shows that 3.2m journeys since July 2015 were paid for using some form of mobile payment.

Uberisation

Travel has not proved immune to technology’s touch. The concept of technology enabled disruption has been encapsulated by “Uber”; the mobile phone based app service which connects passengers with cabs. The service has challenged traditional taxi cabs and pricing models across the globe, inciting significant protests from London to Sao Paulo. Yet Uber’s quick, convenient and cheap service continues to gain traction and market share in many cities. With a valuation of over $60 billion, the ride-sharing colossus is the world’s most valuable private technology company.

The “uberisation of “X” is now shorthand for the disruptive force and impact of technology enabled innovation on traditional services, sectors or institutions. The uberisation of financial services started some time ago and for some users of new fintech services, technology has moved beyond disruption to create sustainable pockets of innovative financial services. P2P lending and crowdfunding sites unite borrowers with new or alternative sources of capital. In the US, “Lending Club”, the peer to peer platform service, has grown in 7 years to a $1 billion IPO which valued the business at $8 billion. Lending Club describes itself as “the world’s largest online credit marketplace”, which operates “fully online with no branch infrastructure, and use technology to lower cost and deliver an amazing experience.” It has funded over $13bn in loans. For some borrowers, traditional banks are not a first option. Some start-ups have turned to crowdfunding websites, such as Seedrs, which has Andy Murray as an investor and strategic advisor.

New relationships, new opportunities
“Technology has also disrupted the English language. We all ‘like’, ‘friend’ or ‘follow’ people we’ve never met. Some will ‘swipe left’ or “swipe right’ depending on who they’re looking at.”
Artistic capital

The technological democratisation of capital is also re-shaping the creative arts. Musicians, writers and other artists now utilise Patreon, a crowdfunding site, to appeal directly to fans to support the creators they love. Patrons can donate money for a specific piece of art or donate on a monthly basis for content, enabling the artist to operate independently. Recently, Sir Clive Sinclair, the British inventor behind the ZX Sinclair Spectrum, announced he was releasing a retro version of the home computer through crowdfunding site IndieGoGo. He sought the relatively modest amount of £100,000 within 30 days; instead he raised nearly £150,000 in 48 hours, demonstrating the enormous interest in his venture. The re-released Sinclair Spectrum ZX Vega is now freely available on Amazon. Without IndieGoGo it is unlikely his product would have seen the light of day.

The digital corner

Traditional banks have seen challenger banks, such as VirginBank and Metro, establish themselves as viable alternatives. These challengers unburdened by legacy IT systems, use technology to provide a distinctive and innovative approach to customers. Although market share remains relatively small, challenger banks credit themselves with creating new relationships with customers whilst leading the charge against “hidden bank” charges for retail customers in general. Other challenger banks such as Aldermore, Shawbrook, and OakNorth Bank adopt a different approach by focussing on underserved sectors, such as the “buy-to-let” market or SMEs.

We will soon see the emergence of internet based challengers, such as Mondo, Atom and Starling. These banks aim to appeal to disenfranchised, disillusioned and neglected customers by offering sophisticated digital platforms and apps to provide a 24 hour service, promoting ease of use, transparency and clarity. The appeal of such a service is obvious but it remains to be seen if, once these firms obtain their banking licence, they will attract customers in sufficient numbers to pose a real alternative.

Building blocks

Traditional finance has always adapted. Some firms are embracing the opportunities bought forth by technology. R3, a consortium of over 40 banks, has joined to develop and use blockchain, the underlying digital ledger for Bitcoin and considered the real technological innovation. Blockchain functions as a completely transparent, shared public ledger for Bitcoin. It avoids the need for third party intermediaries, reduces costs and increases transparency because transactions are verified by users on a peer to peer network. R3 has already announced that 11 of the banks have successfully used blockchain to conduct mock trades with each other using a private peer to peer network.

It is somewhat ironic that the technology underlying bitcoin, which was originally designed to allow online payments “to be sent directly from one party to another without going through a financial institution”, looks likely to protect traditional financial institutions. The disruptive force of technology looks set to create opportunities for everyone – traditional incumbent and new innovator alike.
Cyber defences: An invisible wall against an unknowable threat

The greatest challenge for firms seeking to defend themselves against cyber-attack is that the immediacy of the existing risk and cost is not readily perceived – and therefore the required defences are not budgeted for.

“Intellectually people can acknowledge that cyber is a problem,” says Peter Armstrong, executive director, Cyber, Willis Towers Watson, “but viscerally, deep down, they think it is somebody else’s problem.”

In a June 2014 report, entitled Net Losses: Estimating the Global Cost of Cybercrime, the Center for Strategic and International Studies (CSIS) and McAfee, the online security firm, said that the internet economy “annually generates between $2 trillion and $3 trillion... [while the cost of] cyber crime is equal to between 15 and 20 per cent of the value created by the internet”. It estimated annual global cash losses to sit between $375 billion and $575 billion.

Armstrong believes that attributing these costs within organisations as increases in total risk exposure will be the most important change to occur over the next five years. Cyber vulnerabilities should be viewed as enablers, amplifiers and accelerators of the exposures that are already established in an organisation’s portfolio of risks.

“Firms must understand their cyber vulnerabilities and how they impact the overall level of risk. That will allow resources to be attributed to the risk solution appropriately.”

Armstrong argues that the biggest single development that could occur would be to recognise that the losses outlined in the CSIS report are not sustainable. The result would be segmented pricing of capital based upon the effectiveness of cyber defence in an organisation.

“After all a construction company with a lousy health and safety record pays more for insurance and investment capital. It’s time the same motivator applied to cyber defence and risk management.”
Risk culture starts to come of age
While references to the concept of risk culture are relatively new, shortcomings in risk awareness and management have become identified with the global economic crisis and major industrial accidents.

**Organisational culture**

Risk Culture is an aspect of organisational culture as a whole. There are several key insights that our understanding of organisational culture can contribute:

- **Culture matters**: Organisational culture really does make a difference. Although culture is sometimes regarded as ‘soft’, it plays a powerful role in determining behaviour and organisational effectiveness.

- **Much of culture lies beneath the surface**: Some aspects of culture, such as the management reporting line, are quite visible and readily apparent. Other psychological and social aspects, such as the unwritten lore, informal relationships and people's personal attitudes are more hidden beneath the surface.

- **There is no ‘best’ culture**: Cultures vary between (and within) organisations - and they should. A company competing on the basis of its creativity will need a different culture to succeed than another competing on the basis of operational efficiency.

- **Culture can be articulated, measured and managed**: To some, the very notion of organisational culture seems ethereal and difficult to describe, let alone quantify or manage. However, there are well developed approaches that provide effective ways to do just this

**Financial services context**

The financial services industry is perhaps the sector where risk culture has come under the closest scrutiny in recent times.

There is little doubt that an important contributor to the financial crisis of 2008 was the prevalence of a culture that promoted the pursuit of short-term profits at the expense of long-term value generation, which was exacerbated by being entrenched into individuals’ rewards.

In recent years, firms have launched reviews of their operational and governance models to address weaknesses that were considered to have contributed to the increased and often unrecognised risks. These reviews have addressed a wide range of areas, including product complexity, incentive schemes and oversight. More, however, remains to be done.

For example, the conclusion of a review of one financial services company’s governance procedures that Willis Towers Watson was asked to carry out could be applied to many incidents in the sector over the last few years: “There was nothing wrong with their governance procedures – apart from the fact that they didn’t use them.”

Although progress has generally been made in setting out the case for improvements in risk culture, many organisations are still struggling with the practical side of how to measure risk culture effectively and embed their desired culture across their business.
Safety culture

In other sectors such as energy, oil and gas, construction, transportation, mining and manufacturing, safety is frequently cited as the top business priority. Where safety incidents have occurred, large or small, investigations have often identified organisational culture as an underlying cause. But what aspects of culture are most important in developing a strong safety culture?

In research conducted by Willis Towers Watson, employees of businesses recognised for their safety records reported positive, open relationships with their line managers, who were seen as technically knowledgeable, responsive to input and were forthcoming with recognition for good work. Good line management was found to create a sense of empowerment. Individual employees were able to take responsibility through delegated authority and access to relevant information. They were encouraged to develop innovative solutions to problems. Positive safety environments were also found to have a stronger emphasis on collaboration and teamwork - which were found to be especially important in exceptionally busy environments.

Measuring risk culture

For all the mounting evidence of the value of culture in how organisations behave, some managers, and some risk managers in particular, have shied away from the concept of risk culture, not knowing quite how to approach it. But, in keeping with the mantra that “what gets measured gets managed”, if risk culture is to be effectively managed, it surely needs to be measured. Fortunately, there are well developed approaches that can do just this. In Willis Towers Watson, we have developed two complimentary approaches to risk culture assessment.

A high level Workshop approach focuses on the Processes that shape the underlying risk culture of an organisation, examining these in terms of their impact on the culture of the business. This expert-led approach gives a quick, accessible health-check of the key People Processes and Risk Processes, and highlights any areas for attention. (The kinds of People/Risk processes covered by the workshop are outlined diagrammatically in the section on Managing Risk Culture, below.)

But we also know that a more in depth approach is needed to peel back the layers and get to the real underlying risk culture of an organisation. Organisational surveys can be a great tool to access genuine feedback and insights from across a diverse organisation. However, although surveys can be quite easy to implement, it is worth noting that it is all too easy to implement survey poorly, in ways that provide little or misleading insight, and can even undermine a positive culture. Key things to ensure include:

Good questionnaire design
- Tailor designed questions – needs differ between businesses, so one size does not fit all
- Question crafting – the wording of questions is key, and needs expert input

Robust methodology
- Anonymity – people should feel able to respond candidly, so use a trusted third party
- Survey population – target the right population(s) and, if needed, use appropriate sampling

Analysis
- Benchmarking – external benchmarking is key to placing results in a meaningful context
- Combining data types – combining qualitative and quantitative data to create rich insights
- Action-oriented analysis – advanced statistical analysis can highlight the key drivers for culture improvement

Communication and reporting
- Closing the feedback loop – ensure findings are communicated back to the business
- Top level engagement – tap into external expertise to engage leadership around the findings
- Supporting local insight – engage the business by providing localised results to line managers for their own areas
- Action Planning – embed improvements through supported action planning and monitoring

As well as providing insights and embedding a positive risk culture directly, a systematic approach to measuring risk culture often also has several less direct but equally beneficial consequences. These can include:

- A high visibility approach demonstrates leadership attention, so helps set the Tone from the Top
- Managers developing a richer understanding and vocabulary around risk culture, enabling constructive internal dialogue
- The ability to evidence progress externally, e.g. to industry regulators and rating agencies
Managing risk culture

With the appropriate insights, support and resources it is possible to manage organisational culture - it just can’t be done overnight. A few key guiding principles include:

- There should be a clear and compelling vision and strategy that people can understand and buy into
- The desired culture should be articulated and modelled from the highest level in the organisation
- Companies should pay attention to the ‘hidden’ side of culture that lies beneath the surface, listen to people’s concerns, understand their personal interests and fears and respond to these. Some aspects of culture (such as systems, procedures and processes) offer managers the opportunity to address them directly, whereas others (such as people’s attitudes and beliefs) can only be impacted indirectly
- Existing systems, processes and policies tend to support the status quo, so these should be reviewed and modified to reflect required cultural changes, including approaches. Key People Processes and Risk Processes are explored in the Risk Culture Workshop are illustrated below:

Although experience shows that leaders and managers can remould the risk culture of an organisation, there are also limitations on what can be achieved, and it is also easy for some actions to bring about unintended consequences. Nowhere is this the case more than in the use of incentives and rewards to influence risk culture.

Rewards and performance management

There is no question that rewards – and variable incentive compensation in particular – can and do drive behaviour. In this way, rewards can be a powerful tool. The problem, however, is that rewards won’t necessarily always drive the desired behaviours or outcomes.

This has led many organisations to focus on the risks, or potential risks, created by rewards. Examples of such risks might include:

- A CEO or senior leadership team that takes actions to maximise the stock price in the short-term, thus risking long-term profitability and growth, because their rewards are linked to earnings per share
- A leadership team that makes overly generous assumptions in recognising revenue in order to produce better results that drive higher bonuses
- Call centre staff who are rewarded based on meeting objectives related to the average length of each call.

Importantly, the real risk of these situations is faced by the company, not the individuals taking these actions.

The current focus on incentives, we would argue, is both prudent but also dangerous. It is prudent because we know that poorly designed incentives can create bad outcomes. But it is also dangerous because it leads to a false notion that incentives can be used to ‘control’ risk and it places an unreasonable burden on incentives and rewards in general to serve as the primary tool to manage behaviour.
Incentives create rather than control risk

No incentive or reward programme design can be used to control risk. Rather, incentives create risk.

This is not to suggest, however, that firms should not worry about their reward design and just get on with things. Conducting a comprehensive risk assessment of incentive programmes, involving risk identification, analysis and prioritisation, is a process that companies will find beneficial.

Changing the design of the incentive plan is one potential course of action. For instance, a business may decide that using an uncapped incentive plan for certain jobs creates too great of a risk of windfalls that are not reflective of the effort required to drive the result. Two other important elements also come into play – incentive governance, and performance management.

Incentive governance refers to the oversight and control processes in place to monitor and manage the incentive plan – other words, all of the things that need to happen throughout the lifecycle of an incentive plan.

Performance management

There is a fundamental law of incentives that all too many organisations are quick to overlook – namely, you can’t pay for everything you need someone to do. Incentives can be a powerful motivator and driver of certain results and outcomes, but not all. Part of the way that incentive plan risk can and must be controlled is through the role that managers play – the types of goals and objectives they set, the way they provide feedback, and how they coach and direct the team’s performance (as well as when and how they provide recognition). Clear guidelines, criteria, and tools need to be developed to support managers in this regard.

Conclusions

Risk culture is fundamental to an organisation’s ability to manage its risks and so to achieve its strategic objectives. This is best demonstrated by briefly considering the contrary – there are simply too many cases of organisations (and their stakeholders) suffering from the consequences of a poor risk culture.

Just as no two organisations are exactly alike, there is no single ideal risk culture. Rather, each organisation should develop its own understanding of the risk culture that works best in its own circumstances.

Much of an organisation’s risk culture lies ‘beneath the surface’, so important cultural characteristics may not be immediately apparent, but they can be identified, measured and understood using a range of qualitative and quantitative approaches.

Once understood, risk culture can be shaped and managed, using a range of managerial levers. But managing culture is not easy and attempts to shape culture are prone to unintended consequences. In particular, attempts to use incentive / reward systems as a silver bullet to control risk culture are ill-founded. While financial reward can play an important role in shaping risk culture it is important to realise that a more holistic approach is needed to bring about a more robust and appropriate risk culture in most organisations.

This article is a revised summary of a chapter on risk culture by Ron Burke, Oliver Davidson, Patricia MacKenzie and Mike Wilkinson in the recently published book “Enterprise Risk Management: A common framework for the entire organization” published by Elsevier.

A complete version of the article is available at: https://www.willistowerswatson.com/en/insights/2016/02/Perspectives-Risk-culture-starts-to-come-of-age
“While financial reward can play an important role in shaping risk culture it is important to realise that a more holistic approach is needed to bring about a more robust and appropriate risk culture in most organisations.”
Section five

Global talent and skills race

Demographic and behavioural changes

The customer is always right... Harry Gordon Selfridge’s mantra is as popular and relevant as ever. Yet for the financial services sector, faced with mounting regulation and new competitors, it’s not always clear what the customer wants, let alone who they are or where they may be found.
These two megatrends cover subjects that financial providers often underestimate, sometimes to their peril. First up, global skills and talent. Not long ago, the best global white-collar talent would have beaten a path to the doors of leading lenders, hedge funds and insurers in search of steady employment and ready bonuses.

No longer. Financial firms have struggled post-crisis to find the right skills to complement a complex and challenging world. Experienced managers are leaving the industry behind or seeking employment at lightly regulated non-bank institutions. Graduates are eschewing financial behemoths, preferring the freedom offered by fast-growing startups.

This megatrend ranks third lowest, in terms of significance of impact at the financial sector level, in the Willis Towers Watson Financial Institutions Risk Index, with a score of 5.9. Its composite score – risk severity plus the effort involved in managing that risk – when evaluated by C-suite respondents in relation to their business, is 11.32.

C-suite executives rank the threat of losing hardened talent to peers or other industries as the second most severe challenge to their company’s wellbeing, handing it a weighting of 6.4 out of 10. Only the risk posed by renewed economic turmoil receives a higher mark.

Even executives in the less risk-sensitive Americas region, who play down risk when compared with their European and Asian peers throughout the survey, rate this as their second-highest point of corporate stress.

Its composite risk score of 12.32 is only beaten by two other risks – fears of economic turmoil and the cost of installing new IT infrastructure, placing it number three in the risk order of lists on page 7. It is also one of many examples in the index where financial leaders sense the severity of the threat to their firm’s long-term viability, but show greater confidence in the firm’s ability to mitigate the risk, as is shown by a score of 5.9 for the ease of risk management.

Making a mistake

This is a mistake. Gerardo Hernandez Correa, head of the Financial Supervisor of Colombia and a member of the board of directors of the Association of Supervisors of Banks of the Americas, notes that some older bankers developed their careers at a time when “most people used banks as a matter of course, so those bankers didn’t have to work that hard to find customers or to think about new customer products”.

Yet the world has changed. More than ever corporates need both young and veteran leaders who can identify, understand, and manage new and emerging risks. Dr John Lee, group chief risk officer at Malaysia’s largest lender, Maybank, warns that the risk management pool will continue to shrink as talent gravitates away from the financial sector. “People who are talented and experienced enough to lead and support the risk management programmes of leading banks are few and far between,” he says. Dr Lee believes the answer lies in organisations joining forces to enrich and deepen the talent pool. Tomorrow’s talent is likely to have better qualifications, skills and, says Hernandez Correa, “a greater sense of social responsibility”.

Risk analysis by region: Global talent and skills race

*composite risk score reflects the addition of severity of risk and ease of risk management
This thinking is echoed by Mike McGavick, chief executive of XL Catlin, who believes the social aspect of insurance makes it an increasingly attractive target for young and talented executives. “Younger generations realise our work connects very deeply to the difference they want to make in society, and they see the kind of innovation that is at hand in insurance is really key to bringing more and more solutions to society,” he says.

Despite the attractions of the insurance industry, insurance companies are still acutely aware of the risk, sitting above the sector-wide average for this megatrend. As McGavick adds: “Attracting and retaining top talent is a key piece of our strategy.”

Drilling down, Europe’s fear of missing out on new growth opportunities is revealed. Asian and Latin American financial firms are far more secure in their belief about their ability to cater to a new generation of more demanding customers, ranking that threat a 5.3, where 10 denotes a virtually unmanageable risk. Broadly speaking, business leaders view this megatrend as important, but not a game-changer like new technology or a shifting regulatory environment. They know the market is transforming around them, but largely feel comfortable in their ability to move and change with the times.

Demographic and behavioural changes

The second, interlinked megatrend covers demographic and behavioural changes, and is vital for firms the length and breadth of the financial spectrum. “Behavioural change among millennials is a big issue for the financial services,” says Ismail Dawood, chief financial officer, investment services at BNY Mellon. Even as the world ages, it is moving online. Young people avoid bank branches, opting for newer payment services ranging from PayPal to Skrill. Older customers demand higher returns and more transparency on investments.

Meanwhile, new customers are popping up all over the world, from ultra-high-net-worth families in the Gulf, to Asia’s growing mass middle market. Robert Pozen, senior fellow at the Brookings Institution in Washington, believes that demographic and behavioural changes among customers are affecting the way financial institutions operate. “In the West, where there’s an ageing population, there’s been a shift away from savings for retirement and now it’s about what I call the distribution phase,” he says.

Overall, this megatrend ranks second lowest across the index, scoring 5.79 out of 10 in its impact on the financial sector. When C-suite respondents were asked to evaluate the megatrend in relation to their own business, it earned a composite score of 11.26, slightly below average. Regional and industry scores vary, with Asian financial services firms judging this a far riskier megatrend than their peers in the Americas or Europe, the Middle East and Africa.
Although this megatrend scores in the low single digits across the board, there is a notable fear felt across the financial sector – powerful new customer bases developing in markets beyond the reach of traditional financial models. C-suite executives mark this threat at 61, where 10 denotes a very severe risk. Indeed, rapidly changing customer preferences in key growth markets is one of five key risk factors highlighted by Maybank’s Lee. Included on his list is the highly mobile nature of consumers, many of whom want to be able to do anything, anywhere, online. Even the great retailer Mr Selfridge might have struggled to provide the perfect modern package of online banking services.

Summary

- The need to retain skills is more relevant than ever, notably in areas such as risk management, yet financial firms fail to recognise its importance.
- Industry players should join forces to deepen the available talent pool.
- The threat of losing senior managers to lightly regulated peers is ranked as the third most pressing risk in the top 10 risk issues featured on page 7.
- Traditional financial services firms are scrambling to understand and locate new customers as they age and move online.
- European financial firms, however, retain a higher fear of missing out on new opportunities in fast-growing emerging markets.

Risk analysis by sector: Global talent and skills race

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<th>Average composite risk score</th>
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<td>◆ Sector with the lowest risk</td>
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Ranking

1. Regulatory pressure prompting people to leave or move to lightly regulated firms
2. Increasing complexity moving risk management to board level and C-suite
3. Need to develop and up-skill risk managers to deal with complexity and new risk issues
4. Recruiting and retaining staff against competing industries
5. Potential talent gap as skills needed to remain competitive change

Risk analysis by sector: Demographic and behavioural changes

<table>
<thead>
<tr>
<th>Average composite risk score</th>
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<tbody>
<tr>
<td>◆ Sector with the lowest risk</td>
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Ranking

1. New customer base in emerging markets not served by traditional models
2. Mature customers moving against intermediaries
3. New generation of customers requiring different service and transactions
4. Grey market becoming larger and more demanding of high-touch services
5. Rise of major LatAm and Asian “mass-affluent” consumers
There exists a monumental opportunity for financial institutions to work more closely with employers and their employees to help address their biggest respective risks – namely talent management and retirement planning. These two issues may seem poles apart but linking the two via an over-arching, visionary solution could reap unquestionable rewards for the bold and the brave.
Talent management and retirement planning

Talent management

Talent management is the current buzzword in all business circles. In fact, the threat of losing talent and skills to peers or other industries ranks second only to economic turmoil in terms of the most severe challenges to a company’s wellbeing. This finding is mirrored by an independent, global, annual survey of CEOs’ most pressing business challenges, which found that the attraction and retention of talent is the number-one challenge on the minds of CEOs across all sectors (10% higher than operational excellence).

So why is employee risk so conspicuously absent at strategic board level? The answer can generally be tracked back to the fact that no one area (human resources, risk, finance, operations) maintains a truly holistic view of employee issues or data. Add to that the fact that even a “simple” incident may involve human resources, claims, occupational health, insurers (employers liability, group income protection and private medical insurance) and it’s easy to see why there exists fractured and ineffective management and mitigation of employee risk.

This demands a totally new way of thinking across financial institutions, consultants and client companies – a joined-up approach to employee risk incorporating pensions (including financial education), healthcare, risk, employers’ liability and occupational health. In short, employee risk is without doubt a huge problem for business – both physically and financially. But it’s a problem that can be solved, and therein lies the first half opportunity for financial institutions.

Retirement planning

The second half, as mentioned above, requires a focus on the biggest risk in the eyes of employees: namely retirement planning. Here also employers have a key role to play, with some help and innovative thinking from financial institutions and consultants. According to Robert Merton, School of Management Distinguished Professor of Finance at MIT Sloan School of Management in the U.S., speaking at a recent event in London, focus group studies show that employees trust their employers when it comes to retirement planning – above banks, asset managers and insurance companies. “When employees have to make a decision on retirement planning they look at what the employer is recommending to those who haven’t signed up yet – the default.

So employers have a duty to get the default right. It’s good for customers and it’s good for business,” says Professor Merton. He adds: “Engagement is still a big issue. People simply don’t like doing personal finance. We need to start talking about income, risk, returns and volatility from a much earlier age to avoid the panic and freeze close to retirement.”

Employers have an opportunity to provide their employees with the resources they need, in the form of a comprehensive communication and education programme plus a competitive default option, to help them maximise their retirement savings plans. This kind of support can only lead to positive repercussions throughout the workforce and thereby also help improve talent management.

Loaves & fishes...

Thanks to our rapidly ageing society and diminishing working-age population, government and financial institutions face some serious challenges. Funds need to last longer, and there clearly isn’t an appetite by individuals to save more or take on more risk. So innovation around trying to get more from the assets we have is required. According to Professor Merton, a focus on income instead of ‘the pot’ during the accumulation stage is required. He says:

“We need to start asking people what a good retirement looks like to them. This is generally looked at in terms of retaining a certain standard of living and that, in turn, is defined as a stream of income. However, in the DC world the focus is all on the end pot.

There’s a big difference between wealth and permanent income. So the focus needs to move towards measuring volatility of income in retirement, not volatility of the pot. This would help aid individual understanding.”

Flexibility and customisation at the payout stage is key to helping individuals understand and engage with the process thereby ensuring better outcomes. It’s likely that equity release will become a major financial product in the next few years, allowing for more flexibility in financial planning.

Change is imminent. Joined-up thinking is in. Silos are out. Employers need innovative thinking to help achieve their talent management goals. Employees are unlikely to settle for less.
Rise of the middle class in Asia and Latin America

The global middle class is nearing one billion and with significant increases in Asia and Latin America, financial institutions would be wise to invest in these seemingly unstoppable markets.

Consumers in Asia and Latin America are at the forefront of both the swelling of the global middle classes and the growing pool of investable money. According to the Organisation for Economic Co-operation and Development, Asia-Pacific will represent 66 per cent of the global middle class population by 2030. The wealth of the mass affluent – those with $100,000 to $1 million of assets – in Asia-Pacific is expected to more than double from $20.5 trillion in 2012 to $43.4 trillion by 2025.

In Latin America the story is similar. The numbers making up Latin America’s middle classes have grown by half in the past decade – now standing at 30 per cent of the population, according to figures from the World Bank.

Mass-affluent wealth in Latin America is also expected to more than double over the next five years alone, mimicking Asia’s mass affluent wealth ascent. Some commentators suggest that wealth in the region is expected to increase from $2.1 trillion to $4.5 trillion between 2012 and 2025.

New opportunities

The wealth boost in these regions means financial institutions have a new client base to explore as a new generation demands financial products and looks for innovative ways to invest. Pensions and mutual funds are two areas that are of particular interest to consumers in Asia and Latin America. Thanks to the take-up of defined contribution pensions, global pension fund assets are expected to reach almost $60 trillion over the next five years, from around $36 trillion in 2015. In Asia and Latin America, pension fund assets are forecast to more than double between 2012 and 2025. Latin American pension assets are predicted to reach $5 trillion in 2025, up from $2.4 trillion, while Asian pension assets are set to grow to $6.5 trillion from $3.2 trillion over the same period.

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This rise in pension fund assets will fuel an increase in mutual fund growth. But it is not just pensions and investment funds that are undergoing change – insurance is too. Odd Haavik, chief executive, Asia & Europe at Global Wealth Solutions, which provides life insurance and other estate management services to high-net-worth individuals, families and businesses, says a generational shifting of wealth in Asia has created a driver for change in insurance. However, change is not just happening in the spread of wealth; attitudes to wealth are also shifting. Younger generations are more inclined than their parents to embrace and understand the value of wealth management, making them a key target demographic for new entrants in both Asia-Pacific and Latin America.

“The key driver to the growth of the use of insurance in Asia has been the generational asset transfer that has begun to take place,”

Haavik explains. “Asia has a lot of first generation wealth beginning to pass to the second generation and, as the second generation is often better educated and has a more international outlook, the traditional scepticism towards life insurance has reduced somewhat.”

A boost in the insurance market has been influenced by fluctuations in global stock markets in recent years, which have left some investors wary and looking for a way to escape the risks they perceive in investing.

“The volatility of the markets here has also played a part. A lot of clients appreciate the safety and stability of life insurance policies and that they have zero correlation to other investment options,” says Haavik.
Over the coming years, he predicts the shift towards individual risk management, from life insurance to personal assets, will be a big opportunity for financial institutions.

“My feeling is that personal risk management is a subject that will become increasingly important in the next few years and we are already seeing the beginning of this trend,” he says.

Risks remain
While financial institutions may be looking to Asia and Latin America, this shift is not without risk. A rise in investible assets does not necessarily correlate to a rise in margins. This is due to regulatory costs and commercial costs associated with increasing distribution networks and regularly updating technology.

Similarly, greater transparency will continue to come at a cost for asset managers and wealth management firms. Existing financial institutions also need to be aware not just of internal pressures, but forces exacted from outside, particularly the introduction of new players to the wealth management market. The threats could come from unlikely places as wealth managers find themselves competing not only with their peers, but with social media and technology companies for a slice of mass-affluent wealth.

With established, far-reaching distribution networks, social media companies would not have to take too many steps to provide financial services, particularly to second generation investors who are digital natives and are comfortable living their lives – and making financial transactions – online.

“My feeling is that personal risk management is a subject that will become increasingly important in the next few years and we are already seeing the beginning of this trend.”
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Threats and opportunities of demographic change

The landscape for recruitment is changing far more dramatically than many employers realise. Adapting to the new dynamics will be essential for financial groups seeking not only to hire the best, but also to grow sustainably into new regions of the world.

The race to recruit the finance world’s best individuals has become a war for talent, according to leading academics. Dramatic shifts in demographics mean countries such as the United States, Japan and much of Europe are keen to attract students of finance and economics to their universities and graduate schemes, and to retain the services of top talent. However, this dynamic is set to change. In a 2009 paper published in the Journal of International Management, Schon Beechler and Ian Woodward, affiliate professors at the INSEAD business school, argued that the “increasing mobility of people and organisations” makes the business environment in general “more demanding and complex”.

“Despite today’s global financial circumstances,” the pair wrote, “the capacity of organisations to attract, develop, motivate and retain talent will remain a critical strategic issue for the 21st century’s knowledge economies.”

Natalia Char, regional financial institutions industry leader for Latin America at Willis Towers Watson, says international companies that previously hired in emerging markets just for call centres and back-office facilities are now seeking distribution and product capabilities to expand into under-penetrated areas. So will emigrating talent begin to head back home?

Local expansion

With a population of 200 million people, growth in Brazil is easy to find in various forms, Char says, despite lacklustre economic expansion. She goes on to say that according to information from CEPAL (Economic Commission for Latin America and the Caribbean), in the last ten years, the finance industry has provided more “formal employment” than has mining and infrastructure, typically seen as Latin America’s key industries.

On the other side of the world, Asia presents a similarly enticing prospect for financial companies. An increasingly affluent middle class is driving demand for finance sectors, such as private banking, asset management, treasury and insurance services. In addition, an improving corporate governance and regulatory landscape is creating a need for more professionals with internal audit, tax and regulatory skills. An example of this can be found in Singapore, one of Asia’s main financial hubs.

The number of fund management groups based there grew substantially in 2014, according to Tony Mitchell, Asia Regional Leader at Willis Towers Watson. From 158 firms based on the island city at the end of 2013, within 12 months this had increased to 289, a rise of 83 per cent.
"The population in the financial services industry in Asia will definitely grow and seize a larger share of the workforce from some other industries," Mitchell predicts. He highlights Kuala Lumpur as an up-and-coming financial centre, helped by its history of commodities production and, more recently, its blossoming technology sector. Growth may be easy to see in Asia and Latin America, but it is not easy to access.

"Asia is a big continent of 3.5 billion people in 26 countries," Mitchell explains. "There are more than 150 languages with many unspoken rules about business, culture and trust. What can be done in one country may be totally impossible in another."

Char cites a similar problem with Brazil. "It is still so big that everybody wants to be there. But, it will be easier for foreign companies to choose a local partner or buy an existing company that will understand the environment and the local regulations," she says.

**Beyond 2025**

Despite a more affluent and educated workforce, some Asian economies will soon face a demographic challenge of their own. In China the one-child policy introduced in 1980 and the traditional preference for males has led to a generation of men with "little or no prospect of marrying", according to a June 2014 article published by Allianz. In 2025, China's population will still be growing, but an estimate from the United Nations predicts it will peak in 2035.

Back in Brazil, the country is attempting to tackle its demographic problem. The World Factbook, produced by the US Central Intelligence Agency, estimates that within ten years a currently "favourable age structure" will begin to shift. However, programmes aimed at supporting students wanting to study abroad are reportedly helping to encourage Brazilians to return to their home country to find full-time employment.

"To address the demographic shifts, businesses will need to continue with the drive to raise productivity through business restructuring, workforce retraining and talent retention."

Data from the United Nations shows a dramatic increase in the number of foreign workers in Asia's leading economies, with South Korea, Thailand, Singapore and Malaysia all seeing their nonnative populations rocket since 1990.

Presence in these growing economies is seen as vital by most financial groups with aspirations outside their home country’s borders. Competition for talent is getting fiercer than ever, however, as local companies grow and gifted individuals begin to see more opportunities to succeed in their chosen field far closer to home.

For companies to succeed in this changing environment, INSEAD's Beechler and Woodward call for "businesses, practitioners and academics to move away from the competitive, winner-loser mentality" behind the war for talent and the hunt for star employees. Instead they promote the concept of “talent solutions” – leaving behind a focus on individuals, and taking a broader approach to recruiting, training and retaining talent in the hope this will create a positive company culture.
Financial institutions risk index

Overall Impact Of Risk: The relative size of the bubbles is representative of the multiplication of the severity of risk score and ease of risk management score.
**Regulatory changes and complexity: 14.39**

1. Businesses exploiting light-touch regulatory regimes
2. Challenges of compliance with multiple regulators
3. Operating in regimes with strong regulation or high-risk customers
4. Rise of competitors exempt from strong regulation
5. Tension between customer trust of higher regulation and need for business flexibility
6. Increasing costs of regulatory compliance and political unpredictability

**Digitalisation and technological advances: 13.31**

7. New entrants and challengers using technology for service simplification
8. Technological advances changing interaction
9. Increased transparency putting pressure on traditional sources of revenue or cost
10. Technological ubiquity creating new risks (e.g. cyber-attacks)
11. Increasing costs associated with IT infrastructure investment

**Changes in investment, capital sources and returns: 11.88**

12. Drag on returns caused by regulatory capital requirements
13. Lower returns on capital versus new entrants with lighter regulatory burdens
14. Macroeconomic factors: QE impact and inflation/deflation
15. Search for yield encouraging riskier products or behaviours

**Global talent and skills race: 11.32**

16. Regulatory pressure prompting people to leave or move to lightly regulated firms
17. Potential talent gap as skills needed to remain competitive change
18. Recruiting and retaining staff against competing industries
19. Increasing complexity moving risk management to board level and C-suite
20. Need to develop and up-skill risk managers to deal with complexity and new risk issues

**Demographic and behavioural changes: 11.26**

21. New generation of customers requiring different service and transactions
22. Rise of major LatAm and Asian “mass-affluent” consumers
23. Grey market becoming larger and more demanding of high-touch services
24. New customer base in emerging markets not served by traditional models
25. Mature customers moving against intermediaries

**Business Operating Model pressures: 11.14**

26. Profitability pressure under traditional business model
27. Loss of intermediaries
28. The rise of specialist competitors
29. Focus shift causing loss of clients and potential markets
30. New intermediaries creating risks
31. Technological advances prompting new challengers
About Willis Towers Watson

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