

INTRODUCTION	1
THE ROAD WE ARE ON	2
BLIND SPOTS:	
ASKING TOO MUCH OF CENTRAL BANKERS	12
GETTING STRESS TESTING RIGHT	17
INTO THE DIGITAL UNKNOWN	20
THE TALENT CHALLENGE	23
RETURNING INSURANCE TO GROWTH	26
DERISKING PENSIONS	29

INTRODUCTION

In 2003, Oliver Wyman published *The Future of Financial Services*, examining the long-term trends in the industry. Then, there appeared to be a natural trajectory for national financial sectors. Globalization, demographic change, and deepening of financial product usage seemed to set a predictable path, and the financial sector largely built its growth and returns model around these drivers. There seemed to be little uncertainty. Subsequent events dispelled that notion.

The landscape has changed since then, characterized by greater regional divergence, stronger regulatory intervention, an end to the long cycle of falling interest rates, the uncertain effects of technology, and the hunt for unmet or poorly-served financial needs. While economic optimism is starting to return, much hard work remains in all of the industry's subsectors. But a return to sustainable earnings growth is possible for the firms that tackle the challenges we highlight.

In our *State of the Financial Services Industry* report this year, we briefly analyze the road the industry is on. In the first section, we survey the trends observable across the world's major economic regions: North America, Europe, Asia Pacific, and Latin America. There are, of course, significant variations within these regions; sometimes we identify them, but usually we take the liberty of glossing over them for the sake of the bigger picture.

We then focus most of our report on potential blind-spots. This is not a report about risks, and our blind-spots are not necessarily risk factors. They are the areas in our industry that we believe warrant greater attention from both industry practitioners and policymakers to ensure the road we are on is one leading to a healthy financial sector which supports the global economy.

Our short list of blind-spots is far from comprehensive; our selection reflects the points of view of the Oliver Wyman partners who have contributed to this year's report. We hope you will find the ideas thought-provoking, even if you disagree with them.

THE ROAD WE ARE ON

REGIONS, RETURNS AND THE COMPETITIVE LANDSCAPE

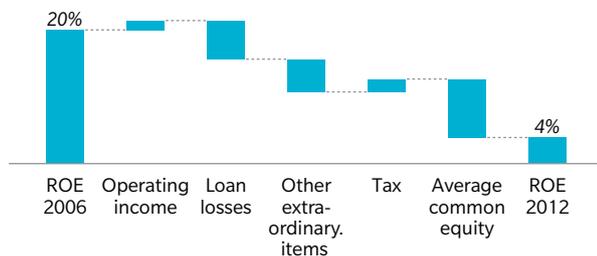
Though often described as global, the financial crisis really hit the US and Western Europe. Its effect on the financial firms in those regions was greater than elsewhere, those regions have recovered slowest from the global recession, and their regulatory response has been more dramatic too. As a result, several of the

most developed financial sectors now find themselves on a hard path – struggling to profit in the face of slow economic and credit growth, customer distrust, market saturation, and burdensome regulation.

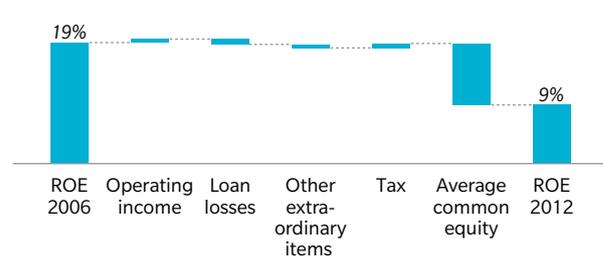
Some challenges are common across the world. New technologies threaten to disrupt retail financial services business models in developed and developing markets alike. In wholesale banking, the pressure of increased

EXHIBIT 1: DRIVERS OF CHANGES IN BANKING RETURNS 2006-12, FOR THE LARGEST BANKS IN EACH REGION

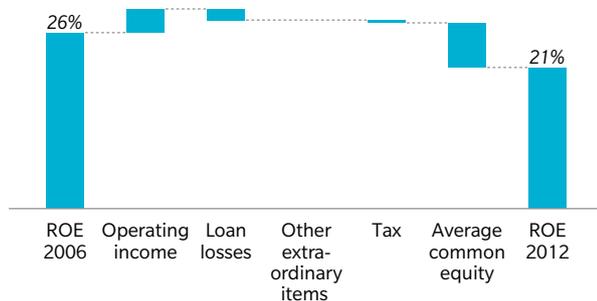
EUROPE



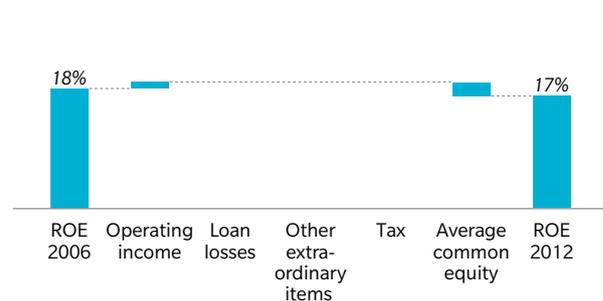
NORTH AMERICA



LATIN AMERICA



ASIA PACIFIC REGION



Note: Other extraordinary items include: profit/loss from discontinued operations, other non-operating income and expense, change in fair value of own debt, non-recurring expense, non-recurring income, equity accounted profit and loss (non operating), securities and other credit impairment charges, etc. Includes sample of 80 banks for Europe, top 20 banks for North and Latin America, top 3-5 banks by country for Asia Pacific (covering Australia, New Zealand, South Korea, India, Malaysia, Singapore, China and Japan).

Sources: Bankscope (published by Bureau van Dijk) and Oliver Wyman analysis. The analyses are only based on banks with full available data across the years.

operating and capital costs presage a shake-out of capacity which is already reducing market liquidity and, especially in Europe, restricting access to credit for non-rated companies. In insurance globally, the focus must be on finding sustainable profitability and growth, and on careful handling of both the unusual interest rate environment and capital markets volatility on the balance sheet.

Other challenges are more local. The performance of financial firms is always correlated to the performance of the real economies they serve – as some put it, financial services is a leveraged bet on the real economy. But national domicile is a more important factor in a financial institution's performance today than at any time during at least the last fifteen years. This is especially true of banks. Put simply, weak institutions in good economies can fare better today than well-run institutions in struggling economies. At a more macro level, financial firms in emerging markets are doing well while many of those in the most developed economies struggle to return the cost of their capital.¹

The changes in returns from pre-crisis days are striking. All geographies show robust revenue and operating income – in some cases surprisingly so. Even in Europe, banking revenues have grown since the crisis. But continued credit losses and restructuring costs in Europe, and regulatory fines and higher capital minima in both Europe and North America, are reducing returns in those regions. Latin America and most of Asia Pacific (outside Japan, Korea and Taiwan) remain high-return markets for the time being (although foreign firms can suffer in many markets), with some likely at unsustainable levels. Returns in insurance have also languished with property and casualty sector returns

still primarily driven by the underwriting cycle and life insurers' fortunes driven by credit, interest rate and equity markets. The sector has experienced little by way of premium or valuation growth over the last decade.

As a result, we see a financial services world that is particularly divergent:

- **North America** Generally well capitalized firms with low risk; regulatory demands continuing to be the most challenging issue, including both safety and soundness and micro-managing of business models; moderate economic recovery starting to generate modest demand for commercial and consumer credit; low loan-to-deposit ratios putting high pressure on margins; life insurers benefiting from the demographic tailwinds with the Federal Reserve tapering relieving the pressure on spreads
- **Europe** Firms standing on the threshold of once-in-a-generation restructuring; the challenges of decoupling from sovereign credit risk and the transition to European Banking Union still uncertain; and with an insurance industry potentially hampered in its global competitiveness by stringent regulation
- **Asia Pacific** Solid, if not spectacular, growth in most markets; some concerns about credit quality and the impact of regulation, in particular Basel III as a material concern to banking returns and economic activity; significantly higher tail risk as political tensions increase; but potential upside if the industry adjusts from the "old industrial" model (exported and short-term bank lending and financing of state-owned enterprises and multi-nationals) towards a new economic model focused on domestic consumption and innovation in the SME sector
- **Latin America** With per capita GDP at an inflection point for financial services demand, and many long-term investment needs requiring funding, an agenda much more focused on expanded access to financial products, and prudent expansion of credit growth

¹ Australia and Canada are notable exceptions.

Even given the meager returns available in the major regions, we might have expected the low regulatory burden on shadow banks and non-banks to have had a bigger effect on the competitive landscape. Crisis responses have reinforced entry barriers for traditional financial firms, as well as the attractiveness of industry participation for potential entrants in the regulated sector. But non-traditional competitors, small today, are beginning to build once more: for example, non-banks, retailers or manufacturers (re-)entering the consumer lending and mortgages businesses and new e-players in payments and direct lending. Most dramatically, significant value is being created at the periphery of the industry by non-banks delivering infrastructure and information-based services. While only gaining single digits of market share in core financial intermediation, it would be unwise to discount the threat.

The forecast of large-scale disintermediation of banks in credit markets, however, has been exaggerated. Insurers have been constrained by uncertainty, now largely resolved, over Solvency II and a general shortage of origination and underwriting capabilities. Outside of the US, credit markets would actually benefit from an increase in disintermediation and in greater investor involvement. In Europe, capital and liquidity constraints make it difficult for banks to lend more. And Asian and Latin American investor bases remain shallow.² Recent changes to insurance regulation will help, but the conundrum of how to match the world's long-term saving and long-term financing needs (explored in our 2012 State of the industry "The Real Financial Crisis: Why Financial Intermediation is Failing") remains unresolved.

² For a more expansive treatment, see Oliver Wyman's recent publication with the Fung Global Institute: *Asia Finance 2020: Framing a New Asian Financial Architecture* Christian Edelmann (Oliver Wyman), Andrew Sheng (Fung Global Institute) and Chow Soon Ng (Fung Global Institute).

REGULATION, FRAGMENTATION AND SOVEREIGN DEPENDENCY

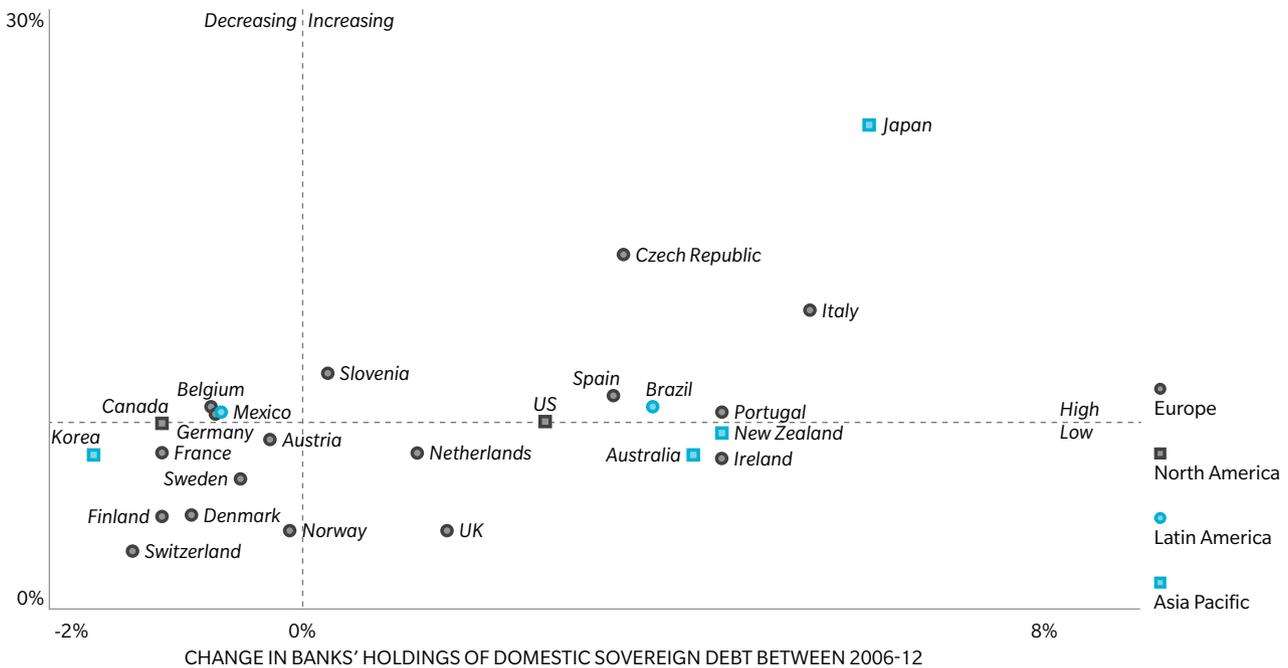
So far, as discussed, the crisis has strengthened the linking of national and financial services industry fortunes. Notwithstanding efforts to decouple, governments today remain guarantors of domestic banks' credit and banks must hold increasingly large quantities of their government's bonds to satisfy liquidity requirements. In effect, the financial services industry is aiding the central banks in underwriting government debt irrespective of the fiscal well-being of the sovereign – a great concern if developed economies do not successfully tackle their deficits. At the same time, increasing regulatory burdens – at the national, regional (EU), and international (BIS) level – continue to constrain credit expansion.

EXHIBIT 2: A BRIEF TAXONOMY OF REGULATION

REFORM AREA	EXAMPLES OF INITIATIVES
Attempts to eliminate the implicit and explicit guarantees	<ul style="list-style-type: none"> Alternative resolution regime to create non-bankruptcy non-bailout solutions for failing banks Expansion of scope of regulatory authority to govern non-banks Contingent capital solutions for systematically important institutions Creation of "living wills"
Increased safety and soundness	<ul style="list-style-type: none"> Migration of derivatives to exchanges Basel III capital and liquidity standards Introduction/expansion of maximum leverage ratios Compensation reform Restrictions on riskier activity (e.g. proprietary trading, private equity investing)
Consumer protection	<ul style="list-style-type: none"> Creation of consumer protection bodies Conduct regulation in Europe US CARD Act limitations on re-pricing for risk Limits on debit interchange fees Provision to impose a fiduciary duty on advisors to consumers/retail investors

EXHIBIT 3: BANKS' HOLDINGS OF DOMESTIC SOVEREIGN DEBT

% OF BANKING SECTOR ASSETS, Q1 2006-Q3 2012



Note: Greece not shown in the table given the high change between 2006 and 2012 (-8%) mostly due to the official debt restructuring. The value of government debt holdings of Greek banks fell from 12.4% in Q4 2011 to 8% in Q1 2012.

Sources: IMF, Oliver Wyman analysis, Central Banks.

Understandably, governments of the countries hardest hit by the crisis have responded with the strictest new regulations. In Europe and the US, banks are struggling to replace the returns lost to regulation aimed at protecting consumers and maintaining systemic stability. Not only do these rules push up the amount of capital and liquidity that banks must hold, but they are also limiting their sources of revenue.

Regulators are simultaneously making it harder for banks to operate internationally and, thus, to detach their fortunes from those of their domestic economies. This is partly because the fixed operational costs of

compliance with local regulation have become much higher, which disadvantages smaller operations within each market. Moreover, national regulators increasingly demand that international banks satisfy capital and liquidity requirements locally, thereby lessening the benefits of an international balance sheet. This balkanization of the balance sheet will bring banks closer to the environment that globally active insurers have been living under for decades; having to contend with myriad constraints that are imposed by national or, in the US, state-level regulation. Many US and European firms are winding up their subscale foreign operations to concentrate on their domestic markets.

Additionally, there has been a worrying breakdown in international coordination on regulation. US and European regulators sometimes pursue quite different paths from each other, for example, on stress testing or on remuneration. And other regulators have been much slower to implement solutions to what they often see as somebody else's crisis. Asia regulators in particular remain remarkably uncoordinated given the increasing amount of global regulation that is affecting them collectively (Basel III, Dodd Frank or FATCA are good examples).

HOW WILL EARNINGS GROW?

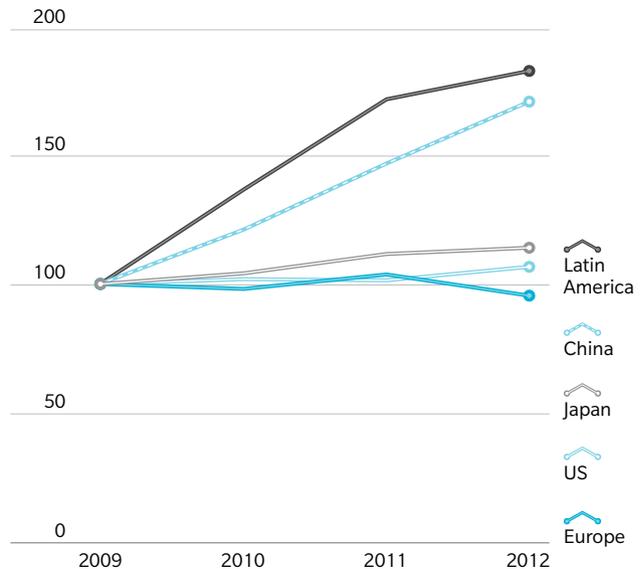
With the benefit of the rear view mirror, five themes drove the last period of growth in financial services (and the winners in the last cycle were often those firms that most adeptly exploited these trends): credit expansion (on balance sheet and in the capital markets) linked to the long period of economic growth, financial deepening, demographic shifts, globalization and technology.

As the industry hunts for sustainable growth, will the same drivers re-emerge? Will new growth drivers emerge from society's unmet needs? Or will a shortage of growth necessitate significant productivity gains across the industry?

Credit expansion: continuing but bounded by leverage limits and skewed across regions

Ultimately there is no doubt earnings growth in financial services will have to come from economic recovery and the return to a normalized interest rate environment. But just as credit expansion trends have diverged over the last five years, they will likely continue to do

EXHIBIT 4: DOMESTIC CREDIT TO PRIVATE SECTOR* INDEXED TO 100 IN 2009



* Financial resources provided to the private sector, such as through loans, purchases of nonequity securities, and trade credits and other accounts receivable, that establish a claim for repayment. For some countries these claims include credit to public enterprises.

Source: World Bank.

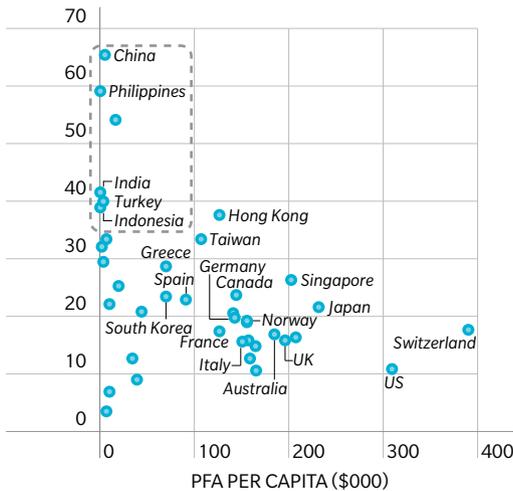
so, with European banks in particular finding credit expansion difficult. The clamp-down on leverage will constrain growth.

Liability-side revenues will also contribute as monetary policy normalizes. Ultra-low interest rates have eliminated the margin on deposits, and severely pressured the spreads on insurers' general accounts. With so much money chasing yield, risk premiums are low. However the rate cycle has turned. The effects, ranging from shorter-term yield curve rises to longer-term increased savings rates, will be positive for earnings.

EXHIBIT 5: GLOBAL FINANCIAL PRODUCT USAGE

SHARE OF PERSONAL FINANCIAL ASSETS, 2012
HELD IN CASH, DEPOSITS AND SAVINGS ACCOUNT
FOR EACH COUNTRY

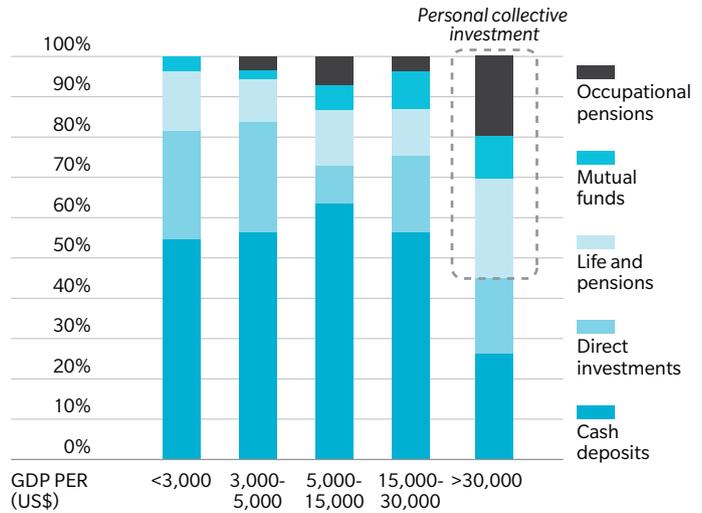
% CASH DEPOSIT SHARE OF PFA



* Excludes home equity.

Sources: IMF world economic outlook database, OECD, Oliver Wyman analysis.

FINANCIAL DEEPENING AT HOUSEHOLD LEVEL, 2012*



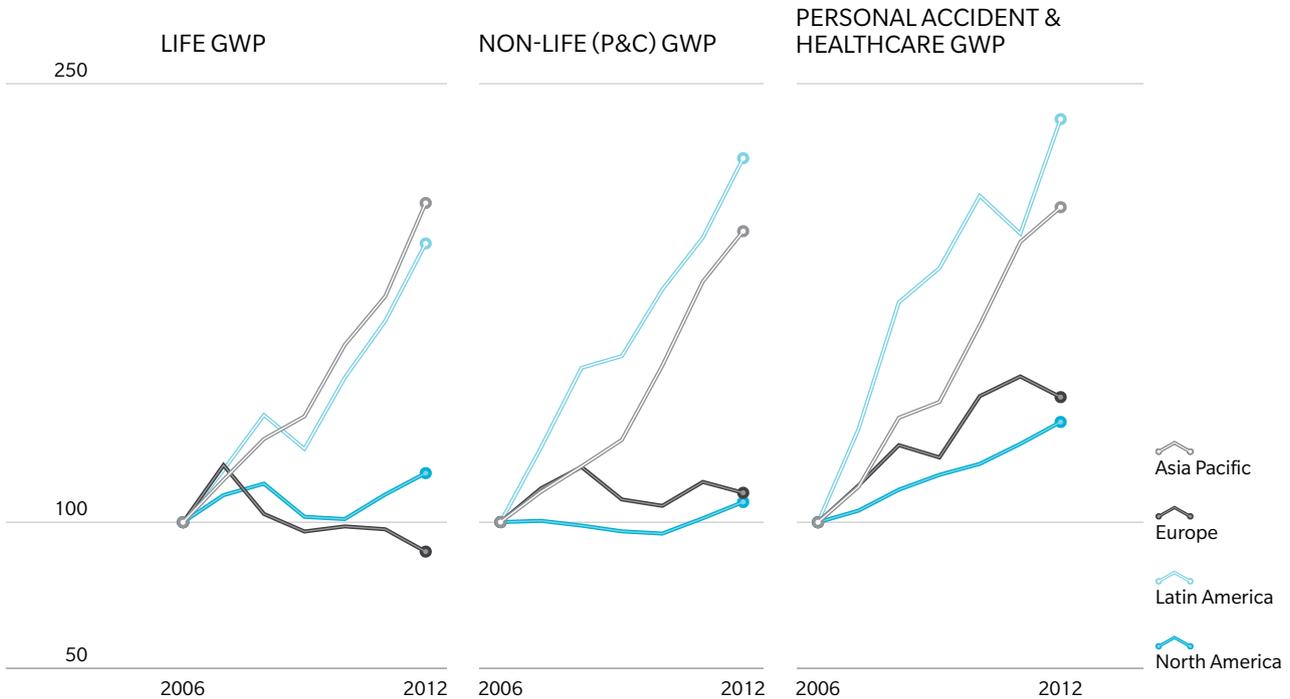
Financial deepening: facing headwinds driven by market maturity

As wealth increases, the use of financial products increases disproportionately, and financial sector revenues grow rapidly, significantly above GDP growth rates.

But this rapid growth cannot go on forever. The relationship between per capita Gross Domestic Product (GDP) and financial services spending

must stabilize. While emerging economies are steeply increasing penetration, developed ones have approached saturation. This phenomenon is most evident in insurance. The financial crisis and its aftermath have done little to reduce demand for insurance products or to increase the cost of supplying them. In the developing world they are advancing but from a very low base. In mature markets, insurance premiums have hardly grown for a decade. Insurers in developed economies must find ways to sell more into apparently saturated markets.

EXHIBIT 6: INSURANCE GROSS WRITTEN PREMIUM GROWTH BY REGION
INDEXED TO 100, 2006-12



Source: AXCO. Included countries North America: US & Canada; Latin America: Argentina, Chile, Colombia, Mexico, Peru, Venezuela; Europe: Austria, Belgium, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Italy, Lithuania, Luxembourg, Netherlands, Norway, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, Spain, Sweden, Turkey, UK; Asia Pacific: Australia, China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, Vietnam.

Demographic change will reinforce the developed vs. emerging markets story

Demographic change also disadvantages developed-economy financial sectors. As people get richer they live longer and have fewer children, so richer countries are older countries. That might not matter to financial firms if they served all financial needs. But they do not. In many economies, large slices of health insurance, pensions, and care for the elderly are provided by governments

and funded by taxation rather than from private savings or insurance. Older populations thus generate less revenue for financial firms, all else being equal. And given that government finances suffer too, the dependence of financial firms on governments makes this a double burden. Life insurers are a notable exception, where they play a major role in the provision of retirement benefits (income and longevity guarantees); unfortunately the industry’s track record of managing the risk in those lines of business has been less than stellar.

Not only do emerging financial sectors now enjoy the advantage of youth, but many of their governments have opted, or have time to opt, for private rather than tax-funded health and pensions systems. This means that, even as their populations begin to age, financial services profits may not suffer.

Globalization: in reverse, leading to domestic consolidation that will benefit only the middle

One obvious response for developed economy financial firms trapped by poor in-market economics is to seek economies of scale or scope.

International expansion has its attractions – especially for developed economy financial firms to “follow the growth” and enter the emerging markets. Financial firms from mature markets have advanced products, operations, and skills that should allow them to outperform less sophisticated firms from emerging markets. They should be able to capture much of the coming growth in financial services spend in emerging markets.

Yet this strategy has proved difficult to pull off. Part of the problem is underestimating the importance of local knowledge and connections. Another part is overestimating the true operational economies of multi-domestic presence, which are very small. To this list we must add regulatory obstacles. We have already mentioned the “nationalizing” effects of new solvency and liquidity regulations. But that is only the start of the problem, with both home and host regulators often militating against significant acquisitions.

Domestic or regional expansion also has its limits. Consolidation will occur among smaller and mid-sized players in all geographies, aiding new players to leap

into the leading pack. In the US, regulations create multiple thresholds that may hinder consolidation. We expect significant continued restructuring in Europe, particularly if the banking union manages to mitigate the oversized national exposures of the leading banks. And regional champions will continue to emerge in Asia and Latin America. But consolidation is unlikely to benefit either the largest firms or wholesale market players where concentration is already high.

Technology and data: a risk of some missing the boat, but the nimble will prosper

Information technology presents opportunities as well as threats. As consumers become more comfortable with transacting and buying financial services electronically, the market positions of traditional banks and insurers will be disrupted. On the one hand, firms that specialize in managing information and consumer experiences are already capturing a significant share of the value from processing and data, leaving traditional firms with little more than is due to financial intermediation and risk management (see last year’s “The State of the Financial Services Industry 2013: A Money and Information Business”). On the other hand, incumbents still hold many cards. As with all capital intensive industries, risk intermediation businesses are hard to capture. Notwithstanding skepticism about the industry overall, consumers still trust their own financial institutions more than other firms for most finance-related decisions. Finally, banks and insurers still command the bulk of the financial services information asset and the most valuable ways to deploy it. So technology will reshape the competitive landscape but, given the technology partners available, the most likely winners will be those financial firms who embrace it.

Unmet needs could create growth, if regulators allow

Many financial needs are still unmet in developing markets. As we have noted, penetration of all savings and insurance products remains low. Even in the developed markets many unmet needs still exist.

Major examples include:

- Provision for the growing retirement needs of aging populations during a currently unattractive dissaving phase
- Finance for increasingly expensive and complex healthcare systems as diagnostics and therapies improve
- Supporting mass consumers in managing a cost-of-living challenge that existed long before the recession hit
- Broadening the available sources of funding for small and early-stage businesses and projects
- Effectively matching society's long-term saving and long-term financing needs, including filling the shortfall in global infrastructure and energy finance
- Insuring newly emerging risks in property & casualty for private and corporate clients, for example from globally connected value chains or in cyber and social media
- Extracting the maximum utility from customers' financial information to support their decision making; and simplifying small retail payments while linking them to purchases

The challenge of conduct regulation, and in some cases Basel III and Solvency II rules, may make access to these and other opportunities difficult. But the firms that can unlock paths to some of these will secure elusive growth.

Greater imagination required on cost and investments

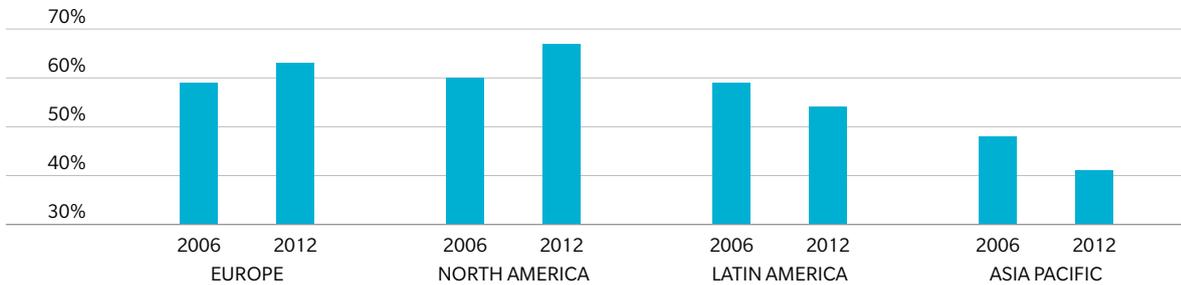
The choice between growth-hunting strategies offering equity-like returns and more stable business models focused on predictable bond-style returns is stark. Developed-economy financial firms, finding it difficult to increase revenues and possibly prevented from consolidating, must cut costs. Rapid advances in information technology offer hope: in a world of online purchasing, micropayments and check capture, all those expensive branches and staff might now be less necessary. And the great mass of customer-information that financial firms can gather will allow them to better align their product offerings and service levels with customers' likely spend.

But despite waves of cost-cutting, US and European firms are failing to make headway on productivity and cost-efficiency. Emerging markets, unencumbered by old infrastructure, can often find it easier to adapt or leapfrog.

The time has come for financial firms to be more radical. They need to define the service model that they will offer customers and be brutal about ensuring the operating model is delivering that and no more. This will require selective investment in areas where firms seek competitive advantage (e.g., service), and much greater use of shared infrastructure and vendors for commodity activities that don't provide meaningful differentiation. A specific challenge for insurers will be to develop lower cost distribution franchises, especially in life and pensions. For banks, both service and infrastructure are a challenge. We therefore expect supply chains to emerge where much more of the cost base of the industry is sourced from utilities or third party specialists. This shift from "owned" to "rented" is a big cultural change, one that many firms will struggle with, but it is necessary nonetheless.

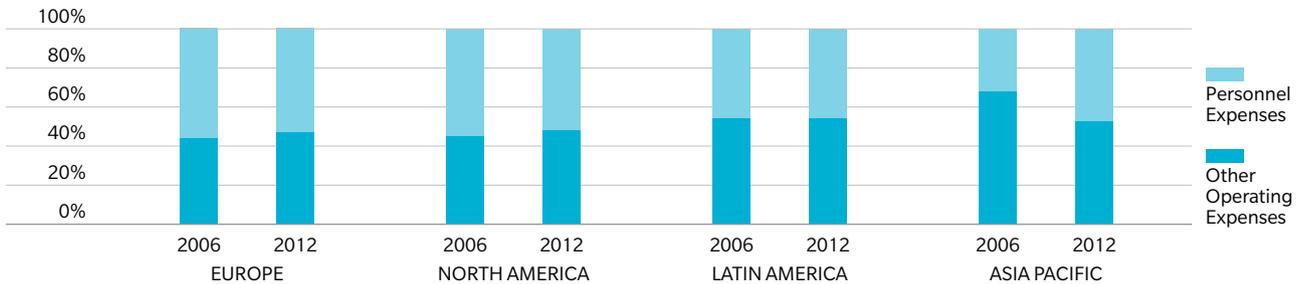
EXHIBIT 7: COST TRAJECTORY FOR THE LARGEST BANKS IN EACH REGION, 2006-12

COST/INCOME RATIO



COSTS SPLIT

SHARE OF THE TOTAL OPERATING EXPENSES



Sources: Bankscope (published by Bureau van Dijk) on a sample of 80 banks for Europe, top 20 banks for North and Latin America, top 3-5 banks by country for Asia Pacific (covering Australia, New Zealand, South Korea, India, Malaysia, Singapore, China and Japan). Oliver Wyman analysis. The analyses are only based on banks with full available data across the years.

Broadly speaking, this is where things stand with the financial services industry at the beginning of 2014.

It is an unstable and still uncertain state of affairs. Returns below the cost of capital cannot be sustained forever. Interest rates cannot remain zero. Regulatory proposals are not yet settled; indeed, some might not even materialize at all. Nor is it yet clear what will be the ultimate effects of the new rules that have so far been imposed. The economic development of China, Brazil and other emerging markets is likely to be volatile. And rapid advances in digital technology threaten to transform financial services and the way they are delivered.

Hard work remains to set the industry on a more attractive road – and management and strategists are still driving with blind-spots. The natural temptation is to simply stay in lane and keep moving in the same direction. But that is not a serious option when the road ahead contains obstacles. We all need to crane our necks and look into the blind spots.

In the following sections we look at six of these blind spots: looming challenges which are receiving too little attention at the highest levels of political, regulatory and industry leadership.

ASKING TOO MUCH OF CENTRAL BANKERS

MICHAEL POULOS

The US Federal Reserve and the ECB responded to the financial crisis by massively increasing the quantity of base money. This sustained the aggregate money supply in the face of rapid consumer and financial sector deleveraging and thereby avoided a deflationary depression spiral. Five years on, near-zero interest rates and monetary expansion continue, not only to avoid deflation but to stimulate economic growth.

Yet growth in the US, UK, and Eurozone remains anemic, especially when compared with rebounds following previous recessions. Why?

The simple answer is that aggressive monetary policy is not enough. Monetary policy is but one of many economic policy levers available to governments seeking to accelerate growth. A complete list would certainly include it, but also several others:

- The level and structure of taxes on capital formation, corporate earnings, personal income, and consumption
- The level and composition of near-term public spending
- The long-term public fiscal balance
- Regulation of the non-financial or “real” economy
- Trade policy
- Regulation of the financial system (capital levels, restrictions of activities, etc.)

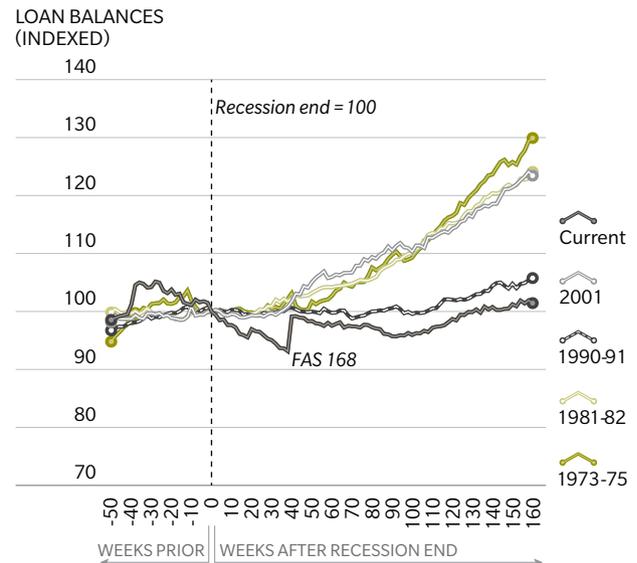
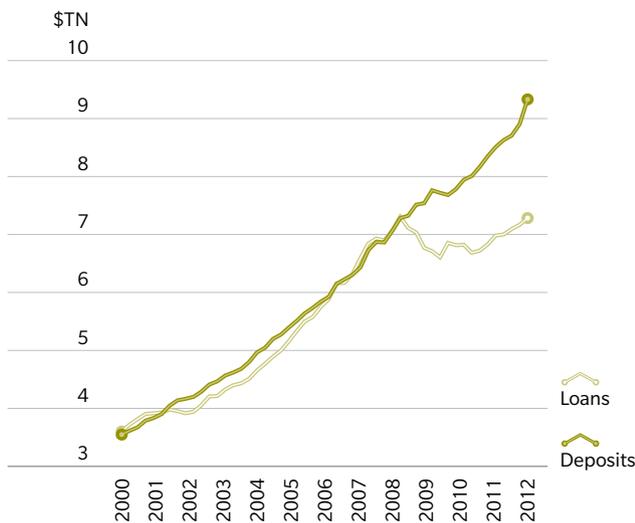
Yet, even following the worst recession since WWII, governments are doing very little to use these levers to stimulate growth. They have not reformed tax regimes in the ways that most economists agree would promote growth. They have not lightened the regulatory burden on businesses, nor removed trade barriers, nor directed stimulus spending to the “shovel ready” infrastructure projects that were supposed to create jobs and promote long-term growth. Indeed, much of Europe is engaged in fiscal tightening, while in the US most fiscal stimulus went to fund public pensions and unemployment benefits that pay people *not* to work. And while few would argue that tightening financial regulation from

the pre-crisis regime was unwarranted, many of the reforms have been overly complex, and not a few (e.g., restrictions on debit card swipe fees) have been irrelevant to safety and soundness.

Alas, sensible deployment of many potentially effective policy tools has become too difficult politically. The US tax code, for example, is the result of decades of “deals” in which politicians grant special exemptions in return for the support of the beneficiaries. This explains why US taxes are so complex, so economically irrational, and so hard to change. Every distortion has a powerful lobby backing it.

EXHIBIT 1: WHILE DEPOSITS ARE GROWING, LOAN GROWTH COMING OUT OF THE CURRENT RECESSION HAS BEEN HISTORICALLY SLOW

TOTAL LOAN AND DEPOSIT BALANCES
ALL US COMMERCIAL BANKS



Sources: Federal Reserve H.8 report, Oliver Wyman analysis.

The same goes for most other areas of potential economic reform. On top of the general “status quo bias” of the electorate, current policy will have many beneficiaries to defend it, and costs that are not obvious to everyone else. Over the short term, reform of individual inefficiencies will probably cost a politician votes. Given frequent elections, politicians have strong incentives to prioritize the short-term.

Legislative sclerosis is only part of the political story. Other forces are actively hampering economic recovery. One particularly acute problem in the US is aggressive litigation. Massive settlements reached by US banks with private litigants, regulators, and various attorneys general have greatly increased the perceived legal risk of lending to any consumer who might have to be serviced in delinquency, or engaging in complex transactions, even with sophisticated counterparties. Making credit intermediation a legally perilous activity is no way to encourage it.

Hence the growing dependence on monetary policy, which is conducted by unelected technocrats rather than elected officials or their political appointees.

The results of this reliance on central banks have been disappointing. The hope that easy money alone could do the trick was always wishful thinking. But the problem is worse than that. Monetary policy itself is malfunctioning.

THE HAVES AND HAVE-NOTS OF EASY MONEY

The new money being created by central banks is not translating into increased borrowing in vital parts of the real economy. There are several reasons. For example, many potential borrowers and credit officers remain “gun shy” following the crisis, and many corporates have maintained large cash reserves from which they can make investments without borrowing.

Yet central banks themselves are part of the problem. Paying interest on excess reserves held by banks reduces the marginal incentive to lend to private borrowers, though to what degree is a matter of some dispute. More importantly, central bank regulators have imposed higher post-crisis capital requirements on bank lending and limited banks’ ability to engage in maturity transformation. And a blizzard of complex regulation has limited many bank activities directly.

These actions are understandable, and in many cases entirely justified. But they are also contractionary. Banks’ increased cost to lend in the new regime undoes the intended effect of accommodative monetary policy: namely, increasing access to low-cost credit to businesses and households. To put it another way, the transmission mechanism for monetary policy is broken, and central bankers share some responsibility for breaking it.

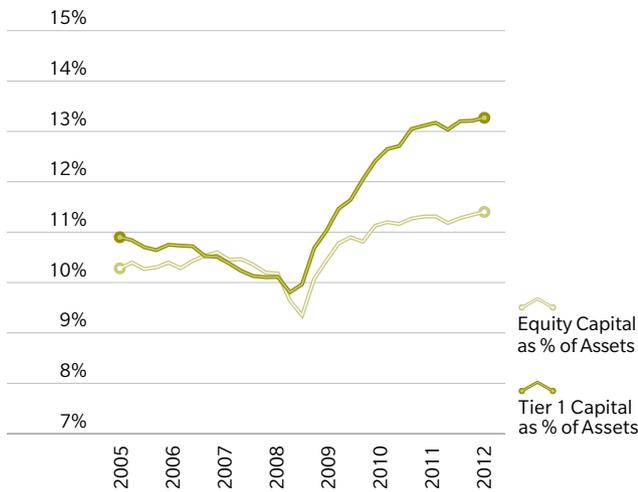
This combination of financial repression and regulatory tightening has created a massive disparity between the haves and have-nots in today's (putatively) easy money regime. Large, rated borrowers who can bypass banks via direct access to bond markets – think large-corporate and government issuers – have never enjoyed freer access to low-priced debt. In the US, middle market lending spreads are also at historic lows.

But, particularly in Europe, smaller borrowers who rely on the banking system are starved. Thus even the most ambitious and innovative monetary policy actions, such

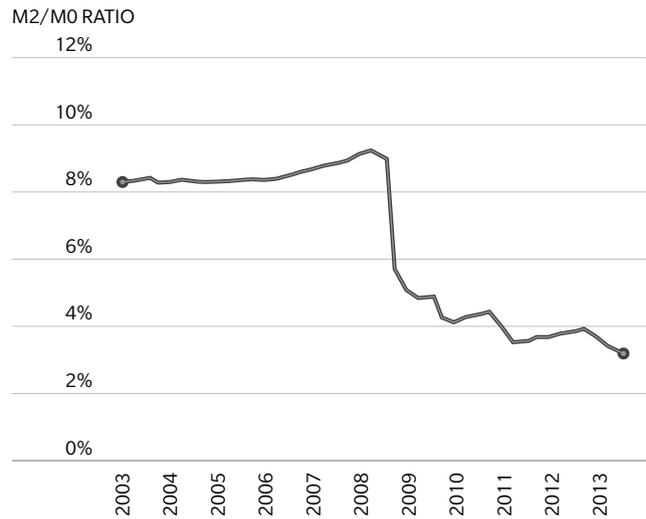
as the ECB's LTRO initiative, are thwarted, as banks receiving support invest in government bonds rather than loans to growth-creating small businesses. Nor does relief for credit-starved borrowers in the Eurozone appear to be in the immediate offing. The asset write-downs that will inevitably result from the ECB's Asset Quality Review will be another drag on bank capital.

EXHIBIT 2: US BANKS ARE SAFER, BUT WORSE TRANSMITTERS OF MONETARY POLICY

CAPITAL RATIOS
FDIC-INSURED COMMERCIAL BANKS
AND SAVINGS INSTITUTIONS



EVOLUTION OF THE MONEY
MULTIPLIER FOR US



Source: SNL data, Oliver Wyman analysis; Thomson Reuters, Datastream.
M0 equals total balances maintained plus currency in circulation.
M1 includes currency, traveler's checks, demand deposits, and similar interest-earning checking accounts.
M2 includes M1, savings deposits and money market deposit accounts, small time deposits, retail money market mutual fund balances.

AN IMPOSSIBLE JOB

To recap: Commercial bank lending is the channel by which central bank liquidity flows into much of the real economy. While trying to flood the economy with liquidity, central banks (and other authorities) are simultaneously closing this channel to many credit-starved borrowers with new bank regulations.

This apparently perverse behavior is not the result of incompetence. It is the result of central bankers' conflicting mandates. Central banks are responsible for monetary policy *and* for ensuring the solvency and stability of the banking sector. So long as other economic policies beyond central bankers' control create contractionary and deflationary pressures, central banks must pursue an expansionary monetary policy. And as long as policy makers maintain a bias to protect bank creditors from losses – either intentionally (e.g., via deposit insurance) or otherwise (e.g., via the widespread belief that wholesale creditors will be bailed out in extremis), central banks must counteract the moral hazard these policies create by imposing strict capital and liquidity requirements on banks.

Central bankers are human beings, not gods. They cannot work miracles. By failing to make structural economic reforms, Western politicians force central bankers to act in ways that are self-defeating and may ultimately cause economic harm. Persistently negative real rates of interest are likely to cause dangerous asset bubbles. And an overly regulated financial sector that favors bond issuers over bank borrowers is sure to misallocate capital.

Western politicians need to pluck up some courage, and assume their share of the growth policy burden from central bankers.

Michael Poulos is head of Oliver Wyman's Americas Financial Services practice group.

GETTING STRESS TESTING RIGHT

In a previous “The State of the Financial Services Industry” report, we made the case for more robust scenario analysis and stress testing to be put at the heart of firms’ strategic planning. Stress-testing is now increasingly a regulatory staple, but challenges remain.

TIL SCHUERMANN

What makes a good strategic plan? One that promises upside to risk, certainly. Perhaps more important, however, is a plan that is robust to downside risk. Is a firm able to survive in the course of adverse economic conditions? Is it able to adapt to such changes – including financial markets disruption – and still emerge from the economic storm sailing strong, and perhaps stronger than its competitors? If the answer is yes, then it is a good strategy.

Stress testing estimates the loss a financial institution may suffer under various adverse scenarios. It is, thus, a vital part of good strategic planning. An increasing number of firms are using it for this purpose; however, the initial impetus for stress testing has been the demands of regulatory compliance.

More than 75% of the US banking system, by assets, is now subject to mandatory semi-annual enterprise-wide stress testing. No major capital action, be it changes in dividends, a share repurchase program, or any significant M&A activity, can be undertaken without going through such an exercise. The UK looks set to head in a similar direction with its recent stress testing proposal, and the Eurozone countries are getting ready to digest the new Single Supervisory Mechanism (SSM) of the ECB, a regime that is expected to include regular stress testing.

It is hard to overstate the importance stress testing has been assigned in the wake of the financial crisis. For better or worse, the regulatory community is putting its supervisory eggs into this basket. The development of the basic idea varies across jurisdictions, but some basic elements are always the same. To explore them, a nautical metaphor may be useful.

Stress testing is like deciding if a ship's design is safe enough by asking how it would fare in a storm. To perform the test, you need to decide how severe and how long the storm is. Then you need to decide what shape the ship should be in once the storm is over. Regulators are settling on the length of the financial storm: about two years. The severity and the specifics of the scenario differ but are typically no less severe than what we experienced in the crisis. When the storm is over, regulators typically want the firm's Tier 1 common capital to be approximately 5-6% of its risk-weighted assets.

With scenario and strategic plan in hand, the institution then proceeds with the arduous task of projecting forward the balance sheet and income statements. Some losses emerge quickly (such as trading positions, credit cards or variable annuities for life insurers), some more slowly (such as commercial real estate exposures). What is the impact on business volumes, on pricing, on deposit and other funding or hedging dynamics? How does this differ in scenarios where the economic shock happens early (say, within the first two quarters) versus where it happens later in the typically two-year long scenario? What is more damaging to the franchise: a sharp decline followed by a rapid recovery or a long slow bleed?

In answering these questions, firms need to remember four things.

First, it is critical that stress-testing is not viewed as a solely regulatory request, but permeates the strategic thinking and activities of the firm. Answering the stress-testing questions above is an extremely difficult task, requiring contributions from every part of the organization: from risk and finance to strategic planning and the business units, from the risk takers to the risk managers. Senior management and board involvement is vital from start to finish, from initial strategic planning and designing stress scenarios to vetting results and approving the final plans. In particular, more needs to be done to support board members, whose expertise in more technical risk and finance matters has improved but not at the pace demanded by the regulators.

Secondly, stress testing must force an empirical standard of scrutiny. Regulators want to know how a strategic plan affects the safety and soundness of the institution. All plans must involve risk, as all aim at returns. Regulators are not opposed to financial institutions taking risks when setting their strategies. Rather, they are opposed to financial institutions developing strategic plans without awareness of the risks they entail.

The post-crisis stress testing regimes are designed in no small part to force financial institutions to comprehensively consider the gamut of risks they are exposed to as a result of the markets they are active in, the clients they serve, and the products they sell. Regulators need to be convinced that the firm has identified all risks and explored how the business strategy would fare through a set of adverse

scenarios, some given by the regulator, some designed on their own. Regulators are unwilling to take a firm's statements at face value. Everything must be documented and supported with empirical analysis. Don't tell me, show me.

Thirdly, stress-testing regimes need to be tailored to the institution. Trading and banking-book dynamics need to be understood. As a particular example, non-banking financial firms, insurers in particular, are being caught in the cross wind as banking-dominated regulators muscle in: the Financial Stability Board has established nine "Global Systemically Important Insurers" (GSII) and the Federal Reserve is wrestling with developing a capital regime, including stress testing, for insurers and other non-bank SIFIs. That rulemaking is not done. Indeed, the divergence in accounting standards, as well as solvency regimes, makes it extremely difficult for a GSII or non-bank SIFI to navigate, let alone plan. So, more work will be required. But the need to embrace stress testing as a central risk management and planning tool among the

largest global insurers and other non-financials is here to stay.

Finally, it is important that firms do not respond solely by trying to mimic regulators' stress-testing models, getting the result the regulator wants but ignoring perils elsewhere. Stress-testing should be a tool for the board and management as well as for regulators.

In summary, both the design of a scenario, as well as the demonstrated unfolding of business dynamics through that scenario, provide valuable insight to management and regulators alike, establishing how well a financial institution actually understands its business and the risks that come with it. A good strategic plan, produced by an organization with top-notch risk and finance capabilities, should comfortably withstand such a test.

Til Schuermann, a former senior vice president at the Federal Reserve Bank of New York, is a partner in Oliver Wyman's Finance and Risk and Public Policy practices.

INTO THE DIGITAL UNKNOWN

MIKE HARDING

The science fiction I enjoyed as a boy got things the wrong way around. Spaceships hurtling across the universe at the speed of light, and teleporting the crew on and off passing planets, had on-board computers the size of trucks with enormous flashing lights and dials. An on-screen telephone conversation was a rare event, reserved for the captain taking orders from Starship Command or threats from his alien nemesis.

As things have actually turned out, we still travel at speeds well short of lightning in devices that, in essence, have not changed for half a century. Yet most of us in the West carry pocket sized devices with more computing power than was imagined for starships, on which we can Skype anyone with a similar device, for free.

The on-going explosion of data storage capacity and “connectivity” gives us more or less instant access to nearly half the people on Earth, to almost every book ever written, to all music recorded...to just about everything humans have discovered or created that isn't a physical object. This will profoundly change the ways we live and do business. The changes we have so far seen are only the beginning.

This is surely true in financial services. We have seen changes, of course. Internet banking is now commonplace, and mobile banking apps are taking off. But just as the computerized cars of 2013 are still quite like the cars of 1993, the 2013 version of the financial industry is still quite like the 1993 version. Given that financial services – unlike cars – are not inherently physical, more profound change must be coming. Let's speculate:

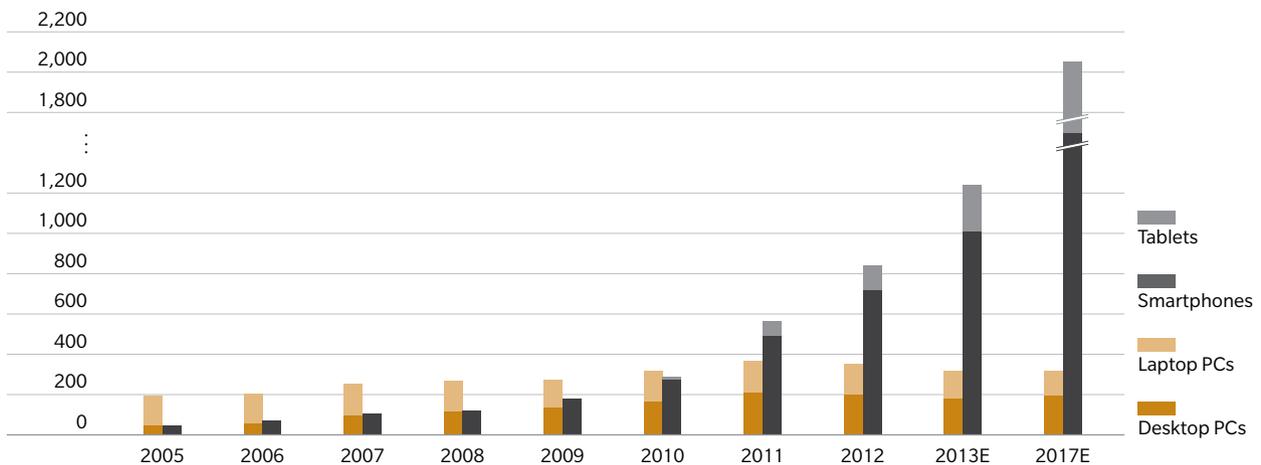
- **No more payment devices** Checks are nearly gone, vestiges of a bygone era like the fountain pens that might once have been used to sign them. And, despite only recently being modern, plastic cards should also become obsolete. Electronic “wallets”, perhaps stored on or accessed by your mobile phone, already provide a more convenient and secure way of doing the same thing. Even your phone is not strictly necessary. Payments could be made by your biometrics, or any other reliable way of identifying you. Cash may disappear too. If some way of making payments that is immaterial, easy, and anonymous can be discovered, there will be no demand for money made of paper or metal.
- **The metamorphosis of branch banking** Like checks, bank branches – at least as they are configured and used today – are vestiges of a bygone day, when a building symbolized financial solidity,

when people felt more comfortable dealing with a person than a screen, when physical money needed to be made safe and when people went shopping on high streets. Much of what gave life to branches is rapidly disappearing. Many will disappear. The rest will inevitably have to transform like other physical retailers – not total annihilation, but reinvention in form and function to meet the changing needs of both banks and their customers.

- **Free and honest advice** Remember when you used to ask the shop assistant for advice when choosing between products? If you are under 30, probably not. Nowadays you can ask a bunch of enthusiastic strangers what they think, not the guy on commission in the shop. And you can compare prices at almost zero cost in effort, time, or money over a wide range of alternatives. Identifying the best buy can be more difficult in financial products than in

EXHIBIT 1: # OF DEVICE SHIPMENTS

2005–2017E, VALUES IN MM



Sources: The Economist – Beyond PC – Oct 8th 2011, IDC, Oliver Wyman analysis.

holidays, cars, or TVs – and the cost of error greater. So financial advisors will survive the information revolution, but they will have to do a better job and not all will be paid from sales commissions.

- **Much less cross-subsidy in insurance** Insurers used to know only the basic facts about you: sex, age, address, job and so on. You got insurance at a price that reflected the risks for people of your basic type. Now insurers can collect masses of information about you. They can know what you read, where you go, what you buy, who your friends are and, if you have telematics, how carefully you drive (and, if you refuse telematics, they can assume you drive badly). So they can price your insurance not for people quite like you, but for someone just like you – and, what's more, for people like you are now as opposed to last year or maybe even last month. If you were a low-risk member of your old group, that's good news: you are in line for a discount. If not, you will have to change your ways or pay the price.
- **Event-based marketing** You do not buy financial products every week, like groceries. You tend to buy them when something big happens, such as starting at an institution of higher education, getting your first job, having a child, or retiring. If financial firms knew when these events occurred, they could offer you a personal loan, mortgage, pension plan, reverse mortgage or other financial product just when you are likely to buy it. Well, now they can, because most of us advertise such events on Facebook, LinkedIn and the like. Sometimes the relevant big events are impersonal. The 2011 earthquake in Christchurch, New Zealand inspired many people far from its location to increase their insurance cover. Financial firms can use online chatter to gauge emerging reactions to such "world events" and offer people the solutions they are seeking.

The big established financial firms face a challenge. The payments and distribution infrastructure they have invested in used to give them a big advantage. But the return on these investments has been under steady pressure. At the same time, to keep pace with changing customer behavior and new offerings from competitors, these firms need to invest more in new technology and business processes. But in which of the ever-expanding list of possibilities should they invest?

Financial services providers know their world is changing. But they don't know exactly how, or when. Digital era providers, such as Google, are very different creatures who live on different food. But they are increasingly moving into the natural habitat of traditional financial firms. No one knows who will thrive, who will become extinct or what new creatures will emerge. But one thing is certain: financial services will change profoundly.

Mike Harding leads Oliver Wyman's Digital capability across practices.

THE TALENT CHALLENGE

NICK STUDER

Great people are the foundation of great organizations. That is no less true for financial institutions. For many years, financial firms enjoyed advantages in their proposition to talent along several dimensions including returns, growth, compensation, and social prestige. Most of those advantages no longer hold true. The financial services industry faces a looming talent problem and industry leaders need to put talent management much higher on their personal agendas.

Financial services is a far less attractive career than it was, at least in the US and Europe. Financial rewards are being reduced by lower returns, by new rules on compensation, and by relentless political and media scrutiny. The work is increasingly dominated by regulatory compliance and managing legal and headline risk, rather than growing the core business. Innovation is being stifled by product regulation and legal peril. And the prestige of the job is diminished. Many firms are culling “revenue seats”; employment growth now comes from compliance.

Compare financial services with working in an “information” business, such as Google or Apple or one of the countless younger firms (one is tempted to say “even” younger – Google was founded in 1998). These businesses are lightly-regulated, dynamic, and offer talented staff potentially great rewards – and they are considered cool. It is no wonder that firms are having trouble recruiting the best and brightest, from new graduates to seasoned executives.

Yet financial firms are no less in need of high-caliber talent, from fresh BAs to the C-suite, than they have ever been. On the contrary. When volumes, revenues and profits were growing smartly, weaknesses in staff might be disguised or overlooked. Now that firms are running uphill, they need the strongest athletes.

More specific developments are also creating talent challenges for firms. The increasing “digitalization” of financial services requires employees who can build (or specify and buy) the underlying technology. Just as important is the understanding of changing customer attitudes, preferences, and behavioral patterns. Traditional financial services firms have been slow to attract or develop these skills.

Regulatory developments not only require an increase in the number and quality of risk and compliance staff but also new qualities in line managers. Since the effective abolition of the caveat emptor principle, incidents that might once have cost no more than the loss of an unhappy customer can now expose it to fines in the tens or even hundreds of millions.

In short, financial firms are in a position of needing better talent just when they are becoming less competitive in the talent market. So what can they do?

One *sine qua non*: financial institutions must restore their profitability and returns. Because legacy profit models cannot be revived, restoring high returns will require changes of business model. Simultaneously, banks must repair their reputation. This will take time, no matter what is done, but the new business model must help. The new-model bank must be a place that talented professionals’ are proud to work.

These are large tasks, beyond the scope of this paper and stretching past the bounds of a pure “talent strategy”. What other immediate steps can be taken? How can financial institutions make working for them more attractive and simultaneously reinforce the cultural changes required to restore brands and comply with conduct regulation? We offer four suggestions:

1. ENSURE SENIOR MANAGEMENT OWN THEIR TALENT STRATEGY

Don’t rely solely on the Human Resources (HR) staff. As with risk and control, business and functional leaders should form a “first line”, with core responsibility for talent outcomes. HR professionals will design, advise, train, support and, importantly, hold them to account. But business leaders, and functional leaders too (where this is often weakest), need to take ownership of their talent strategy.

2. OFFER MORE THAN MONEY

Personal development has leapt in importance for employees. The best talent increasingly expect to receive training throughout their careers, and to pass through more roles and more employers. Younger employees, especially, are happy to trade depth for breadth and take on alternative career paths even at the cost of slower vertical progression early on.

Variety and role rotation can benefit not only the employee but also the firm. More rotation between risk and line functions at senior levels would be particularly useful.

Employees are also demanding increased flexibility or customization in their working arrangements. They want to be able to trade pay for other benefits, such as personal time, and they want to be able to work remotely where their role allows. While unlimited flexibility is impossible, stretch your organization to offer a rounded employee proposition.

3. RELEASE THE INFORMAL ORGANIZATION

Create opportunities for self-improvement in staff, and remove barriers to self-starters; free the informal networks in your organization to solve some of these challenges for you. Promote cross-silo and especially function collaboration. Re-examine your office layouts to encourage creativity and collaboration. Encourage the informal organization through facebook, internal news, blogs and tweets. And form cross-hierarchical and cross-functional teams for business problem-solving and for extra-curricular activities.

4. MANAGE EGOS AND DON'T COMPROMISE ON CULTURE

Some of the brightest minds of the last generation went into financial services – especially investment banking – partly for the intellectual challenge and partly for the money. By the late 2000s, the industry had developed a reputation, in some cases deserved, of a culture of perceived superiority and disregard for ethical propriety and the primacy of clients' interests. The crisis has helped to end that arrogance but vestiges remain. Many of the industry's best-paid employees

overestimate their personal contributions to financial success. If unreasonable egos push too far or threaten your culture, let them leave or show them the door. They can be replaced.

Overall, trust in financial services needs to be rebuilt. Accept occasional failure in business endeavors but do not accept excuses about ethics. Your scrutiny of ethics should cover not only how your staff deal with customers but also how they deal with each other. Part of your job is to mentor and teach. But you cannot teach morality to adults; if they do not already have it, you are unlikely to instill it in them. The rotten apples must be thrown out of the barrel.

Nick Studer is managing partner of Oliver Wyman's Financial Services practice group.

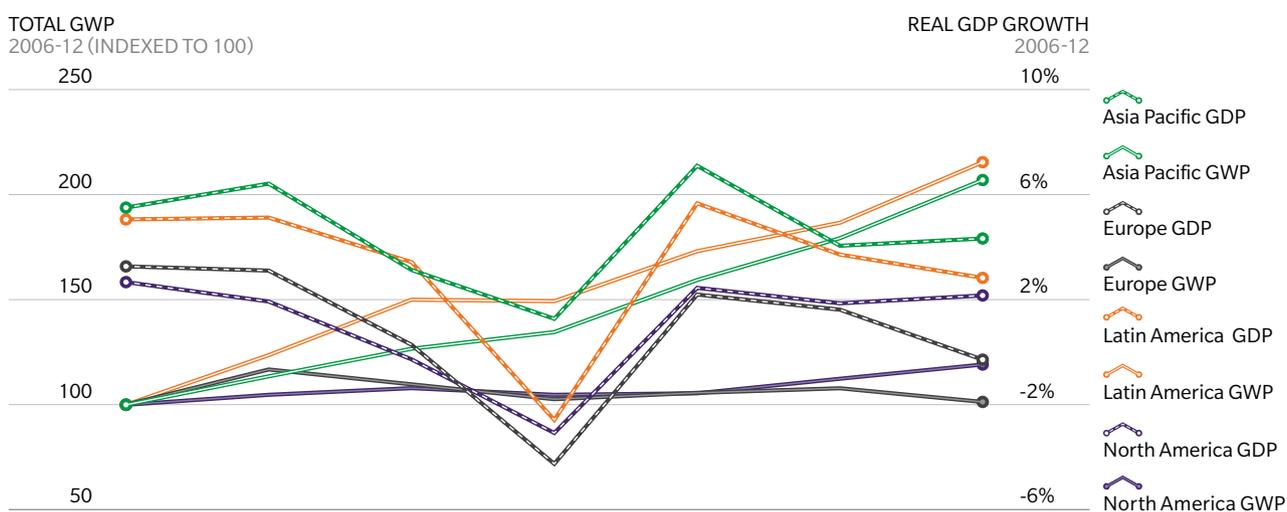
RETURNING INSURANCE TO GROWTH

BERNHARD KOTANKO
JOHN WHITWORTH

Insurance in mature markets has apparently reached a saturation point, unable to grow faster than GDP. While growth in life and pensions premiums varies with regulatory and tax regimes, property and casualty (P&C) insurance premiums are actually contracting. Overall, real premium growth has been close to zero over the last ten years.

Unsurprisingly, the same is true of insurers' earnings-per-share and market values. Since 2002, Stoxx Europe Insurance has grown by barely 3% and Stoxx North America Insurance is still 2% down. Over the same period, the Stoxx Global 1800 grew by almost 70%. It is only in the last two years that insurance has staged a small recovery to its historic lows.

EXHIBIT 1: INSURANCE IN MATURE MARKETS HAS LOST ITS ABILITY TO GROW AT THE LEVEL OF REAL GDP AND BEYOND



Source: AXCO, World Bank. Included countries North America: US & Canada; Latin America: Argentina, Chile, Colombia, Mexico, Peru, Venezuela; Europe: Austria, Belgium, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Italy, Lithuania, Luxembourg, Netherlands, Norway, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, Spain, Sweden, Turkey, UK; Asia Pacific: Australia, China, Hong Kong, India, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, Vietnam.

Conventional wisdom accepts this low growth as an unavoidable consequence of market maturity, and senior managers try to maintain profitability by increasing efficiency and cutting costs.

We think this conventional view is too pessimistic. Six big developments present insurers with opportunities to accelerate premium growth in mature markets.

1. NEW RISKS

The way people live and conduct business is changing. And so, therefore, are the risks they face and the way these risks are connected. This creates opportunities for insurers to provide new products and services. For example, identity theft was almost unheard of 20 years ago. Now it is a risk worth insuring. Or, for another example, supply chains and their associated risks have changed dramatically, involving technology that either was not used or did not exist 20 years ago. Where simply insuring a vehicle or specific “business interruption” may have once sufficed, businesses are now more likely to require a comprehensive supply chain policy. Even the dramatic increase in divorce and second families creates potential demand for new insurance products.

2. UNITARY POLICIES

Insurance policies have traditionally been designed and priced for large groups of only roughly similar people. Variation within these groups means that most customers are either under-priced or over-priced, and few get the precise cover that suits them. The massively increased quantity of information now available to insurers, from the internet and technology such as telematics, means that policies can be tailored to the particular characteristics and behavior or policy holders. This means insurers can now create “segments of one”.

Just as a shoe shop that could always produce a pair that fits would increase sales, so should insurers who can create segments of one. Such precise targeting of policies can also be aimed at individual occasions or assets as well as individuals. For example, personal injury insurance can be sold just before the ski trip and last only as long. Similarly, new “annex” insurance policies are achieving impressive growth at high margins for small assets such as glasses, mobile phones, or online transactions.

3. PUBLIC TO PRIVATE

Governments tax citizens and then provide them with “free” pensions, health insurance, old-age care and unemployment insurance, among other things. Commercial insurers have thus been largely crowded out of these markets. However, the level of cover provided by such “social insurance” will need to fall in many western countries. Populations are aging and governments are already near their fiscal limits. This will create opportunities for insurers to fill the gaps left by retreating governments. Even moderately affluent people are likely to be dissatisfied by the level of social insurance or even excluded from it.

4. LONG-TERM SAVINGS

The global asset pool grows at a stable rate of 4-6% and the need for long-term savings is increasing at an even faster pace with the aging of the population. Insurers are a major collector of these savings and thus one of the largest institutional investors. Maintaining and expanding this role as a premier collector and manager of long-term retirement savings could be a critical source for further growth. This may include the full step into asset management, which some global insurers have already made.

5. PROFITING FROM ILLIQUIDITY

Unlike banks, insurers have very stable, illiquid liabilities. Pension and P&C claims cannot be “called” by the policy holders. Rather, they pay out in a predictable fashion, uncorrelated with the economic cycle. This makes insurers natural investors in illiquid assets, such as commercial loans or infrastructure, which pay illiquidity premia that insurers are now failing to capture. Regulation is partly to blame, with solvency requirements driving up the cost of holding such assets. But, as we have argued elsewhere, even with these regulations, insurers could increase their market value by up to 50% by exploiting the stability of their liabilities for investment in illiquid assets. This however will require an entirely new set of capabilities and capital markets access for insurers.

6. BEYOND INSURANCE

Insurers have unique information about the risks facing individuals and businesses. This can be used to provide more than just insurance policies. Insurers should be able to offer services at many points on the “risk value chain”. Examples include the use of actuarial insight in accident prevention, telematics in cars and supply chain management for businesses.

Each of these opportunities involves uncertainty. Will there be sufficient demand? Will regulators intentionally or inadvertently shut down the opportunity? Will the new ventures and products be well designed and profitable? To pursue them, insurers must take steps into the unknown.

Many will be reluctant. Insurance firms have notoriously conservative institutional cultures. This has usually served them well. But in the current situation, caution will be costly. It will lead to another decade of stagnation. Insurers must become more entrepreneurial and innovative. That will require them to develop not only their capabilities in product development but their willingness to live with uncertainty. With a little strategic courage they should be able to return to real growth.

Bernhard Kotanko leads Oliver Wyman’s EMEA Insurance practice; John Whitworth is a partner in the practice and leads the UK Insurance team.

DERISKING PENSIONS

MICK MOLONEY
RAMY TADROS

With the benefit of hindsight, corporate defined benefit (DB) pension plans within Anglo-Saxon economies will be viewed as largely a 20th Century phenomenon. The trend away from using corporate balance sheets to underpin retirement income guarantees through a “shadow insurance” structure is well underway. The US in particular is rapidly becoming the poster child for this exit play.

US corporations, which have been busy for many years shutting plans to future generations of employees, are now rapidly moving to trim existing balance sheet exposures through a combination of paying lump sums to individuals and transferring their obligation to insurers via “pension buyouts”. While some questions remain about exact timing, the next three to five years will see a massive flow of these liabilities from corporates to individuals and insurance companies.

The shift away from DB pensions is poised to accelerate. The \$25 BN General Motors and \$8 BN Verizon mega pension risk transfer transactions of 2012 blazed new trails, and have removed much of the uncertainty that held back plan sponsors in the past.

Before these transactions, conventional wisdom said that deals above \$1 BN were not possible due to limited insurer capacity and limitations in the bond markets. However, 2012 saw \$36 BN¹ in combined deal volume, and a number of insurers have made it clear that they are willing and able to close on multi-billion dollar deals.

1 Source: Mercer.

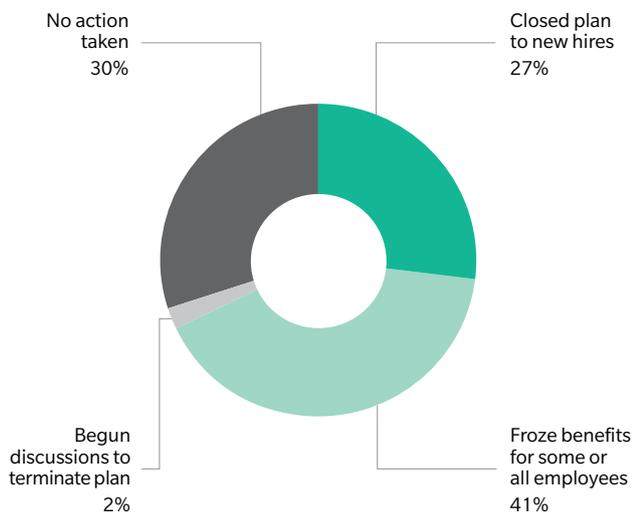
The General Motors and Verizon transactions also provided important information about investors' reactions to such corporate actions. Prior to these deals, no one knew definitively how investors would respond to transactions of this size and scope. In particular, management could not be sure that investors would see through some of the unflattering accounting optics into the underlying economics of the transaction. Fortunately, analysts correctly interpreted the transactions, and the markets appropriately responded with a whimper rather than a roar.

The demand for annuity buyouts is tightly linked to financial markets, as better-funded plans can more easily afford annuities. Increased interest rates (reducing

the cost of the liability) or continued buoyancy in asset markets could make risk transfer a real opportunity for a large number of plans in 2014. In many respects 2013 was a banner year for plans, with interest rate increases reducing liabilities' values while strong equity market performance increased asset values. As a result, 20% of plans finished the year over 100% funded compared with 5% at year-end 2012. That amounts to a four-fold increase in the number of plans that are in the territory where a pension buyout is feasible.

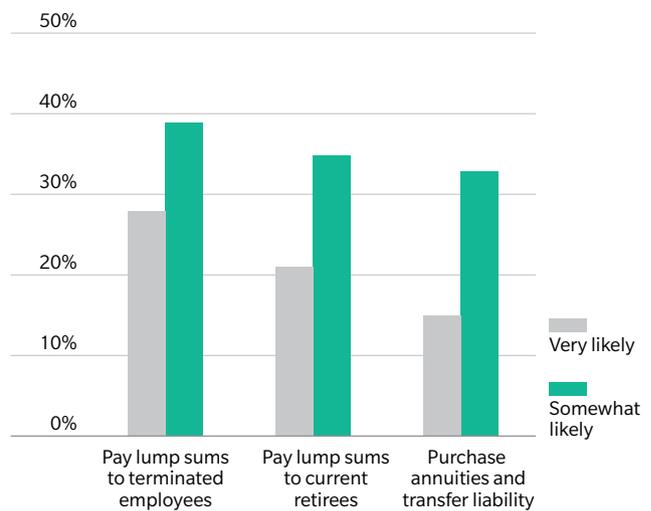
At the same time, market supply dynamics are still evolving. So far, large US insurers have had more than enough capacity to meet demand. But it is not clear how much appetite the major players have, particularly for

EXHIBIT 1: LAST PLAN ACTION TAKEN IN PAST TEN YEARS



Source: Towers Watson, "US Pension Risk Management: What comes next?", November 2013.

EXHIBIT 2: LIKELIHOOD OF PENSION REDUCTION ACTIONS IN THE NEXT TWO YEARS



Source: Mercer/CFO Research, "Evolving Pension Risk Strategies", June 2013.

jumbo pension transactions where competition for deals is limited. A number of new players, foreign insurers and reinsurers are interested in entering the market but, in the meantime, there is a potential “race to the exit” if short-term capacity is limited.

Perhaps the biggest lesson of the 2012 deals was that such transactions are complex and require significant planning and analysis. Plan sponsors will be well-advised to start planning now, so that they are not left out when the time comes.

IMPACT ON THE FINANCIAL SERVICES INDUSTRY

Regardless of whether the DB exit story unfolds over the next two years or the next ten, the impacts will be significant. We expect the majority of the \$250 BN in terminated-employee pension liabilities² to be transferred to individuals via lump sums, and much of the \$1 TN in retiree liabilities² to be transferred to insurers via annuities. This means that somewhere between \$500 BN and \$750 BN is likely to move from institutional asset managers to insurance company balance sheets and retail accounts.

This will represent a major opportunity for players who can position themselves to capture those assets. We expect to see more product innovation from insurers. In particular, successful insurers will look to further tailor their product offering to the needs of the corporate plan sponsors and the retirees. Asset managers could look to limit the outflow of assets from their existing DB mandates by combining their existing Liability Driven Investing offering, with additional true risk-transfer features such as longevity risk protection.

Finally, this shift could have a profound effect on the capital markets. Given the lack of capital requirements and hitherto generous (albeit gradually tightening) funding requirements, corporate DB plans have traditionally favored fairly aggressive investment allocations against what are essentially long-dated fixed liabilities. Insurers, on the other hand, must adopt fairly tight asset-liability matching strategies and look to invest in a diversified, high-grade, fixed income portfolio with tight limits on duration mis-matching. The resulting demand for long-dated corporate credit will be yet another manifestation of the “Greenspan conundrum”, with the demographic reality of the aging population manifesting itself in the demand for long-dated credit.

Mick Moloney is a partner in, and Ramy Tadros is practice head of, Oliver Wyman's Americas Insurance practice.

² Source: US Department of Labor.

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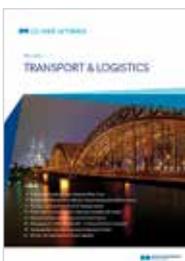
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THE STATE OF THE FINANCIAL SERVICES INDUSTRY 2011

THE FINANCIAL CRISIS OF 2015 – AN AVOIDABLE HISTORY

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THE STATE OF THE FINANCIAL SERVICES INDUSTRY 2012

THE REAL FINANCIAL CRISIS: WHY FINANCIAL INTERMEDIATION IS FAILING

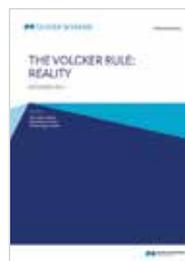
The 15th edition examines what can be seen as a failure of the financial system's intermediation of borrowers and savers: its causes, impacts, and implications for financial institutions



THE STATE OF THE FINANCIAL SERVICES INDUSTRY 2013

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THE VOLCKER RULE: REALITY

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