



Frontiers in Finance

For decision-makers in financial services
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Letter from the editors



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The vastly more complex challenges now unfolding across the financial services landscape demand distinctly new approaches by senior management. Business leaders must rethink how to deftly manage expectations from increasingly impatient stakeholders, and apply genuine innovation to strategy, service delivery and operational processes. These solutions must be highly focused and integrated, to address pressing, short-term priorities, while also flexible and scalable, to respond to tomorrow's yet unknown threats and opportunities. Management must also undertake these strategies in a transparent manner, to repair trust in financial institutions following past blows to public confidence, including the recent Panama Papers revelations.

The articles in this edition of *Frontiers in Finance* speak to these challenges. They range from the looming impact of next generational investors on wealth management, and the mounting compliance demands upon internal audit, to accelerating industry-wide efforts to transform banking payments and capital markets transactions with disruptive blockchain technology.

In light of the scope and diversity of these issues, many of the success factors for financial services organizations are changing right before our eyes. As Jeremy Anderson's Chairman's message points out, financial institutions must be prepared to reinvent themselves, including the way they are led and how decisions are made. As such, we consider how deep change must be injected into current management approaches, whether by evolving the post of Chief Financial Officer, empowering the Chief Data Officer, or encouraging data analytics experimentation to regain customer relevance, drive efficiency and identify fresh growth.

Our feature articles also explore how a number of financial services organizations are now bringing this prescription to life and moving from concept to action in the marketplace. We see that the emerging banking force Atlas Mara is successfully penetrating untapped opportunities in Africa, and how incumbent global insurers are redefining the rules of partnership and collaboration to test the non-conventional Blue Marble micro-insurance consortium.

We hope this issue of *Frontiers in Finance* brings greater clarity to some of today's critical issues and highlights practical steps that can lay the groundwork for business transformation that responds effectively to the dramatic, continuous change facing the industry.

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The courage to change

By **Jeremy Anderson**
Chairman, Global Financial Services



Jeremy Anderson

“
There are important lessons to be learned from how the best and most successful innovators of the last decade, outside financial services, have performed. ”

The articles in this edition of *Frontiers in Finance* illustrate yet again the huge scale and pace of the changes taking place in the global economy, and the complexity of the challenge which these external changes impose on the financial services industry.

Some are driven by technology, from how data is changing the way we service customers, satisfy the regulators and undertake stress testing, to how technology can strip out costs, streamline processes and disintermediate roles, whether through robo-advisers at the front end or blockchain technologies at the back end. Others are demographic, transforming customer needs, attitudes and demands. Others again are macroeconomic: a fundamental challenge is how to secure growth and profitability in a low interest rate environment, whether this be through new markets or through the development of new products and services.

So a key challenge for management is how to create a management team with the right capabilities in the organization to manage complex, multi-dimensional change: in the value chain and in the face of the threat from new entrants and disintermediation, sustaining profitable business while satisfying regulators' demands for safety, security and accountability.

New focus

This is a seminal moment for financial services. In the immediate wake of the financial crisis, the prime focus had to be on the battle of the balance

sheet: reshaping the business to match the new environment, building relevant new business models, recapitalizing, deleveraging and eliminating non-core or over-risky lines of business. These changes are continuing: we have recently seen major institutions withdrawing from whole geographic regions and insurers closing down complete business sectors. This process has been complex and challenging, but in effect it's been about rebuilding the *old* business models.

Today, the nature of the management challenge has changed. It now has to focus on the development of new business models which can take advantage of the new opportunities and dislocations which change creates, while preventing the loss of value to new entrants and disruptors. These new business models have to be developed in a complex and rapidly-changing environment, with new dynamics and the breaking down of traditional vertical integration, and with new entrants, industry disruptors and innovative technology reshaping the landscape.

Momentum and speed are vital. A five year strategy which delivers results in year five is not good enough. We need much more flexible and optional strategies which can reshape the business and deliver results much more quickly.

Focus on customers

We have reiterated on a number of occasions that a fundamental priority has to be to put satisfying customers



at the heart of business strategy. In the present context, a relentless focus on serving customers and clients is essential, because customers — both corporate and individual — respond rapidly and directly to the kind of changes we are seeing.

This is a point to which we shall return. For now, the lesson is that financial institutions need to develop speed and momentum, not just to execute current business models, but to respond to change in an uncertain environment, whether this is a result of technological change, monetary policy, commodity price shocks or a slowdown in China. This requires particular approaches to the identification, nurturing and management of talent: it implies the development of a collaborative approach to strategy, problem solving and execution which can be harnessed at speed.

So identifying and motivating new talent for the future — creative, responsive and imaginative — is a priority. Collaboration has to become a core competency. This is not easy, since it involves recasting operational models away from the command and control paradigm at the same time as regulators are demanding ever greater discipline and control.

More difficult

Today's CEOs face an unprecedented landscape. The theme of the Davos WEF meeting this year was *The Fourth Industrial Revolution*. While this may be an exaggeration, it is nonetheless true that, to succeed in the world we are entering, CEOs need to ensure their organizations can master new technologies and approaches which they may not personally yet fully understand.

In the past, CEOs knew how to frame the right questions and direct the right resources to resolving strategic challenges, based on their accumulation of specialist subject matter knowledge over the years. This was often helped by location within the framework of stable leadership teams. But the dramatic headlines we see today are evidence of profound impact on the deep psyche of the industry, greater than anything our predecessors experienced: issues of cyber-security, FinTech, big data, social networks, machine learning, distributed ledger technology and blockchain, the huge focus on digital technology for distribution and customer interaction,

consumer revolt against big brands, the emergence of platforms which integrate financial, social and lifetime needs and experiences... no single individual can hope to comprehend all this fully.

The financial services industry has had quantitative analysts, complex products, massive computer technology for decades; this much is not new.

What is now new is the need to create an ecosystem which can identify, pull in, create trust and align the new sources of talent.

The multi-dimensional complexity of today's challenges means that speed, alignment, agility and execution are vital.

Very few large institutions today have those characteristics — fewer than in the decades before the global financial crisis. Before the crisis, there was a steady process of consolidation in the industry, stemming from the battle for scale, growth and profit. Complexity emerged from this growth. The crisis itself triggered a further wave of consolidation and complexity, as strong institutions absorbed weaker ones. Still greater complexity has followed in the wake of the regulatory imperative.

As a result of this corporate complexity, there has been less money, less time and less management energy available to concentrate on building a flexible business and technology architecture for an increasingly uncertain world. The complex infrastructure of IT, applications and data simply adds to the burden. It is more difficult now.

Learning the lessons

There are important lessons to be learned from how the best and most successful innovators of the last decade, outside financial services, have performed. Amazon, for example, has grown exponentially, from books to eBooks, Kindle, cloud services, just-in-time delivery, grocery services, drone delivery... it has achieved this through relentless execution in the pursuit of new market opportunities. In seven years, from a standing start, Uber has grown to become a multi-billion dollar business, operating in dozens of countries, through speed, focus and aggression; so successful has the core concept been that it has spawned the noun 'uberization' to describe a business model which disintermediates established — and over-regulated or protectionist-providers.

We cannot draw direct parallels because they come from non-regulated sectors, can expand across borders because they rely largely on technology, and do not have the quarterly profit pressures of most financial institutions. However, they do show us that change will be increasingly rapid and complex. Even if the geopolitical and macroeconomic environment stay stable, blurring industry boundaries, new players, new technology and changing customer needs and expectations will bring plenty of change.

Serving customers effectively will be more and more critical. Customers respond virtually immediately to new technological developments, new ways of interacting with their financial service providers, new ways of thinking. In many cases, consumers are themselves the engine of rapid change, through the adoption — and abandonment — of social media platforms or changes in attitudes to brands or sectors. It is difficult for large, long-established institutions to move at such speed. It is not easy for their leaders. Somehow we will have to learn how.

Change and complexity

The last eight years has been a period dominated, of course, by the aftermath of the global financial crisis; and by the efforts of political leaders, regulators and the financial services industry to stabilize the global economy and rebuild a financial sector which can play its proper role in promoting growth and prosperity. We are not there yet. Indeed, we will never get there if the goal is seen as a return to some pre-crisis golden age. Even if stability can be achieved within a sustainable macroeconomic context, the environment in which financial services operates will be very different from that of a decade ago.

If there is one theme which has underpinned our *Frontiers* articles in recent years, it has been the attempt to make sense of how the industry needs to develop next, and it often revolves around **the management of change in complex environments**. Those who reach positions of seniority and leadership in our industry will need to lead their organizations through this change by nurturing the talent and collaboration necessary to create the agility and alignment to execute at speed. They have to be explorers. And they have to have the courage to change, and to create change. ■

Can a strong customer covenant lead to lighter touch regulation?

By **Giles Williams**, KPMG in the UK



Giles Williams

Highlights

- With new players continuing to enter traditional banking territory, the age-old principles of financial stability, sound ethics and efficient operations are as valid now as they ever were.
- As alternative banking providers grow in size and importance, can they win customer trust without the need for heavy intervention — or will tougher regulatory demands stifle innovation and competition?

The emergence of new, often non-traditional, players in banking is gathering pace, whether they are companies from other sectors extending their brands, telecommunications providers seeking a share of the payments markets, or peer-to-peer lending and crowdfunding groups offering alternative ways to borrow and invest.

Since the global financial crisis, increasingly tough capital requirements are forcing banks to take fewer risks and scale back their lending. The most recent examples are the US Federal Reserve Board's (FRB) *Total Loss-Absorbing Capacity* (TLAC) and Europe's *Minimum Requirement for Own Funds and Eligible Liabilities* (MREL), requiring banks to hold

higher levels of capital as a safety buffer, to prevent the need for future bailouts.

These and other rulings are causing established banks to scale back, opening the door a little wider to fresh competitors, many of whom have enjoyed relatively light touch regulation. Once new entrants reach a critical mass, however, and become designated as 'systemically important', their activities will be under far greater scrutiny from consumers, the media, government and regulators, all eager to avoid scandals and ensure that customers' money is safe.

If such reassurance cannot be found, there is a strong temptation to deliver the same strict levels of regulation that apply to banks, which could ultimately

deter competition and diversity. The challenge facing non-banks, as well as challenger banks, is to build the kind of trust that convinces consumers and, more importantly, regulators, that heavy restrictions are unnecessary. In an age where the smallest error or incident goes viral over social media within minutes, this is no easy task.

A changing payments environment

We are becoming accustomed to new ways of making payments. Some public transit systems enable commuters to use contactless, prepaid cards, smartphones or even smartwatches to make their way through the barriers. ApplePay is just the latest in a stream of phone-based mobile payment systems offered by many banks and non-banks.

Numerous peer-to-peer mechanisms are surfacing, often for common interest groups as wide-ranging as parents selling used baby clothes, students sharing house bills, and online traders exchanging antiques and other items. The majority of these systems require pre-loaded

accounts that enable simple, one-click, instant transactions.

People use such vehicles because they have faith that their money will be delivered or received quickly. Given the rapidly evolving nature of the new payments markets, few countries have created regulatory frameworks. The current European Union (EU) E-Money Directive, in existence since 2009, asks for proof of appropriate systems and audit trails, but does not offer deposit protection — which has not dampened enthusiasm for new methods.

In the US, mobile money and e-money are unregulated, although any non-banks becoming significant issuers of e-money will probably be obliged, at some future point, to establish a voluntary reporting system, similar to that faced by travelers' checks issuers, to confirm the volume in circulation.

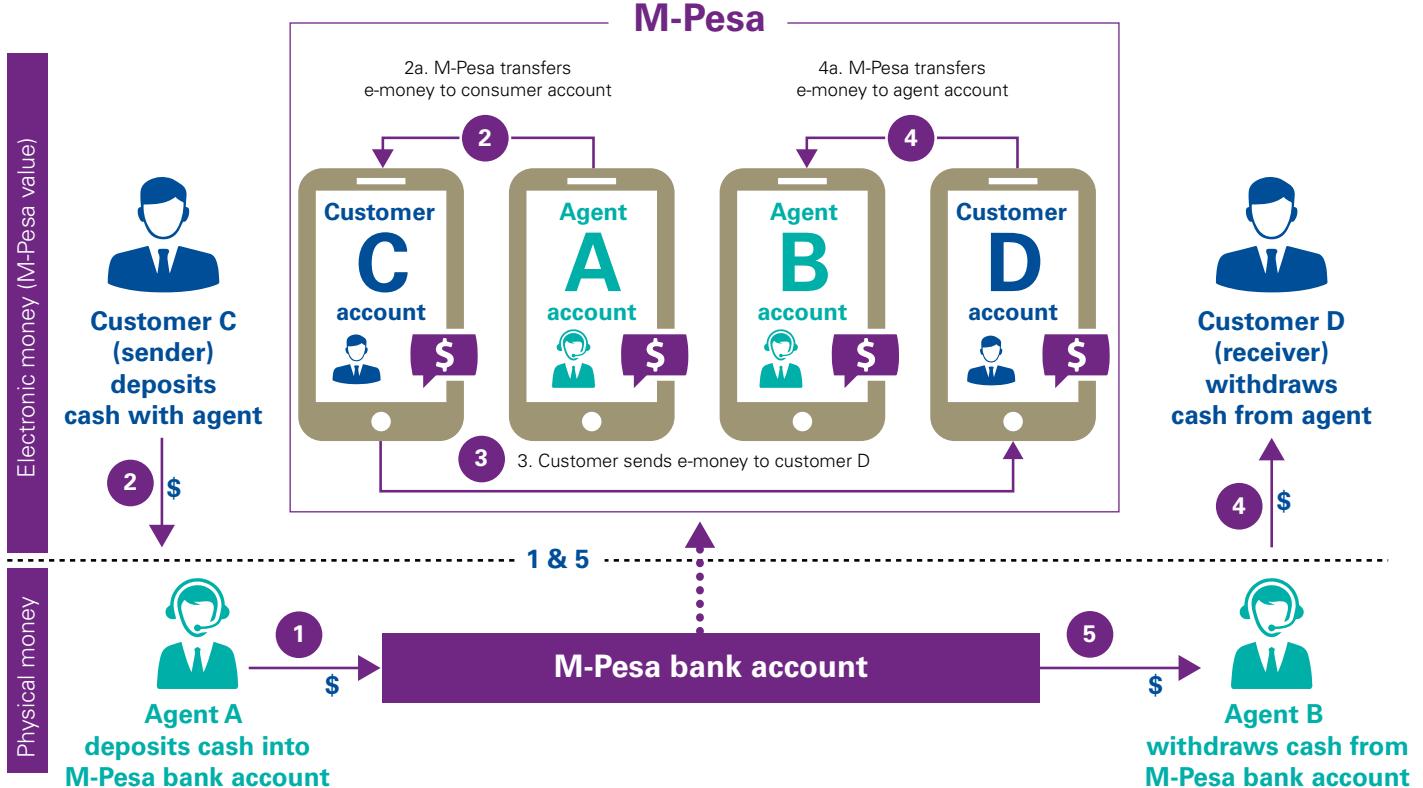
In many mature markets, mobile payments are still in their infancy, and regulators are adopting a 'wait and see' position. Total mobile transactions at retail payment points in the US for 2016 are projected at

just 0.16 percent of gross domestic product (GDP).¹ In the developing world, however, the concept is taking off much faster, most notably in Saharan Africa, Southeast Asia and Latin America.

Kenya's M-Pesa system, run by the country's largest mobile phone operator, Safaricom (part of the Vodafone group), is an interesting example. M-Pesa is now a part of daily life for Kenyans, with services including money deposit and withdrawal, remittance delivery, bill payment and microcredit. Customers load up their account with cash at over 40,000 retail points around the country, and the most recent figures available, from 2013, suggest that well over 40 percent of the country's GDP flowed through this system.²

Despite occasional glitches, where the system comes down, Kenyan citizens and businesses continue to use M-Pesa. Although not a fully regulated financial institution, M-Pesa has always sought to behave like one, by meeting the same levels of reporting, anti-money laundering, information technology (IT) security and know your customer (KYC) processes.

M-Pesa: How it works



¹ Mobile Payments Will Triple in the US in 2016, e-marketer, 26 October 2015.

² M-Pesa and the Rise of the Global Mobile Money Market, Forbes, 12 August 2015.

Key questions for non-bank financial services providers

- Can your business model withstand the costs of being fully regulated?
- Have you engaged fully with the regulatory authorities, in order to minimize the degree of regulation imposed?
- Have you considered how you can win a strong customer covenant?

Crucially, Safaricom's management has engaged closely with Kenyan regulators from the outset, to provide necessary assurance.

In virtually every country, existing mobile payments providers are not categorized as banks, so are not obliged to hold capital. As these payments start to take up a greater share of the wallet, and include larger value transactions, the potential for losing significant sums of money rises, which will almost certainly arouse the interest of regulators.

Diverse sources of credit

Behind many consumer and business-to-business purchases lies a web of lending organizations that support the leasing of vehicles, home improvement products, electronic items and other goods. Some of these lenders are banks (with ready access to wholesale funding markets), but many are not, and, so long as they do not achieve a critical mass, they remain unregulated.

Crowdfunding, peer-to-peer lending and unit funds all represent vehicles for credit, based upon funds gathered from a collection of investors. Those placing their money into such funds have less protection than a simple bank deposit. Loan-based crowdfunding platforms in the UK must be authorized by the Financial Conduct Authority (FCA) and are set minimum capital requirements.

Investment-based crowdfunding is regulated in the US for sums over 1 million US dollars (US\$) and must satisfy reporting requirements, although no capital limits are specified. As with other investment products, future rules are likely

to focus on transparency of information, in order to give investors a reasonable view of any risks involved.

Deposits and savings

Online and branch-based challenger banks are launching in many markets, typically aiming to offer lower-cost, customer-friendly banking. Although these institutions are not usually burdened with volatile investment banking businesses, they face similar regulations to traditional banks, most notably in the form of capital requirements. With limited access to wholesale funding, and a lack of scale to spread their fixed costs, the business model needs to be low-cost in order to be profitable.

Some countries, such as the UK, have tried to shake up their banking markets by easing regulatory barriers to entry for such institutions, with measures such as lower required capital levels and fast-track licensing.

India handed out licenses to over 20 new banks in 2015 and its Reserve Bank has pledged to begin what it calls an 'on tap' regime for licenses. In the past, a handful of licenses were granted every decade or so, but in the future, it is anticipated that approval would be given to any institution that meets the regulator's conditions.³

The past two decades have seen numerous companies from sectors such as retail and travel entering the banking sphere, as a form of brand extension. These organizations are regulated like banks, and, rather than presenting a full range of banking services, some are focusing on niches such as loans and savings accounts.

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Some countries, such as the UK, have tried to shake up their banking markets by easing regulatory barriers to entry for such institutions, with measures such as lower required capital levels and fast-track licensing.

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³ India's newly-licensed banks carry potential seeds of revolution, Financial Times, 12 October 2015.

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If the SIFI regulatory bar is set too high, it could deter new businesses from entering banking, thus preserving the status quo, and creating a two-tier system of established banks and (relatively) unregulated peer-to-peer lending.

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Despite taking a respectable market share, they have not been major disrupters—yet. However, by building up large amounts of data on customers' financial and retail behavior, they may be creating a platform for innovative new products and services that are unlike traditional bank offerings. This would give the regulators something new to think about.

Given the sensitivity of consumers, it's perhaps not surprising that deposits and savings services remain relatively conventional in form, whether offered by new or existing providers.

Regulation versus innovation

For the fifth year in a row, the 2016 Edelman Trust Barometer™ ranks financial services as the least trusted sector.⁴ Yet, in spite of financial crises, a widening choice of banking options and a new generation of consumers raised on online commerce, a substantial proportion of consumers remain loyal to banks. The added security of higher capital levels, tighter risk management processes, and, in some countries, guaranteed deposit returns (albeit, with an upper limit) may, to some extent at least, have soothed the nerves of customers. It seems that, no matter how low banking managed to sink in the public's affection, people are still wary of putting their money into alternative institutions.

Few would argue that additional regulation was necessary to curb the worst excesses of recent years, bring greater financial stability, appropriate risk-taking, and ensure that the organizational infrastructure, processes and controls are up to the task.

But, is regulation placing a stranglehold on innovation? The decision by GE to sell

much of its hugely profitable GE Capital financial services arm highlights the dilemma facing non-banks, or indeed, any new entrant to the arena. Having been designated a systemically important financial institution (SIFI) in 2015, GE decided that it did not want to endure the hassle of tougher and more costly rules that come with such a status. As regulations get stricter, other, similar companies might follow suit, which could reduce the flow of credit.

If the SIFI regulatory bar is set too high, it could deter new businesses from entering banking, thus preserving the status quo, and creating a two-tier system of established banks and (relatively) unregulated peer-to-peer lending.

We all want our money to be safe. And we all want healthy competition and new products that meet our personal and business needs and embrace new technology. Regulators, therefore, must consider how to temper the worst excesses of recent years, while leaving growing room for fresh faces.

New entrants, on the other hand, could do worse than to adhere to the time-honored principles of banking: secure deposits; fast, safe payment systems; prudent lending that borrowers can repay; transparent savings and investment products.

If new disruptors can meet these demands, while providing innovative services, and can win—and maintain—a high level of trust and consumer confidence, they may be able to thrive without such a heavy regulatory hand. ■

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Data insights: regulation's silver lining

Turning compliance into competitive advantage

By **Atul Subbiah**, Partner, KPMG China

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Highlights

- Regulatory reporting can help leading financial institutions learn more about their businesses through better data insights, and enhancing competitiveness, efficiency and risk management.
- Successful financial institutions adopt cultures that embrace the power of data, to aid decision-making.
- Single, standardized platforms for data management enable organizations to deal with current and emerging regulatory requirements, ideally through one abstracted system, speeding up the compliance process, reducing duplication and cutting costs.

Turn the pages of virtually any major financial services regulatory document and the word 'data' features highly. Banks, capital markets and other institutions are tasked with collecting, calculating and submitting hundreds of thousands, and possibly millions, of data points a month to regulators, with serious consequences for any errors or misleading conclusions.

Not only must reports be accurate, comprehensive and in a specified format, but, increasingly, regulators are demanding evidence of the source,

or 'traceability', of the data to verify its credibility. Satisfying these various requirements is a major headache, especially for those organizations with complex structures and disparate systems, where data is typically stored in a range of formats and must be pulled together manually.

With a host of different types of reports covering data associated with risk (e.g. credit exposures), finance, customer transactions, capital (e.g. trading details), treasury (e.g. liquidity levels), profit and loss accounts, and human resources (HR), there is inevitably a



significant overlap between different sets of regulatory requirements, and potential duplication involved in preparing submissions.

Governance is another hot topic. In the UK, the Senior Managers and Certification Regime (SM&CR), coming into effect in March 2016, introduces a new level of responsibility for senior individuals within financial firms who will become personally accountable for breaching regulations or causing serious damage to their institution. This regime, which could well be replicated in other countries, will put additional pressure on data quality.

Embracing a new data culture

Over the past few years, financial institutions have devoted much time, energy and money to develop processes for producing regulatory reports. Although some have managed to consolidate and rationalize their technology infrastructures, others have built systems in a piecemeal fashion as a reaction to each new directive. And, with many reports still prepared manually on spreadsheets, the pressure to meet deadlines is intense, especially when multiple regulations have similar submission dates.

What's more, the regulatory world never stands still, so amendments to existing requirements, or new initiatives, can put additional demands on existing systems.

Given the high degree of commonality between different regulations, now could be an ideal moment to establish standardized ways of managing data for every type of requirement. By investing in middle and back-office systems, and building an enterprise-wide platform for data, organizations can 'do it once and do it right' with a single data warehouse, rather than creating separate processes to satisfy each regulatory body. An integrated view of data across products should lead to more consistent, accurate reporting, with clear sources that can be traced instantly.

System upgrades can also involve joint ventures or alliances, or even acquisitions of specialist technology firms.

However, the potential for data lies way beyond mere compliance. Rather than being seen as a burden, the push to meet regulatory demands can instead

be viewed as an opportunity to harness the power of data to improve the quality of decisions and enhance the business. By valuing data as a genuine resource, companies can embed governance standards and build a 'data culture', with the support of technology.

Everyday decisions on trading, investment, risk management and loans can be transformed by the availability of powerful information that is more current, more complete and more accurate, enabling faster responses to queries and sales opportunities, and better risk management.

Chief data officers (CDOs), as data custodians, are in a unique position to lay the foundations for sophisticated data management strategies and coordinate information across the organization. With overall responsibility for data governance and quality, they can help raise analytic capabilities within finance, risk and business units, and link different functions such as sales, marketing, risk management, customer service and HR, utilizing the skills of centralized data aggregation specialists. CDOs are not purely internally focused, and should also be part of a bank's efforts to better understand customer needs by overseeing the way that customer data is collected and used.

Once companies have a common, standardized approach to data, there are further opportunities for automation through robotics, which can speed up processing times, raise accuracy and cut costs.

Raising the game operationally and commercially

Regulation can be a catalyst for improved data management, analysis and reporting, offering some remarkable insights. Organizations with a strong data culture and a systematic approach to reporting and analysis will gain a closer understanding of customer behavior, identify market trends earlier, and compare the performance of business units, teams and individuals. For example:

- By better understanding financial risk exposures, sources of income and customer bases of their trading desks, capital markets firms can now be

Do it once and do it right

An increasing number of banks are recognizing the benefits of integrated systems that provide a platform for different compliance needs and also support important commercial decisions by taking on a holistic data strategy that covers treasury, finance, capital management and risk.

Example 1

One multinational bank has created a new treasury platform that could meet and adapt to existing and emerging regulatory provisions (such as Basel III and Dodd-Frank), as well as provide automated risk reporting, improved controls, optimized cost of capital, stress testing and enhanced data analytics.

Example 2

In another instance, a major bank wanted to improve its liquidity infrastructure and reporting. This required coordination and input from the five business divisions as well as group treasury. The liquidity data had to be fit for both internal management information and external reporting, and be simple to audit. The new infrastructure produced much higher quality data and was able to support weekly, monthly and quarterly liquidity returns to the regulatory authority.

Banking and capital markets

compliant with the Volcker Rule and compare desks with one another to evaluate both the relative profitability as well as the risks they're carrying — something they had previously struggled to achieve.

- The quality data that has been reconciled with finance and produced to meet the Basel Committee of Banking Supervision (BCBS) 239 requirement can also be used to improve cross-selling, thanks to accurate models that predict customer propensity to buy. Costs should also come down, through lower operational losses (as a result of making better decisions on loans and other risks) and reduced capital requirements.

Retail banks are making all kinds of new discoveries about their customers, such as direct correlations between account balance levels and the propensity to buy new products. During a standard regulatory exercise, one bank found that it had relationship managers in certain regions, and thus did not need to spend further resources in these branches.

Advanced data insights offer more complete and up-to-the-minute knowledge, which enables capital markets firms to optimize portfolio composition and carry out trades faster. And, all financial services companies should benefit from faster analysis and more efficient modeling, which improve targeting and pricing, credit and liquidity models, and capital planning.

Global regulatory impact of data

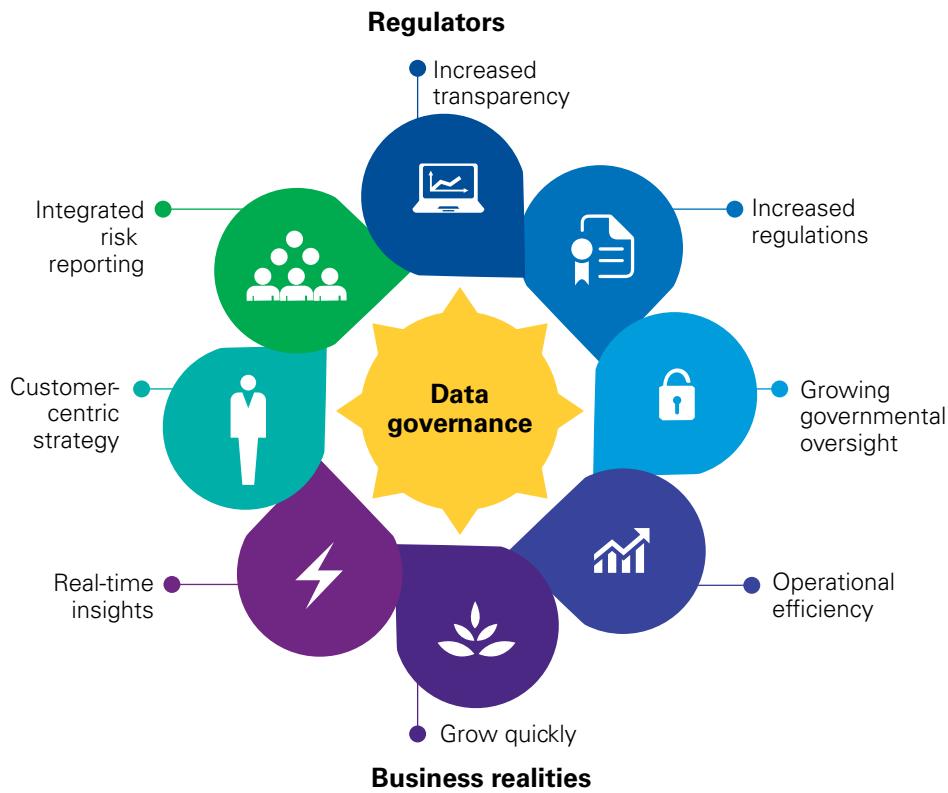
For global banks, especially those with regional operations in Europe, Asia and the Middle East, risk data aggregation has become a laborious task of aggregating risk data and positional/transactional data across various jurisdictions with the intent of complying with global as well as local regulations with the same goal. This is especially relevant in Asia where regulators are moving to an increasingly stringent risk-based capital framework. A variety of institutions look at BCBS 239 as a technology challenge,

Location	Qualitative objection?	Quantitative objection?	Budget	Cum. budget	Size	Basel status	Reasons for FRB objection
Japanese investment bank	No	No	US\$40 MM 2014 US\$60 MM 2015	+US\$ 100 MM	US\$106 BN	US Basel II compliant	<ul style="list-style-type: none"> — Passed — Does not include foundational B2 expenses, est. US\$250 MM
European investment bank	Yes	No	US\$10 MM 2012 US\$50 MM 2013 US\$50 MM 2014	US\$ 100 MM	US\$180 BN	Not US Basel compliant	<ul style="list-style-type: none"> — Inadequate governance and weak internal controls around data management and governance — Deficiencies in estimating revenue and losses for material aspects of its operations under a stress scenario — Global/local regulatory findings undermined credibility
European investment bank	Yes	No	US\$13 MM 2013 US\$50 MM 2014	US\$63 MM	US\$122 BN	Not US Basel compliant	<ul style="list-style-type: none"> — Inadequate governance and weak internal controls — Deficiencies in estimating revenue and losses under a stress scenario and for ensuring the appropriateness of loss estimates across business lines given a specific stress scenario
Spanish investment bank	Yes	No	US\$50 MM 2014 US\$50 MM 2015	US\$100 MM	US\$77 BN	Not US Basel compliant	<ul style="list-style-type: none"> — Widespread and significant deficiencies in governance, internal controls, risk identification and risk management, management information system (MIS), and assumptions and analysis that support its capital planning process
North American investment bank	No	No	US\$25 MM 2013 US\$35 MM 2014	US\$60 MM	US\$179 BN	Not US Basel compliant	<ul style="list-style-type: none"> — Passed, leveraged strong data — Starting from different place — Regulatory feedback focused on foundational risk management and risk identification; data management; capital policy; governance/effective challenge

Source: KPMG research 2015

whereas institutions that have a leg up view the issue as enabling a risk infrastructure that is quasi real time with a scenario-based risk analytical engine. This infrastructure would feed into the front line and business decisioning framework, where traders and the likes factor in funding costs, capital and liquidity implications, while factoring in counterparty and credit risk decisions. This becomes even more imperative when considering trade booking strategies for global banks in an era where capital is scarce and, ultimately, king. ■

Data governance



Key questions

- Has your organization considered the duplication in data requirements across different regulations?
- Do you have a plan for consolidating all regulatory data collection, analysis and reporting?
- Is compliance reporting a separate activity, or is it integrated with risk, as well as commercial and customer-facing functions?

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Recovery and resolution: preserving our engines of growth

By **Francisco Uria Fernandez**, Partner, KPMG in Spain
By **Richard Heis**, Partner, KPMG in the UK
By **Giles Williams**, Partner, KPMG in the UK



Francisco Uria Fernandez



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Giles Williams

As international banks seek to balance clients' expectations of universal service with politicians' demands to protect taxpayers from economic failure, it is becoming increasingly unrealistic to hold ever-larger amounts of capital and eligible liabilities. By rethinking their recovery and resolution plans, banks could significantly reduce the prospects of needing a bailout, and, in the process, demonstrate that they can function effectively on lower capital levels.

"Too big to fail." Four short words that have been the subject of unceasing debate since the financial world was turned upside down in 2008–09. The subsequent years have seen a number of regulatory measures designed to increase capital, tighten up governance and operating practices, and mitigate any further need for government bailouts of global systemically important banks (G-SIBs).

The latest of these initiatives was introduced by the Financial Stability Board (FSB) in late 2015 and relates to a bank's *Total Loss-Absorbing Capacity* (TLAC). It imposes stringent capital and eligible liability requirements on the largest banks in the world, meaning that in the event of a crisis, losses would likely be absorbed by those investors who bought the debt (rather than taxpayers). This debt would then be used to recapitalize — 'bail-in' — the bank. In future, these banks'

holding companies will have to retain levels of bail-in debt that roughly match shareholders' equity.

In the event of a crash, TLAC increases the chance of stabilizing a bank and restoring solvency, thereby buying time for an orderly restructuring and/or a solvent wind-down, all of which can help to ensure continuity of service to the wider economy. Few would argue with this as an aspiration. The critical issue becomes: Do the regulations allow the banks to continue to support the wider economy while still maintaining a safety net? In short: will TLAC make banking resolution a real possibility?

By 2019, the banks falling under TLAC will have to hold a minimum of 16 percent of consolidated, risk-weighted assets, expected to rise to 18 percent by 2022. When compared to the current Basel III threshold of 10.5 percent of regulatory (tier 1 and 2) capital, this is a big leap, especially considering the need for new eligible instruments for bail-in.

Facing a higher cost of capital, global banks can mitigate this cost by raising the price of credit, reducing shareholder returns, cutting their wage bills or exiting certain markets; meaning that banks ultimately have some tough choices to make in the upcoming years. The paradox is that a new regulation aimed to strengthen G-SIBs could make it more difficult for them to get the capital the new regulation is requiring.

On the other hand, the regulations could be the catalyst for banks to radically rethink their approach to recovery and resolution, to prevent the prospect of capital shortfalls.

A complex and uncoordinated regulatory landscape

TLAC has been released at a similar time to Europe's own separate capital buffer regulations, *Minimum Requirement for Own Funds and Eligible Liabilities* (MREL), imposed by the Single Resolution Board (SRB), a new European authority set up to address the issue of failing banks. European-based G-SIBs will now have to comply with both MREL and TLAC and reconcile two different approaches and potentially conflicting sets of regulations.

MREL and TLAC share the common objective of ensuring that banks have sufficient resources to absorb losses as well as stabilize and maintain market access. Nevertheless, there are some discernible differences, not least the fact that MREL is European-only and applies to over 6,000 banks of all sizes, whereas TLAC is global, and only affects 30 or so institutions. This will drive asset classes on the balance sheet and thus impact credit origination in the wider economy, which could affect, for example, jobs and growth.

The main difference between TLAC and MREL is that TLAC is a common requirement in percentage terms for all G-SIBs while MREL gives greater

Two broad resolution strategies: 'single' and 'multiple' points of entry

- Under 'single' point of entry, the entity at the top of the group is typically placed into resolution, with the subsidiaries continuing as going concerns. Such an approach helps to address the challenge of highly complex group interdependencies.
- In groups where local business units are largely autonomous, or where there are clear boundaries between different lines, a multiple point-of-entry may be preferred. This can only succeed where the local firms have sufficient independent funding and loss-absorbing capacity.

Another sensitive issue is the degree to which central banks and regulators seek to protect the interests of their domestic banks around the world. Without greater coordination between different regulators, and clear, agreed procedures for distribution of capital, the prospect remains of a possible 'asset grab'. Regulators, creditors, insolvency practitioners and legal entities could partake in a multiparty, multijurisdiction battle, especially in cases where some assets are looked after by one country, yet owned by another. In the midst of this scramble — which may well involve court cases and arbitration — the bank's customers could be the big losers, struggling to get back what is rightfully theirs. In Europe, the Credit Institutions Directive seeks to reduce these types of disputes between EU entities by giving primacy to the host country's process.

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The critical issue becomes: Do the regulations allow the banks to continue to support the wider economy while still maintaining a safety net? ”

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The relatively unilateral nature of regulatory development in the sector leaves international banks searching for ways to establish recovery and resolution plans that simultaneously satisfy different requirements.

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flexibility, with capital requirements set by the resolution authority on a bank-by-bank basis, taking into account the specific risk profile (indeed, very small banks may have no need for MREL, with current capital requirements sufficing). The European Commission is currently considering a way to reduce the gap between TLAC and MREL for affected European banks.

Planning your resolution strategy

The relatively unilateral nature of regulatory development in the sector leaves international banks searching for ways to establish recovery and resolution plans that simultaneously satisfy different requirements. Larger, multinational banks typically operate complex intercompany asset transfers and payments, which already creates considerable complexity.

Balancing incentives with safety

Arguably the most critical question is: **How can economies ensure that their banks avoid taking excessive risks, yet remain engines of growth capable of lending to businesses?**

Each increase in required capital levels could also limit the ability to provide much-needed credit to national and global economies. For example, TLAC demands greater levels of

loss-absorbing capital for higher-risk investments, which could encourage banks to become more conservative in their lending — or even exit certain markets. Before contemplating such a move, banks will have to consider how they will continue to serve global clients expecting a universal service; a goal that may no longer be economically viable for banks.

A lack of affordable capital, especially for higher-risk investors, could possibly stall growth, creating a form of economic sclerosis that could cause serious systemic harm. It could also open up the market for new players, possibly from outside the traditional financial services sector. However, if these lenders are not regulated, the level of risk (which TLAC, MREL and other rulings are designed to reduce) could rise. Some of these companies are no strangers to controversy, including incidences of regulatory arbitrage with relatively unsafe or boycotted countries.

Furthermore, capital requirements alone cannot remove all risk from the marketplace. Banks are also coping with other risks such as exposure to new, unproven technology, and clearing systems, both of which can increase the potential for fraud and money-laundering.

Big questions facing global banks

- How can you optimize your capital levels while maintaining a presence in key markets?
- To what extent are you engaging with local regulatory authorities, to agree on acceptable capital levels and risk and resolution plans?
- In the event of a collapse at country level, how can you safeguard customer deposits while also satisfying the demands of local regulators, creditors and administrators?
- How can you avoid raising the price of customer credit?

Consistency and simplicity

TLAC and MREL should both accelerate banks' creation of sound, well-drafted resolution plans, which can reduce, or even eliminate, the prospect of costly taxpayer bailouts. They could also lead to simpler bank structures, where, in the event of insolvency, assets are less likely to generate competition for ownership and instead be divided properly, in accordance with legal entities' rights. Both these developments could help persuade regulatory authorities to keep capital requirements at a more modest level, which could release some of the shackles on lending and stimulate economic growth.

Governments and regulators must, however, consider the wider market need for liquidity and try to avoid over-restrictive capital requirements that dampen the market. The lack of a coherent, cross-authority approach to regulation also adds unnecessary layers of complexity and uncertainty to the process of capital adequacy. Greater collaboration could help achieve more consistency and clarity over companies' positions, and aid the recovery and resolution planning process, which again adds efficiency and enables companies to create appropriate capital levels that protect them, without unnecessarily holding back lending power. ■

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Time to soar: CEOs of financial institutions expect more from their finance function

By **Morris Treadway**, KPMG in the UK
By **Martyn van Wensveen**, KPMG in Malaysia (ASEAN)
By **Maurice Lips**, KPMG in the UK
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Morris Treadway

Banking and insurance chief executive officers (CEOs) think it's time for their chief financial officers (CFOs) to shine. But many also have deep misgivings about whether the finance function — and its leadership — is ready to deliver real value to the business strategy.



Martyn van Wensveen

Winds of change keep blowing

Anyone that thinks that the financial services industry has been slow to change has clearly not spent much time in the finance function. Indeed, the last decade — the past 5 years in particular — have been all about change for finance executives.

Change has been driven from all sides: new accounting standards, increased capital adequacy and/or solvency rules, heightened reporting requirements, new regulatory directives and the recent shift towards more integrated reporting are just part of the change sweeping through the financial services industry and flowing into the finance (and risk) functions at financial institutions.

At the same time, bank and insurance CFOs also need to support the organization and its business strategy. New products are being introduced, businesses are being sold or acquired, non-strategic assets are being divested and new markets are coming into scope.

And with each change, the finance function has needed to respond.

Rise above the fray

While bank and insurance sector CEOs seem to sympathize with the plight of the finance function, most clearly expect their CFOs to rise above the challenge. In a recent global survey of more than 370 CEOs commissioned by KPMG International,¹ 67 percent of financial services respondents said they expect the role of their CFO to increase in significance over the next 5 years, the highest percentage among all C-suite executives.

The problem is that few of these CEOs seem to think their finance leadership is currently ready to take on this high profile role. The same survey found that just 53 percent of the financial services CEOs thought their CFO was viewed as a valuable business partner by the business. Only around a third of respondents believed that their CFOs truly understood the challenges



Maurice Lips



Peter Luscombe

¹ *The View from the Top*, KPMG International.

they face as CEOs. Just 19 percent thought that their CFO was currently playing a critical role in supporting the CEO and the board. Simply put, the data suggests that CFOs of financial institutions still have a long way to go if they hope to live up to their CEO's expectations.

Taking an enterprise-wide view of performance

A number of CFOs at the top global banks and insurers are now starting to focus on developing and improving their enterprise performance management (EPM) capabilities. Essentially, they are starting to recognize that — by combining financial data with operational and customer data through the latest wave of integrated EPM solutions — CFOs can start to take a leading role in helping to dynamically manage the planning and execution of the business strategy.

EPM delivers benefits across the organization. At the finance level, improved EPM capabilities enable finance functions to optimize their finance operations and dynamically generate more value-adding reports, allowing the finance function to become a more vital business partner across the enterprise. It can improve the speed, relevance and access to the type of performance reporting and analysis that creates real business insights when and where it is needed most: in the business. And it can help create better alignment between the organization's diverse back-office functions (such as risk, capital management, compliance and operations) to drive better end-to-end decision-making based on a single set of balanced key performance indicators (KPIs).

Improved EPM capabilities also allow the finance function to become a better — and more strategic — business partner. In some cases, this is achieved by driving valuable forward-looking analysis and planning through the EPM's integrated business and financial planning features. Using these advanced EPM functionalities enables finance functions to better anticipate and even predict business outcomes, leveraging sophisticated 'what-if' scenario-based analysis capabilities based on key business drivers, events and relationships. And, in doing so, it can help the finance function become more integrated with the organization's sales and operations planning processes.

This forward-looking EPM feature is especially important for financial institutions, as new accounting standards like IFRS9 for financial instruments and IFRS4 Phase 2 for insurance contracts (both life and non-life) forces them to disclose fair market values and net present value (NPV) calculations on their financial assets and liabilities. This, in turn, will likely make results more volatile and more transparent, which will lead organizations to demand even greater control than they have today.

Many financial services organizations are also seeking to improve their end-to-end performance in key areas such as customer performance. Some have even defined new roles specifically to support improvements in their end-to-end processes. As a result, some organizations are finding that EPM helps deliver a consistent end-to-end framework that ensures consistency in definitions, improves connectivity to show correlations and encourages the reuse of data to improve reconciliation.

From discretionary to mandatory

Perhaps most importantly, a strong EPM capability can enable management to make better business decisions. It can help improve speed and access to information. Leveraging new technologies (such as those on offer at the KPMG Data Observatory), EPM can deliver improved visualization and analytics capabilities, thereby empowering the organization with competitive insights. And it can make sure everyone is looking at consistent data from the same source, improving decision-making confidence. Essentially, it can help management answer the big questions that they are struggling to answer today.

This is exactly what CEOs say they want from their CFOs. Indeed, when we asked CEOs of large financial institutions what their CFO could do to deliver more value, three initiatives boiled to the top:

1. applying financial data analysis to help the organization achieve profitable growth;
2. using financial data analysis to create and implement new operating models; and
3. finding ways to turn the regulatory environment into a competitive advantage.

Questions to evaluate if your organization needs improved Enterprise Performance Management capabilities ...

1. Does your executive team have real insight into the group's true profitability by product, service/channel, country/region and customer?
2. Is your organization combining financial, operational and customer data to make better decisions and create a competitive advantage?
3. Are you able to anticipate future regulatory changes and use those insights to gain entry to new markets using innovative channels faster than your competitors?
4. Do you know which channels currently provide the best growth and profitability and do you have a plan for optimizing them?
5. Are you able to conduct collaborative planning across all of your business functions to optimize investment decisions and improve shareholder return while at the same time maximizing capital efficiency?

All three can be achieved through improved EPM capabilities.

As a result, most CFOs are starting to recognize that investing in EPM is no longer a discretionary activity. It is a source of potential competitive advantage, a way to better manage regulatory requirements and a path to improved efficiency and cost savings. As such, EPM is quickly becoming a mandatory capability for finance functions in the financial services industry.

More than just a reporting tool

We have used words like 'discipline' and 'capability' when we refer to EPM, rather than 'software' or 'solution'. That is because EPM is much more than simply a tool or software package that is 'bolted-

on' to consolidate and analyze global data from existing ERP systems. In fact, the real value of EPM comes only when the organization — led by the finance function — starts to turn that data into real, reliable and actionable insights. And that requires a holistic approach to EPM that spans the enterprise and the whole operating life cycle (as illustrated in Figure 1).

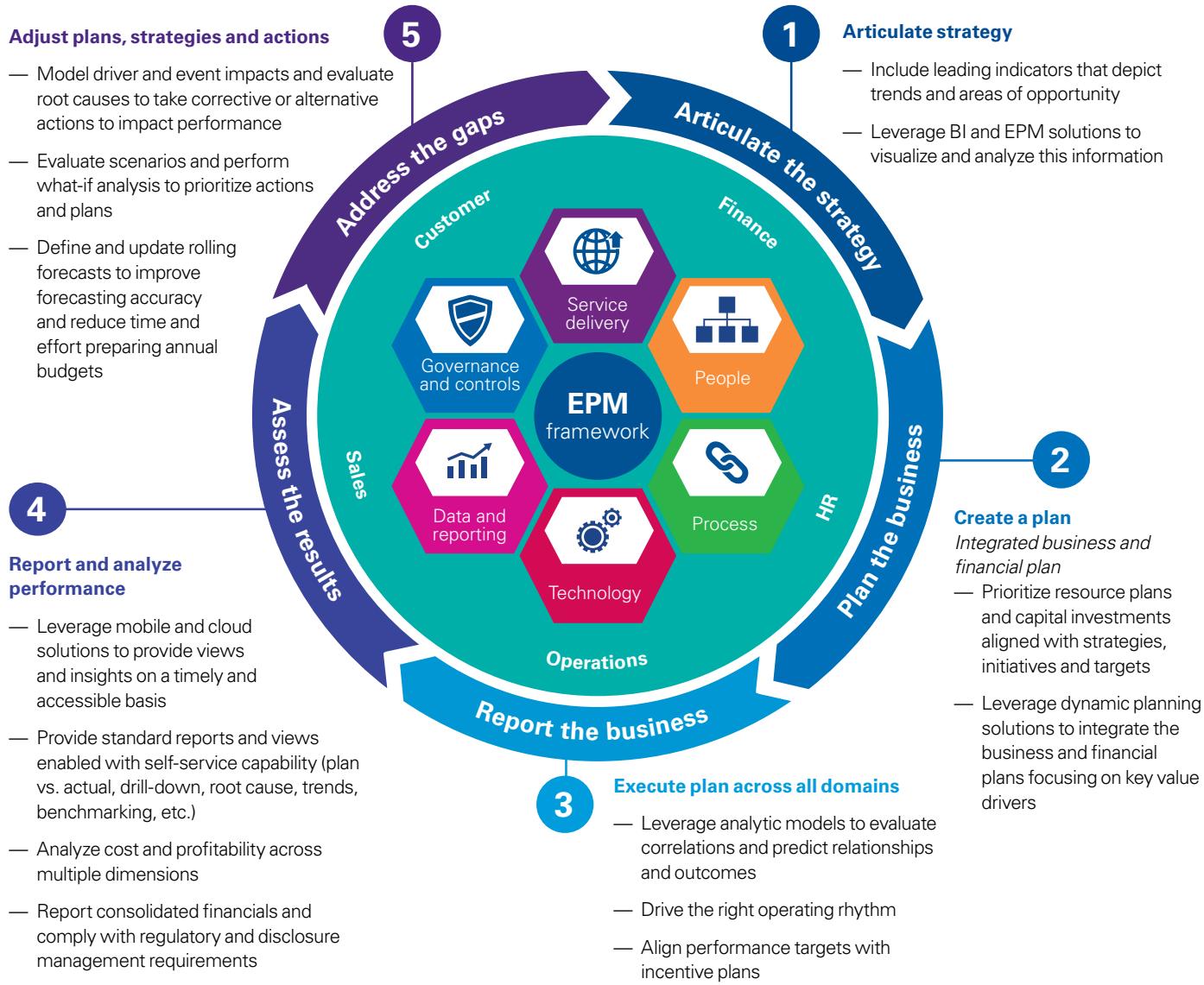
To start, organizations may want to consider flipping the historical 'plan-do-check-act' approach on its head. Indeed, creating a robust and appropriate EPM program requires finance functions to start with the 'act' (i.e. what insights does the business need in order to act), and then 'check' what information is required and whether it is available.

Only then should finance functions move onto the 'do' of building the solution and, ultimately, the planning that can be achieved once the information is available. Once EPM programs are in full swing, finance functions can then go back to the traditional and continuous 'plan-do-check-act' life cycle process and culture.

Become a value player: Solve the business' problems

Securing 'buy-in' from the business for a new approach to EPM is not easy; fatigue with new change programs is high and executives are competing fiercely for resources for their own programs. But buy-in is critical, not only at the executive level but throughout the business and across the enterprise.

Figure 1: EPM leading practices enable a continuous 'plan-do-check-act' process and culture



Source: KPMG International 2016



In this busy environment, CFOs may want to start by helping the business answer one specific (yet critical) management question: *“How can I best help you achieve your business goals?”* Maybe it’s about finding the optimal pricing mix for their products and services. Maybe it’s about identifying the right acquisition targets to drive profitable growth. Or maybe it’s about identifying the most profitable customer segments and channels.

The key is in working collaboratively with the business to solve their problems and then using that opportunity and outcome to drive greater appetite for more advanced EPM capabilities within the business.

A business-led approach

When we work with banks and insurance CFOs to create stronger EPM life cycle discipline and improve their EPM capabilities, we focus on creating a holistic EPM model and approach that recognizes the transformation that is required in process, people and technology to allow CFOs to drive real value from their finance teams.

In doing so, we lead our clients through a business-led technology transformation that instills the necessary EPM awareness, capabilities and skills across the enterprise and throughout the business, helping CFOs meet the evolving and increasingly sophisticated demands of their organization. ■

Bank CFOs leverage EPM to become more strategic

Most banking CFOs are already well on their way to moving from being a scorekeeper to becoming a business partner. But EPM enables CFOs in the banking sector to move one step further by allowing the finance function to combine multiple sets of data — financial, customer, risk and operational, for example — to provide the organization with deeper, more valuable and more strategic reports.

Our experience suggests that the ability to leverage and adopt new technology and approaches will be key. Some of the leading banking CFOs are already using data visualization and predictive analytics to collect, analyze and communicate key data sets. And early adopters are now investing in robo-advisors and other automated technologies that can reduce or eliminate manual intervention.

Aligning the risk and finance functions of insurance companies with EPM

For insurers, one of the big benefits of EPM is closer alignment between the finance and the risk functions.

Creating this alignment is more important today than ever. The finance function is critical to measuring and reporting financial metrics such as gross premiums, investment returns, claims paid and overall profitability, while the risk function needs to estimate the technical reserves based on a complex array of actuarial models covering insurance, market and operational risks. Together, these two form the basis for the all-important equity and solvency ratios of the company.

The latest generation of insurance-specific EPM systems can bring both worlds more closely together. Not only are they able to generate the usual financial and certain regulatory reporting requirements, but they can also support the integrated business planning and management reporting needs of the company through innovative data cubes, on-the-fly dashboard generators and real-time analytical capabilities.

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To learn more about KPMG's approach to Enterprise Performance Management, please see our report:



The view from the top

KPMG International teamed up with Forbes Insights to survey 549 CEOs, business owners and chairmen of large global companies to understand the expectations of a global CFO from the perspective of their CEO. *The view from the top* discusses the key findings and the rise of the 'Renaissance CFO'.

Grow or go: Insurance groups take a portfolio approach to growth



By **Mike Walker**, Global Insurance Restructuring Lead, KPMG in the UK

By **Matthew Smith**, Director, Insurance & Investment Management, Global Strategy Group, KPMG in the UK



Mike Walker

In today's insurance environment, victory belongs to the bold. Margins are under pressure and competition is heating up; insurers can no longer afford to 'sit' on businesses that are underperforming or subscale.

Our experience suggests that — by taking a portfolio approach to their businesses — insurers can start to assess the value and performance of their non-core assets to make bold decisions on whether to 'go' (exit) or 'grow' (build) the business.



Matthew Smith

Time for bold decisions

Facing continued low interest rates, growing rate pressures in the property and casualty (P&C) sector and high levels of competition in both the P&C and life sectors, it seems clear that insurance industry margins will continue to face downward pressure for the near future.

Not surprisingly, most have already undertaken massive cost reduction initiatives in an attempt to shore up margins.

And now, with little room left to cut, some are starting to take a more critical and strategic view of their business as a whole.

Our experience suggests that insurers now need to take bold action and make difficult decisions if they hope to create shareholder value and grow their business. The reality is that too many insurers are carrying businesses that are subscale, underperforming or simply distracting for management.

Assessing your non-core businesses and local operations

- Does the business or operation meet the group profitability and return on earnings (ROEs) thresholds?
- Can the business realistically achieve 'above average' market share growth?
- Does the business or operation target customer segments that play to your strengths?
- Does the distribution strategy support the broader strategic goals of your organization?
- Does the business or operation create value within a diversified strategy?
- Does the business or operation allow management to focus on strategic objectives?

If you answered 'no' to any of these questions, then it may be time to make a 'go' or 'grow' decision.

Taking a portfolio view

We firmly believe that there are significant opportunities to help insurers enhance shareholder value by taking a portfolio view of their non-core assets. And, in doing so, insurance organizations should be able to make clear decisions about whether to 'go' (i.e. exit those markets and businesses that do not meet the strategic objectives of the organization) or 'grow' (i.e. committing to targeted investment to drive transformational change and improvement initiatives that will allow the business to compete effectively).

Indeed, by looking at non-core businesses as a portfolio of assets, insurance executives should be able to properly *assess* each business' strategic fit, performance and synergies which, in turn, will enable them to identify opportunities to *improve* the business through portfolio realignment.

Taking a portfolio view will also provide insurance executives with the insight needed to *prepare* a 'fix, close or sell' strategy that drives a clear approach for non-core assets, and then move through to a robust *execution* plan with appropriate governance.

Go: a bespoke approach to divestment

In those cases where the assessment process leads to the decision to 'go', insurance executives will need to develop a smart divestment strategy for the

business. Interestingly, our experience suggests that the divestment process has evolved considerably over the past decade.

Whereas, in the past, the normal approach to selling a business involved rigid auction processes based on standard checklists and documents, such as information memorandums and vendor due diligence reports, most now recognize that this approach may not be fit for purpose to maximize value.

Instead, insurers are now taking a more bespoke and focused approach to divestment that is largely influenced by four key factors:

- economic conditions
- sellers taking control
- wider buyer populations
- business model changes.

Grow: more than just scale

Insurers need to have sufficient optionality and diversification to respond to a rapidly changing business environment. And while not all divisions and local operations need to be 'market leading', they do need to demonstrate how they can make a positive contribution to the overall strategic ambitions of the organization.

For some, the answer will come in the form of inorganic growth within their subscale businesses. For others,

Seven practical tips for successful divestment

1. **Conduct a rapid readiness assessment:** Focus on informed planning and preparation
2. **Evidence the sales messages:** Prove why the business would be an attractive purchase
3. **Present a robust information package:** Make sure messages are consistent and coherent
4. **Deal only with credible bidders:** Work with bidders you know and trust to deliver
5. **Anticipate the value chips:** Assess any issues or uncertainties that bidders could use to negotiate the price
6. **Be clear about the impact of separation:** Don't underestimate the costs and operational implications
7. **Manage the 'soft' issues:** Ensure you have the required skills, agility and capability to meet the objective

targeted investments to support product growth initiatives or new distribution arrangements offer a lower-risk solution.

However, while many deals have been driven recently by organizations with a (fully understandable) strong focus on costs and efficiency seeking to achieve scale, we often find that scale, in itself, is not a good enough reason to support a deal. Indeed, we believe that acquisitions must also bring complementary capabilities (such as new expertise in specific product lines, increased geographical reach or new distribution models) in order to create a sustainable platform for future growth.

Assess your options

- What capabilities (products, distribution channels, technologies, etc.) do you need in order to meet your strategic aspirations?
- What assets are currently available to help bridge any gaps in your capability needs?
- Do you have the alignment and appetite for making the required investments or partnerships?
- Do you have a plan or strategy for integrating these assets to drive growth?

Grow: responding to a changing environment

New technologies, changing customer demands, new ways of doing business and the threat of innovators

disrupting the traditional business model are all changing the way that insurers view their portfolio of assets and businesses.

Clearly, understanding and capturing the benefits of innovation is a critical imperative, and there are major opportunities available for companies willing to invest in new technologies. Recognizing this, many insurers are now starting to develop new models and ways of working with the financial technology (FinTech) community.

Interestingly, our experience suggests that — in this rapidly evolving space — outright acquisition may not always be the right answer. As a recent report by KPMG International demonstrates, many insurers are now exploring the value that could be generated by investing in partnerships, alliances and innovation hubs in order to broaden their exposure to new innovations and technology solutions.

Key takeaway: be bold

Regardless of whether the decision is to 'go' or 'grow', insurers need to start facing up to the difficult decisions that must be made about their underperforming assets.

Simply put, insurers can no longer afford to sit on businesses that are not delivering value; they must make bold and decisive decisions, and then execute on them in order to win in this environment. ■

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Expect near-term deal activity to be focused on:

- the acquisition of companies that offer complementary capabilities (such as the ability to access customer segments in a user-friendly format driven by the customer)
- partnerships to support and develop innovation (such as incubators and innovation hubs)
- partnerships that create infrastructure to reduce the protection gap
- joint ventures and alliances that bring together complementary skill sets (such as behavioral analytics capabilities to support sales and product development).

Blockchain hitting the big time, but is it ready?



By **Joe Cassidy**, Partner, KPMG in the UK

By **Eamonn Maguire**, Managing Director, KPMG in the US

By **David Montes**, Managing Director, KPMG in the US



Joe Cassidy



Eamonn Maguire



David Montes

Interest in blockchain technologies grew significantly in 2015, with venture capital investment, in particular, growing from \$298 million in 2014 to almost \$460 million this year. This interest in distributed ledger technologies is remarkable given that 5 years ago, it was barely a blip on investor's radars, known mostly for underpinning the Bitcoin digital currency.

Interest in blockchain gaining momentum

These days, a wide range of companies are exploring blockchain as the potential solution to numerous challenges both inside and outside the banking sector. During 2015, Citibank, Santander, Wells Fargo, HSBC and numerous other big banks announced partnerships with FinTech companies looking to leverage blockchain to make banking processes more efficient, timely and secure. At the same time, IBM moved forward with an open source blockchain initiative in tandem with numerous partners, from the London Stock Exchange to technology companies like Cisco and Intel.

These organizations, along with a number of others, believe the potential disruption blockchain could create — in terms of decreasing transaction times, self-automating smart contracts, lowering transaction costs, minimizing fraud and opening the door to micro-transactions — is impossible to ignore. As a result, interest in blockchain is gaining momentum, with investment expected to grow into 2016.

Being honest about the challenges with blockchain

But does the potential live up to the hype? While blockchain's potential is interesting, there are substantial barriers that must be overcome in order to

implement it successfully within banking and capital markets. Regulatory and market changes in particular could hamper blockchain's use on a global scale. Some analysts also suggest that blockchain has been burdened with excessive investor expectations — ones that cannot realistically be fulfilled. At the rate investment is growing, it's possible that investors looking for immediate, short-term success may be disappointed.

Corporate investors need to qualify their expectations when it comes to blockchain — and the obstacles associated with achieving value. The technology is not a silver bullet that can solve every problem tomorrow. As with every technology, blockchain solutions will need time to be tested and to be adapted to the industry requirements at scale. We already see early adoption in some payments use cases, but as the complications grow with asset transfers, for example, more time will be needed to qualify the technology and understand the full implications. To get the most value from blockchain, corporate investors need to be less hopeful and more pragmatic. They need to encourage industry-focused engineers to define the problems blockchain can help resolve, find the best and most cost-effective technology solutions, and work through limitations to scope, scalability, velocity and usability.

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The technology is not a silver bullet that can solve every problem tomorrow. As with every technology, blockchain solutions will need time to be tested and to be adapted to the industry requirements at scale.

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The key to success is the combination of the right skills:

- cryptography
- distributed ledger technology
- deep industry and regulatory experience and knowledge
- technologists who can effectively navigate clients through the current IT landscape.

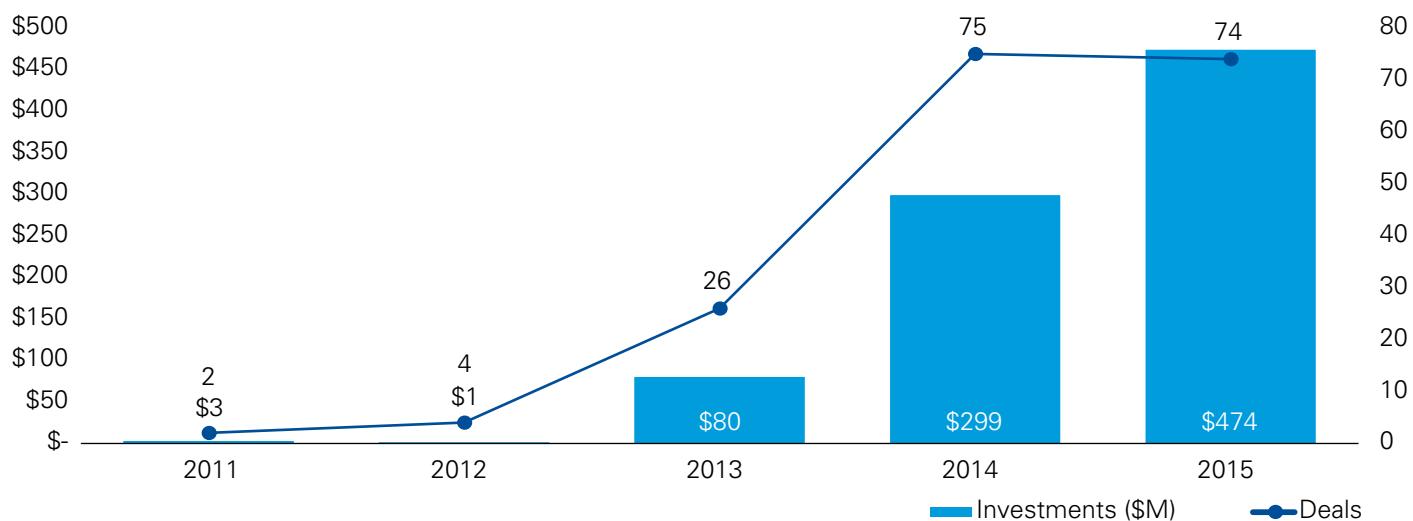
There are significant challenges with respect to each of these areas when it comes to status quo application of distributed ledger solutions to the mainstream components of the banking system.

For example, right now, blockchains created for and demanded by regulators

are not scalable to a degree that can fundamentally replace large scale, high availability platforms. Nor do they provide the speed, ubiquity, application program interfaces (APIs), or controls environment needed by banks and demanded by regulators to conduct day-to-day activities. In addition, many banks continue to work with antique legacy IT systems, which may not be capable of supporting blockchain initiatives or will provide significant challenges if linked to new blockchain technologies. In the area of payments, the technology based on Bitcoin consensus mechanism consumes more computing power and will require initially more resources than the current solutions used by many banks. Beyond these technical challenges, there are some specific areas where fundamental issues relating to business models need to be addressed.

Blockchain and Bitcoin investment activity — Deal volume for global blockchain investment on the rise in 2015

VC-backed companies, 2011-15



Source: *The Pulse of FinTech, 2015 in Review, Global Analysis of FinTech Venture Funding*, KPMG International and CB Insights (data provided by CB Insights) 9 March 2016.

“
Corporates that encourage use-case testing — whether for the securities trading life cycle, the processing of a loan or digital identify verification — and who can learn from this experimentation, will be better positioned to adjust course and achieve the most value. ”

Business model challenges for blockchain

The models by which these use cases are being developed vary greatly. They include utilizing open source protocols, such as Bitcoin or Ethereum, to federated server models, better known as permissioned blockchains or those that support a consensus model amongst known and, possibly at a later stage, potentially unknown parties. Many of today's prominent permissioned blockchain use cases had their origins building APIs on top of the Bitcoin blockchain, such as Chain and Digital Asset's Hyperledger solution. There is an acknowledgment amongst major financial services companies that preference can be found for permissioned networks built for specific markets and product classes. These networks can issue and transfer assets directly between parties who control the assets and are preferable to an initially permission-free technology platform. As a result, many providers began to build their own proprietary blockchain solutions to test those specific use cases that were most in demand by their clients. These included creating solutions addressing the Bitcoin protocol challenges with regards to security, efficient consensus mechanism, scalability, regulatory risk, etc. The result is a fragmented marketplace in which it is critical for clients who are experimenting with blockchain solutions to align with the provider and protocol that will provide the most economic value for any particular use case of interest.

Evidence of the fragmentation across solution providers can be seen in the variety of blockchain/distributed ledger solutions use cases. Solution providers have focused their blockchain solutions on capital markets use cases such as post-trade settlement, syndicated loans and privately held shares to name just a few. This is not to say that these solutions can't and shouldn't be looked at for other use cases. Chain, for example, is supporting the trading of privately held shares proof of concept for NASDAQ, but also has a smaller blockchain for gift cards set up as well. At the same time, Ripple has determined that the optimal use for its network is both domestic and cross-border cross-currency payments and has focused on the payments area after initially pursuing use cases in the post-trade area. Other investment and resource focus decisions on specific use cases are being driven by the nature of the clients, the potential economic benefit and the demand in the marketplace. For a particular use case, the level of focus should be a key consideration when deciding which solution to select as limited funding for new providers may drive resource allocation decisions.

Another key point to consider is that while open, public protocols utilize very specific cryptographic consensus methods such as proof of work, permissioned ledger cryptographic methodologies differ by

solution provider ranging from multi-signature validation to practical byzantine fault tolerance (PBFT) or proof of stake to using traditional change management technology. As a result, solutions must be vetted across a range of capabilities and chosen based on potential value delivered by use case.

The scalability challenge

An additional challenge blockchain/distributed ledger technology needs to overcome is related to the scalability of these point-to-point, bilateral solutions. In the world of permissioned blockchains, in which the majority of large financial institutions will play, scalability may be less of an obstacle depending on the number of nodes required to validate transactions. Larger scale distributed ledgers like those proposed for international payments promising real-time clearing and settlement obviously have more at risk. The asynchronous and ad hoc peer-to-peer nature of these systems poses challenges when compared with the natural throughput of transaction processing engines written in assembler code designed specifically for the processing of higher volume transactions. Solutions to this issue, such as not having reliance on one global system (much like side chains for the Bitcoin protocol), have been discussed but have not yet been validated. Utilizing innovations such as those being developed for web payments may have promise but to date have not been proven.

For financial services organizations, these issues could significantly impact their decisions and plans to move to new distributed ledger platforms. Taken together, these challenges illustrate why there is still a long way to go to gain widespread regulatory acceptance for blockchain within financial services.

Short-term blockchain opportunities do exist

In spite of these challenges, there are still many reasons to continue to pursue innovation in distributed ledger technologies as the potential benefits associated with a breakthrough down

the road are great. One area we see the technology offering particular benefit, in the short term, is digital identity — or what others are calling a digital financial passport. Many banks are excited about this opportunity and can see positive improvements related to how digital identity is currently being facilitated and enabled at banks. Improvements in this area could enable better choice and portability of customers between financial institutions and ultimately higher customer satisfaction as individuals are able to take control over and gain benefit from their own identity. Beyond digital identity, there are a number of other important niches where blockchain could make early gains as well.

Now is the time for experimentation

Given how the technology is evolving, at KPMG, we believe that now is the time for experimentation, not for wholesale technology implementation. Corporates that encourage use-case testing — whether for the securities trading life cycle, the processing of a loan or digital identity verification — and who can learn from this experimentation, will be better positioned to adjust course and achieve the most value. More widespread implementation at this stage could have serious financial consequences should the technology not live up to expectations.

In regard to testing, we see some early examples of this trend taking hold in the marketplace. A great number of the major financial services institutions we work with have proof of concept (POC) and prototype initiatives underway related to blockchain. Larger financial institutions, such as JP Morgan Chase, are now considering how to test for scalability, validate initial hypotheses, build longer term target operating models and enhance business cases based on their POC/prototype results.

We are also seeing work being done related to enhanced international payment capabilities as well as the application of distributed ledger principles to needs for identity management and

other areas. It is clear that the move to test and experiment with distributed ledger technologies is well underway in financial services.

A balanced approach

Having said that, investors need to take a balanced approach to their blockchain investment strategies. To be the disruptor investors envision, blockchain protocols and solutions must evolve to support the reliability, efficiency and scalability requirements expected in the industry. It also needs to be a differentiator, rather than simply an enabler. And, it needs to be adoptable by all parties in the banking supply chain — a fact that will require significant collaboration across industry, regulatory bodies and those supporting potential solutions.

There's little doubt that investment in blockchain has taken off recently, but relative to other FinTech areas such as robo-advisory, machine learning or alternative lending, the scale of investment is still modest. The ability for blockchain to become a true game changer is still in process. Investors need to look beyond the hype and ensure that any technology solution is underpinned by exceptional engineering, a full understanding of the barriers, and clear economics on the costs and benefits associated with the technology.

In this regard, we see many organizations and engineers now undertaking deeper analysis on blockchain and a more balanced and pragmatic view emerging. We see ourselves as part of this group and advocate toward selective and targeted experimentation as a first priority that will yield greater benefit down the road. ■

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Africa rising



Bob Diamond
Founder, Atlas Mara

By **Bill Michael**, EMA Head of Financial Services for KPMG



Bill Michael

With massive growth potential, growing affluence and widespread stability, many financial services executives recognize that sub-Saharan Africa boasts tremendous long-term growth potential. The fragile state of the global economy has created some economic headwinds for Africa; however, the medium and longer term opportunities remain compelling. Yet few global organizations have made any real headway in this diverse and complex set of markets. At the same time, global banks in all regions are actively reconsidering their portfolio with an eye to reducing their footprint to better manage diverse regulatory standards among other challenges. This means some have been asking how Africa fits into their future plans. This consideration leaves room for others to potentially fill the space created and become stronger

regional entities. Bill Michael, Global Head of Banking and Capital Markets at KPMG, recently spoke with Bob Diamond of Atlas Mara about how his firm finds a measure of opportunity where others see challenge and why.

Over the past 2 years, a newly emerging regional player — Atlas Mara — promises to not only radically change the way banking is conducted in Africa, but also offers a new vision for sustainable banking and business in this rapidly changing region.

African opportunity

It is the world's second largest and second most populated continent, it is home to more than a billion people, and by 2030, it will boast 40 percent of the world's population; by 2040 it will surpass China in terms of working age population. Yet this population is massively underserved by the financial services industry. Just a handful of global banks operate in the region and most insurers are only now trying to assess how they might tailor their products to meet the needs of disparate African markets.

In the past 2 years, that picture has begun to change. A real, fast moving example is Atlas Mara, founded by Bob Diamond (the former CEO of Barclays) and Ashish Thakkar (a highly successful African entrepreneur) and backed by investors from the US, Asia and EMEA. The company has acquired eight banks in seven countries in sub-Saharan Africa with further plans for acquisition and growth. It now has more than 1,600 employees and more than US\$2.6 billion in assets across seven markets.

According to Bob Diamond, there is a tremendous need for new banking models in Africa. "The traditional banking model in sub-Saharan Africa is to take deposits and invest them into domestic t-bills but that essentially means there is almost no lending to consumers or businesses," noted Mr. Diamond. "If you are an international company, you can borrow from international banks, and if you are a Chinese company, you can borrow from China's banks, but if you are a small business or an entrepreneur in Kigali or Lusaka, your options are extremely limited."

"When you see stories like Rwanda which — just 21 years ago — was going through a genocide and today is widely viewed as one of the 10 fastest growing economies in the world, it drives home the fact that Africa's rise is sustainable and stable," added Mr. Diamond.

Atlas Mara's experience also illustrates how regulatory regimes have opened up across the continent and how governments are taking a more active role in driving positive change in their economies. When the group purchased BancABC (a leading bank in five African markets) in early 2014, they managed to secure regulatory approval from six different regulatory bodies in less than six months. "It would take a year or two to gain that type of regulatory approval for a foreign investor in the developed markets but Africa's regulators are willing to work hard to attract permanent capital with the know-how to operate."

Mr. Diamond and his partner Ashish Thakkar firmly believe that sub-Saharan Africa has significant potential over the long term. Affluence is rising in most markets throughout Africa, enabled by significant innovation in technology and a corresponding growth in quality data and information. Despite this, regional trade between African countries remains low, making up less than 20 percent of the economic activity in the region, levels far below that of other regions. Alta Mara views the growth potential as tremendous. In their view, enhancing the volume and quality of business lending in Africa delivers more than just banking revenues, it will also pay immediate dividends by enhancing the prospects for trade within the region.

At the same time, new regional trade blocs are gaining momentum and Africa's small businesses are starting to look to neighboring markets for new growth opportunities. "We believe that trade between African markets is about to grow tremendously which, in turn, will bring massive opportunities for financial services organizations across the board," Mr. Diamond added.

The bank for African businesses

Atlas Mara sees a direct correlation between the African economy's success and their company's success. This success is predicated on increased investment in infrastructure, continued good governance and growing demand for customer-focused, innovative financial services.

"We want to be known as the bank for small business in Africa, and we have really focused on fostering relationships with entrepreneurs, small businesses and SME corporate organizations in the markets in which we operate," noted Mr. Diamond. "In our first year as full owners of BancABC, lending was up more than 10 percent but — more importantly — our non-performing loan levels went down."

In part, Mr. Diamond attributes the bank's success to creating specialized lending units targeted to a wide range of potential customer segments such as women, agricultural businesses, tourism and traders. In agriculture, for example, the bank focuses on helping farmers hedge their agricultural output in order to help them invest for the future. Underpinning this segment-specific focus is the organization's successful application of data and analytics to risk modeling for lending. Using a data-driven, analytic approach, Atlas Mara has achieved a much more focused and risk-intelligent view of the market which, in turn, has allowed decision-makers to see both risk and opportunity.

At the same time, Atlas Mara is also benefiting from the better and wider application of best of breed, standard

“Every one of us has this vision that this isn't a job, it's a career, and everyone is willing to walk through walls to achieve our goals.”

banking practices commonly in place in major global banking operations. By applying these practices to less developed banking markets, the company is establishing a competitive advantage. "Many of these things have been available in other markets but have not traditionally been applied in Africa, so they are really quite innovative from a sub-Saharan Africa point of view," Mr. Diamond added.

Taking a long-term view to success

While Atlas Mara has certainly moved quickly to cement a top-ranking position in its markets, the team is clear that building a sustainable footprint in Africa is a long-term investment and opportunity. "Every one of us has this vision that this isn't a job, it's a career, and everyone is willing to walk through walls to achieve our goals," Mr. Diamond boasts.

The team also recognizes that — their experience with BancABC aside — acquiring a banking asset can be a difficult and time-consuming proposition. Not all markets are ready for investment, so selecting the right markets is key. Identifying a top-ranking bank and then acquiring controlling ownership can be tricky depending on the regulatory requirements and restrictions.

Mr. Diamond points out that new owners need to run the bank for some time before they can start to fully integrate the systems and technology. "You need to look at Africa as a 5- to 7-year project

rather than a 1- to 2-year strategy," warns Mr. Diamond. "Africa requires investors and participants to take a long term view."

As a case in point, the Atlas Mara team views the recent drops in commodity prices as a short-term challenge but a long-term benefit for Africa's resource- and commodities-dependent markets. "I think we'll be pleasantly surprised at how well sub-Saharan Africa manages through this change in the commodities cycle," he said. "Yes, it will bring some challenges, but in the long-run, I think we'll see countries really start to manage their resources more efficiently and focus on developing new — or improving existing — industries."

Mr. Diamond and his team are keen to share their story, with the hope of inspiring other companies and financial services organizations to take another look at Africa. "All of my experience in Africa with Barclays and all of our experiences over the past 2 years have made it very clear that Africa is open for business," he says.

However, Mr. Diamond also has some advice for those looking to make their first moves to tap into Africa's growth potential. "You always have to remember that sub-Saharan Africa is made up of 46 different markets," he advises. "There is certainly a consistent sub-Saharan feel — made even stronger by the growth of the four key trading blocs — but each market can be vastly different; you simply can't approach it with a one-size-fits-all approach."

Ultimately, he suggests that the uniqueness of each market is what makes Africa such a special place to work. "Nigeria is massive — more babies are born there each year than across the entire EU region — and growing rapidly supported by oil wealth and resources. On the other side are countries like Rwanda that boasts just 10 million people and almost no resources but sits in the center of some key trade blocs. Both offer tremendous opportunity if you understand Africa."

An emerging opportunity

The challenges facing banks in the African marketplace make its valuation different for different organizations. With ever tighter regulatory and capital, the synergies of capital and client base that drove the geographic expansion of large global banks over the last two decades no longer exist, creating opportunities for smaller, regionally focused competitors.

According to Bisi Laminkana, a Partner with KPMG in Nigeria and Team Lead of the global network's Project Africa Banking initiative, financial services organizations seeking to take part in Africa's growth story will need to balance

opportunity with patience. "The growth potential of Africa is certainly tremendous, and the rewards available to those willing to be bold, savvy and committed to Africa over the long term will be significant," she noted. "The key is to take an innovative approach that combines a deep understanding of the market specifics with a sustained commitment to delivering world-class services leveraging technology and process innovation."

Combining spectacular trends, tremendous growth potential and massive pools of unbanked customers, Africa is rapidly emerging as a good place for smart money to invest. At the same time, it is also proving that banking innovation can lead to substantial economic benefits for both citizens and shareholders alike.

Those interested in Africa will also want to keep an eye out for KPMG Africa's soon-to-be-released report on Banking Industry Customer Satisfaction in Africa. Building on the valuable data uncovered in the 2013 survey, this year's report delves into customer demands and preferences across 18 individual African markets. ■

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Bill has over 20 years' experience in global corporate and investment banking. He qualified as a chartered accountant in Australia before moving to the UK in 1993 to work with global banking clients such as JP Morgan, Deutsche Bank, Credit Suisse and Barclays. He is well known to many global financial services institutions having led major regulatory and advisory projects, finance and risk governance reviews, cross-border due diligence and reviews of high-level controls of major global organizations. Over the last 5 years, he has spearheaded KPMG's work relating to the financial crisis and championed the debate about bank culture and standards and the need for change in the industry.

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The growth potential of Africa is certainly tremendous, and the rewards available to those willing to be bold, savvy and committed to Africa over the long term will be significant.

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Creating a sustainable digital wealth management platform

Catching up and getting ahead

By **Daniel O'Keefe**, Principal, US Strategy Banking Leader, KPMG in the US
By **Jonathan Warmund**, Director, KPMG in the US



Daniel O'Keefe



Jonathan Warmund

As demand for robo advising and robo investing services rises, many bank brokerages and investment houses are starting to recognize that they may have 'missed the boat' on digital wealth management. Yet, while the existing market may be dominated by a handful of players, our experience suggests that it's not too late for banks and investment managers to create a viable, sustainable and compelling value proposition in the robo market.

The democratization of investing

One would be hard-pressed to deny the impact that digital wealth management is having on the investing landscape. In the US market alone, estimates suggest that — by 2020 — more than US\$2.2 trillion in assets under management will be flowing through digital advice platforms, growing at a rate of around 68 percent over the next 5 years.

In part, this massive growth in digital wealth management is being driven by the continued shift in investment patterns — away from actively managed portfolios and towards investment vehicles such as passive exchange traded funds (ETFs). Indeed, according to the Investment Company Institute, more than US\$1 trillion flowed into US domestic equity index funds

between 2007 and 2014 while, at the same time, more than US\$650 billion flowed out of actively managed equity funds.

Interest in digital wealth management services — often known as 'robo investing' — is also being catalyzed by massive growth in demand for investment services from less-wealthy investors attracted by low fees and low minimum balances. Millennials, in particular, are likely to see robo investing as a smart and easy way to invest their growing wealth. But the proposition is also deeply attractive to Gen X and even Baby Boomers, who are looking to diversify their retirement savings.

The important point is that digital advice services are a growing demand for investment solutions rather than simply cannibalizing existing assets under management (AUM) from managed account programs. People (particularly existing banking clients) want to invest their wealth but far too few have had access to investment advice given the high initial minimums for many managed account programs — often starting at \$25,000 for mutual fund or ETF-based portfolios

The competitive environment heats up

Not surprisingly, investment houses, bank brokerages and wealth management advisors have started to rethink their approach to digital wealth management. Whereas most had originally viewed the introduction of robo-investing as more of a marketing or mainstream play, today's investment executives are recognizing the massive value that could be captured — or retained — through digital advice services.

The problem is that — while the vast majority of wealth managers and brokerages opted to take a 'wait and see' approach to digital wealth management — four key players were busy investing significant time, effort and capital into creating digital capabilities. And, as a result, these four players currently dominate the existing market.

Led by two traditional powerhouses — Vanguard and Schwab — and two digital upstarts — Wealthfront and Betterment, — they have brought lower cost investing solutions to the market.

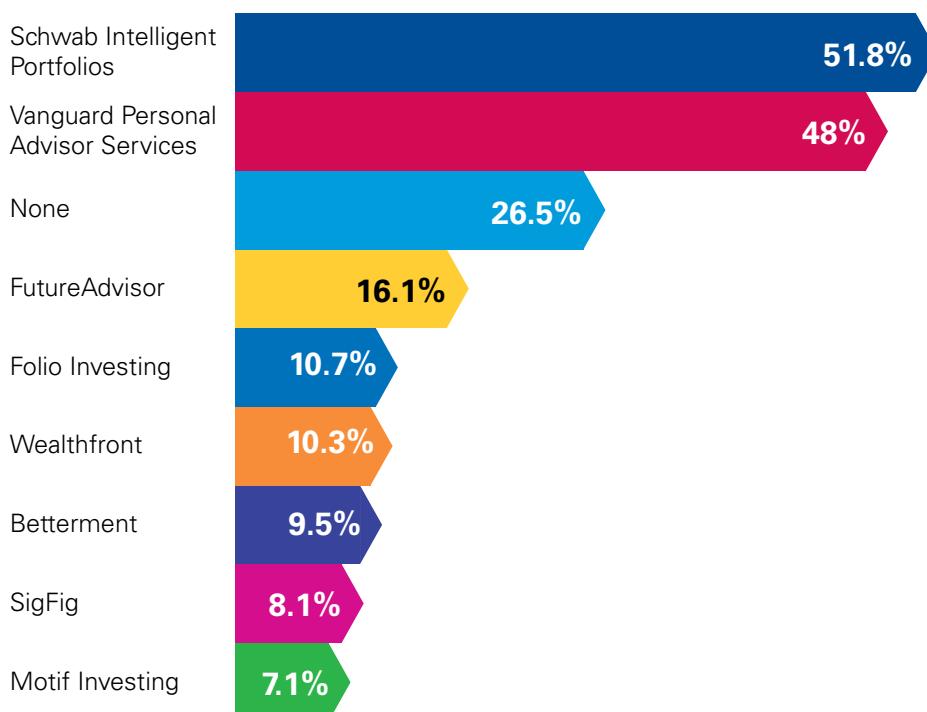
Fractional platforms transform investing

Digital pioneer Folio Investing is a self-clearing broker dealer with a fractional share platform that suggests the potential for democratization of investing by de-coupling the price of any security — stock or ETF — by whatever amount the investor can or is willing to make.

Most digital advice providers are traditional whole-share trading platforms. With fractional-share systems, initial and follow on investments are allocated across all holdings regardless of the price of any one security. On fractional share platforms, it's possible to purchase any dollar amount or percentage of any ETF or individual stock.

Many registered investment advisors (RIAs) use the Folio Institutional platform to create their own models that can be individual securities, ETFs and mutual funds or combinations of all three. The Folio Institutional platform can even support multiple models within an account, enabling an efficient approach to goals-based investing.

Awareness of US online investment providers



Source: KPMG Robo Advising

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Data suggests that there are still significant opportunities for those banks, investment houses and wealth managers able to create a compelling digital model.

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According to our survey, around 50 percent of US-based banking clients are already aware of both Vanguard's Personal Advisor Services offering and Schwab's Intelligent Portfolios offering. Around one-in-ten are aware of Wealthfront and Betterment.

And competitive activity has been picking up. Blackrock, the world's largest asset manager, acquired FutureAdvisor for an estimated US\$150–200 million; JP Morgan recently struck a partnership with Motif Investing; and Pershing (the largest correspondent clearing firm) partnered with Marstone in June 2015 and is now working with IBM to leverage Watson's cognitive computing into digital advice through self-learning technology that incorporate data, patterns and natural language.

It's not too late

Fortunately, our survey indicates that it's not too late to enter the digital advice space. In part, this is because awareness is still fairly low — less than 10 percent of existing banking clients had heard of SigFig, Betterment or Motif Investing — three of the 'upstart' robo advising services. The potential market is also largely untapped; most robo investing solutions have been targeted to existing investment clients leaving a massive market of lower-wealth customers up for grabs.

Our experience and our survey data suggest that there are still significant opportunities for those banks, investment houses and wealth managers able to

create a compelling digital model. Bank brokerages, in particular, have a unique opportunity to capture market share and new customers by offering account aggregation services that provide a unified view of their banking, trust and brokerage accounts across multiple custodians through a single sign-on experience. Almost three-quarters of our survey respondents said this would be a highly attractive offering.

Bank brokerages can also capitalize on their position by offering auto investing services that provide clients the option to regularly transfer a set amount from their checking or savings accounts to their investment portfolio and automatically allocate funds across all holdings (a service almost two-thirds of banking clients said would be attractive to them).

And many banking clients are also interested in working with a financial advisor to supplement digital solutions. From purely 'self-service' to a more extensive high tech and high touch, there's a spectrum of potential business models to consider.

Ultimately, what this means is that there is no 'one-size-fits-all' model for robo investing and digital wealth management. Customers are open to a new value proposition that makes investing easier, and our survey suggests they are actually willing to pay more fees in exchange for the convenience and value of a bundled service offering.

Time to act

While there is significant opportunity still to be won by those with new and compelling value propositions, investment firms and bank brokerages will need to start moving quickly if they hope to capture and retain customers. But with a wide variety of potential business models and services available, many are still unsure about how they might best enter the market.

When we work with bank brokerages and investment houses, we often start by helping executives discover what their customers want. What services would current and new clients value most? What monetary value would they place on digital advice services? What fees would they be willing to pay for digital services, such as platforms that periodically rebalance their portfolios?

Once you know what your clients want and what they will pay for it, investment houses and bank brokerages can then start to develop a strategy and service offering that recognizes their current capabilities and culture, and provides a road map for delivering the right mix of services at the right cost.

However, with competition for investment-related FinTech running

high and companies in this area achieving impressive valuations for their technology, most bank brokerages and investment houses will likely find it difficult or cost prohibitive to simply acquire the technologies and capabilities they need to deliver a robust, secure and effective offering.

As such, most organizations are now focusing on building smart partnerships with FinTech and other potential partners to develop and deploy new robo investing solutions. Many of the digital advice leaders have announced or are currently looking to license their technology. BlackRock — Future Advisor recently signed deals with BBVA and RBC. Understanding what partners are available and what 'white-label' arrangements can be created will be key to assessing the best approach to developing digital wealth management services.

Ultimately, we believe that the opportunity for banks and investment houses is ripe. But organizations will need to move now if they hope to capture their share of the market. Those that do can look forward to a more diversified client base, more loyal clients and more stable fees. Those that do not will eventually find their clients looking for these services from other institutions. ■

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The problem is that — while the vast majority of wealth managers and brokerages opted to take a 'wait and see' approach to digital wealth management — four key players were busy investing significant time, effort and capital into creating digital capabilities. ”

Data, analytics and audit

Getting ready for the era of data-driven audits

By **Jonathan Bingham**, Partner, KPMG in the UK
By **Christoph Hellwig**, Partner, KPMG in Germany
By **Jatin Patel**, Director, KPMG in the UK



Jonathan Bingham



Christoph Hellwig



Jatin Patel

It was only a matter of time before the rapidly evolving world of data and analytics (D&A) permeated the audit process. And today, new approaches to audit are rapidly emerging, offering significant competitive benefits to those able to take advantage of the data-driven environment. But while the value of a data-driven audit should be fairly clear, most financial services organizations are struggling to integrate these new approaches into their internal control/systems environments. Given the heightened scrutiny of financial services, which is leading to the growing risk of regulatory fines or actions, we believe financial services organizations should be pushing harder to realize the benefits of enhanced data tools.

The growing imperative of audit

For financial services organizations, the need for robust assurance processes has never been clearer. Over the past decade, vast amounts of new regulations have been handed down to financial services organizations of all types, demanding massive amounts of data across a wide range of operational areas.

Some large global banks already submit anywhere from 5 to 10 million different pieces of data — per quarter — to regulators. But the challenge isn't necessarily the volume of data that is required but rather the quality of the data. The new higher data standards require a model of assurance that is moving from, say traditionally, 90–95 percent confidence levels to something much higher. Using traditional means to achieve this higher level of confidence is likely impossible or punitively expensive.

Not surprisingly (particularly given that regulators are increasingly holding executives personally responsible for some regulatory requirements), many executives at financial services organizations are now looking for better quality assurance, not only to better manage risks but also to achieve a level of competitive advantage in their markets.

A new approach emerges

Financial services organizations know the power of D&A. Most banks have been working feverishly to apply D&A to areas like customer experience, loan assessments and customer segmentation.

Many investment management houses either use or rely on sophisticated D&A algorithms for automated trading. And some would argue that the insurance sector was the original pioneer of long-range predictive analytics.

Internal auditors also know the power of D&A. Indeed, at its simplest, audit is all about collecting massive amounts of data and correlating it against other internal and external sources to uncover new insights about the business. The introduction of modern D&A tools and approaches takes the audit to the next level.

At the same time, the potential sources of data available for external audit have evolved dramatically. Today, huge pools of external data are being aggregated and companies are able to access it, providing auditors with an unprecedented ability to benchmark internal data against external sources. Across the financial services industry, many now appreciate the value of benchmarking and are realizing, for example, the value of asking for more of the data from Lloyds of London to access the quality of their book, by getting more detail on industry loss ratios.

The value of these pools of data to the external audit process is obvious. Today, financial services organizations are not only able to see if their controls and governance are robust and complete, they are also able to benchmark how they compare to their local, regional and global competitors. Investment management houses, for example, can benchmark their daily fund performance against their competitors'.

The financial implications of a poor internal audit process are becoming much more serious. Regulatory fines and penalties are quickly increasing; some organizations have already faced stiff fines — representing between 2 to 5 percent of global revenues — for non-compliance or poor controls. On the other hand, the scope for losses from misconduct (such as rogue trading) has multiplied. For example, fines in the UK alone were anticipated to top US\$1.35 billion in 2015.¹

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¹ <http://www.reuters.com/article/us-britain-banks-fines-idUSKBN0TR1TK20151208>



New tools and approaches mean that data can now be 'plucked' from the appropriate system and integrated — in near real time — to provide reliable and valuable insights.



banks can achieve competitive views into the entire markets' derivative positions; and insurers can compare the robustness of their statutory and regulatory reports enabling executives to assess the completeness of their information based on a holistic view of the market.

Simply put, the adoption of new, more sophisticated tools and the availability of vast pools of data mean that executives are more likely to find out about issues in their controls and data from their internal auditor rather than through a letter from the regulator.

Running as fast as they can

While the value of a data-led internal audit process is becoming increasingly clear, our experience suggests that few have yet to fully adopt a data-driven internal or external audit process.

The reasons for the slow adoption are varied. In the insurance sector, the absence of industry-wide standards, the need to maintain data records over a long time period (greater than 50 years) and decades of inorganic growth have led to disparate systems and data silos that make it difficult to achieve a single view of the data. In the investment management sector, a history of underinvestment into infrastructure is inhibiting the value of new tools and data pools. In the banking sector, the need to meet capital requirements is siphoning investment away from new projects.

Ask the internal audit department why adoption of new techniques has been slow and they will probably tell you that they are already running as fast as

they can just to keep up with current regulatory requirements. Most have been begging for additional resources to meet their existing workload; adopting a new approach seems a bridge too far for most internal audit departments today.

Start with the data

Interestingly, the biggest challenge facing financial services organizations today likely isn't project fatigue, infrastructure or availability of capital, it's the quality of the data.

That is why we often recommend that our clients start by examining their data controls, governance and strategy. What data is being collected and reported? Is it reliable and timely? Is it fit for purpose? Can its lineage be verified? More often than not, organizations quickly come to realize that the information required is inconsistent, fragmented and siloed. Data controls and governance must be fixed.

We also recommend that our clients examine their data 'culture' and capabilities. The reality is that new D&A tools and techniques require a different skill set than traditional internal audit, and it will take some time for banks, insurers and investment management houses to develop or recruit the right data scientists, business analysts, technology developers and math geeks to properly implement a new data-driven approach. Management, too, must become more data-driven.

It doesn't need to be difficult

Thankfully, many of these barriers are now starting to fall away. Gone are the days when financial services organizations needed to pull their data from various

systems and dump them into massive data warehouses; new tools and approaches mean that data can now be 'plucked' from the appropriate system and integrated — in near real time — to provide reliable and valuable insights.

At the same time, new visualization technologies are taking some of the complexity out of the data. Indeed, a number of organizations (including KPMG) now offer executives the ability to view all of their data — and uncover important data correlations — in a fully immersive visualization space that helps them see their data from virtually every angle, unlocking new perspectives and inspiring new strategies.

New tools and technologies for process mining are also rapidly emerging that enable companies to improve their process and save costs. More than US\$12 billion was invested into FinTech start-ups in 2014, and many of these companies are focused on solving challenges related to data integration, analysis and control within the financial services sector. Traditional service providers are also investing in new ideas and solutions. KPMG Capital, for example, has made a number of investments into D&A companies with solutions that promise to improve not only our audit

services, but also provide our clients with more clarity on their risk profile.

Make it a priority

Given the size and scope for regulatory fines, the financial implications of poor controls and the competitive value that can be harnessed from new, data-driven audit approaches, we firmly believe that financial services executives should be making audit a priority within their D&A strategy.

Data tools can be used to identify risk and provide organizational insights by matching different data bases of structured (transactional) and unstructured data; applying data visualization to unstructured data. With the free flow of data that new tools provide for non-routine transactions, organization can increase assurance through the evaluation of areas where controls are weak or ineffective, perform anti-fraud procedures and challenge the valuation of assets.

Those able to adopt these new approaches — and embed them into the organization as part of their data transformation — should achieve significant competitive advantage. Those unable to do so struggle to get out of the vicious cycle of regulatory scrutiny, fines and reputational damage. ■

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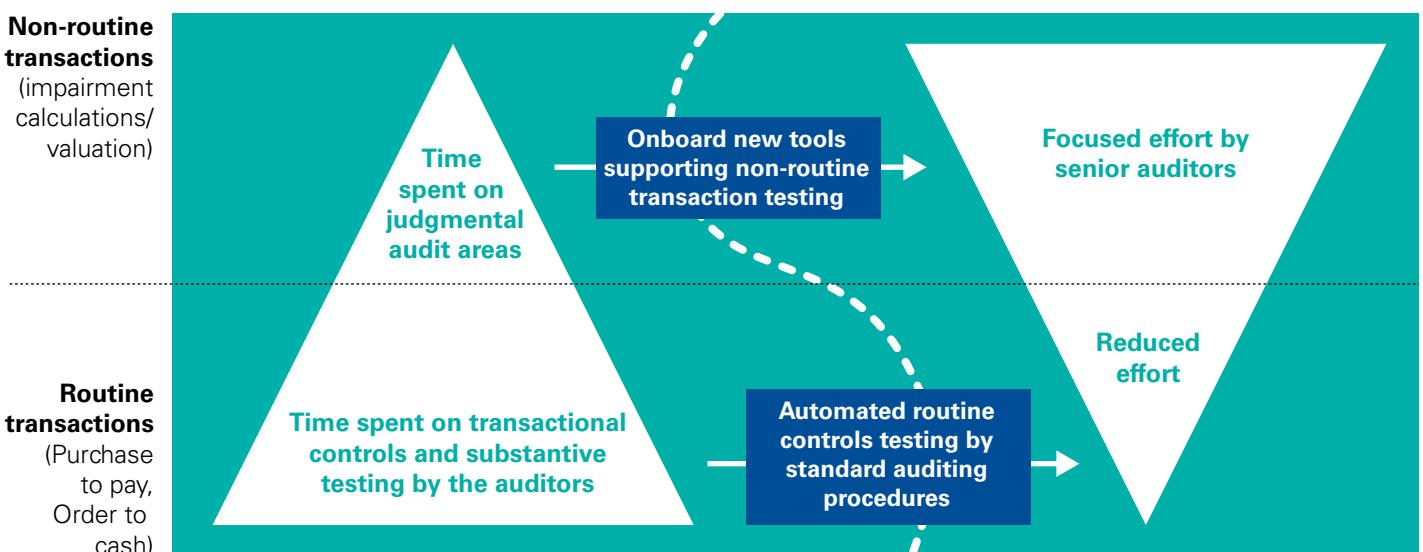
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Apply supporting D&A tools to increase assurance



Taking on the impossible

Competing insurers collaborate to create new markets and solve global challenges



By **Gary Reader**, Global Head of Insurance, KPMG



Gary Reader

To remain relevant — and profitable — in today's world, insurers need to start tackling some of the 'big issues' facing humankind: poverty, resilience, development and the environment, to name a few. Everyone acknowledges that these issues are too big for any one company to solve alone. And now, a group of insurers have come together to show that — when competitors collaborate — anything is possible.

The consortium (officially branded as Blue Marble Microinsurance) is quickly breaking new ground and creating new models for insurers. It is also overcoming new barriers. To learn more about the experience and successes achieved by Blue Marble, I recently sat down with its CEO, Joan Lamm-Tennant. What quickly became clear is that their experience offers new hope in the fight to solve some of the world's most intractable problems.

When Brian Duperreault, CEO of Hamilton Insurance Group, took to the stage at the International Insurance Society (IIS) Conference in Rio in 2012, he brought a singular message to the insurance sector. "For any of us to succeed, all of us must be involved," he argued. "We must work together." And, in doing so, Brian unlocked a new paradigm of cooperation for the insurance sector.

Just over 2 years later, when eight insurance executives took the stage at the World Economic Forum (WEF) in Davos, Switzerland, they delivered on that call to action.

As Brian noted in his address in Rio in 2012, the delivery of insurance protection to the developing world offers massive dividends. "Insurance can secure increased access to capital, reduce income shocks and stabilize income levels, mitigate catastrophe losses, enhance social protection and mutualize and transfer risk," he said. "And yet only a small percentage of this population has access to insurance products, and there are significant gaps between the products offered and the desired protection."

A new view of the Blue Marble

The insurance leaders who stood up at the WEF aimed to make a measurable difference. Formally rebranded as 'Blue Marble Microinsurance' in June 2015, the consortium demonstrates that competitors can collaborate to achieve global objectives.

As Joan Lamm-Tennant, CEO of Blue Marble told me, "Everyone around the table understood that being able to create a successful and sustainable model for delivering insurance to the underserved wasn't about the size of their balance sheet. It was about the mutualization of knowledge."

The founding members also understood that this would require unprecedented levels of cooperation. The fact is that many organizations had tried to create profitable microinsurance businesses in the past, but few had been able to achieve the right type of scale and even fewer had achieved sustainability. The insurers cooperating

in Blue Marble recognized that — more than just creating products — they needed to create a sustainable and viable marketplace.

"By working together, they saw an opportunity to share the innovation costs and uncover new and more efficient distribution channels," noted Joan. "They also recognized that the creation of a transparent and viable marketplace would reduce the regulatory and reputational risks that often come with entering new markets."

From idea to innovation

If you were to ask Joan when her first day on the job was, she would probably tell you it was that day in Rio in 2012. "It was a big day ... it was really the day that the initiative started," she told me. But she also readily admits that getting from the 'call to action' presented at Rio to the Shareholders' Agreement was difficult work. "It took a few years and it took some time for everyone to understand the value we were trying to unlock."

One of the big challenges the Blue Marble team had to overcome related to the ownership of the intellectual property (IP) that would emerge from the venture. At their first meeting, Joan and the unofficial board discussed the story of Tesla and how they opened up the IP on their car batteries in order to create a new marketplace. "The board decided that if we debated over IP, we'd never

Blue Marble Microinsurance was founded by a host of insurance and reinsurance firms, including: American International Group, Inc.; Aspen Insurance Holdings Limited; Guy Carpenter & Company, LLC; Marsh & McLennan Companies, Inc.; Hamilton Insurance Group Ltd.; Old Mutual plc.; Transatlantic Reinsurance Company; XL Catlin; and Zurich Insurance Group.

be able to achieve our goals financially or intellectually; we'd never be able to achieve the innovation necessary to deliver on our mission." Today, Blue Marble runs almost entirely on staff seconded from their members and the IP that is generated remains the property of the marketplace.

Moving the partners from a Memorandum of Understanding (MoU) to a formal Shareholders' Agreement also created challenges (as one might expect when you bring together eight general counsels from eight fiercely competitive organizations to hammer out an agreement). According to Joan, however, the organizations overwhelmingly agreed on the values and mission of what they were trying to achieve which, ultimately, allowed them to overcome any points of debate.

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The insurers participating in Blue Marble knew that, if they wanted to do things differently, they would need the help of partners both inside and outside the industry. ”

"We had a very clear set of values, and whenever we started to reach an impasse, we just went back to our values: We have to be socially relevant, we have to commit to collaboration, and we have to form lasting partnerships," she added. "Being able to go back to our values and our mission was critically important and ensured that what we did supported what we wanted to ultimately achieve."

No time to go it alone

Like many industry participants and observers, KPMG recognizes that insurance can play a clear and central role in helping manage many of the 'big issues' facing humankind, particularly by helping the world respond to global risk, improve resilience and support economic growth. But we also recognize that sustainable solutions will require smart partnerships and alliances between all players in the insurance and financial services ecosystem.

Public-private partnerships (PPPs) would need to be formed, particularly with developing world governments, international development groups and intergovernmental bodies. And partnerships with non-traditional — often even disruptive — players would be critical in order to drive and encourage innovation.

Given the historic distrust between the public and private sectors, the group faced a number of challenges when creating PPPs. "We speak different languages, but we each bring something really important to the table," noted Joan. "The key is really in being humble in knowing what role you can play and having respect for those that play different roles."

Somewhat untraditionally, Blue Marble also focuses on identifying and partnering with insurance technology start-ups and industry disruptors. As Joan points out, to be successful and sustainable, the venture needs to discover new distribution channels and new approaches to product development.

Announcing the launch of a consortium aimed at incubating microinsurance ventures, the group boldly took the first concrete steps towards helping solve one of the world's most difficult challenges: poverty.

"Some of these insurance technology start-ups are creating really novel operating models, interesting ways of collecting and analyzing data, and new ways to reach customers," she added. "It's also allowed our board to look at these companies as enablers and, in some cases, has created a really interesting triad between traditional industry players, Blue Marble and non-traditional insurance tech players."

At KPMG, our experience suggests that these types of partnerships are key to driving innovation and new approaches within the insurance sector. Indeed, we often find that traditional insurance organizations are structured in ways that actually discourage innovation and the vast majority will need to reconsider how they integrate new partners, talent and ideas into their culture in order to achieve real and sustainable innovation at the product and operational level.

Measuring success

While most private sector companies would be highly focused on achieving the traditional financial and market metrics — premium volume, margins, profitability, loan losses and so on — Blue Marble's participants believe that product relevance must come ahead of premium volume and margins. "We need to really figure out

what is important to our customers and help them achieve those goals — that's how we'll be successful in building a market, and that's how we'll create loyal customers as people move from poverty into the middle class," she added.

As such, the Blue Marble leadership team measures their success against four key metrics. The first is sustainability and the team focuses on finding ways to reduce their frictional costs in order to improve the venture's overall sustainability. The second measure is customer validation. "Even though microinsurance is often mandatory in nature, we look at ways to create optionality around it so they can signal to us if we are doing the right thing," noted Joan.

To ensure the initiative is continuously looking for new approaches, Blue Marble also measures the value and innovation that they are delivering to their partners. And, last but not least, the team looks at whether the ventures are creating the expected social impact. "You need to be patient when measuring social impact," she warned. "It can often take years to start to see measurable impacts flowing from your initiative, particularly in terms of economic growth and development."

A new model emerges

While it may take some time for Blue Marble Microinsurance to build a truly viable and sustainable microinsurance market, I firmly believe that the group's cooperative approach offers the best opportunity we have seen to date to make a real impact in the fight against poverty.

At KPMG, we have been very active in helping clients in the financial services sector build new relationships and partnerships with traditional and non-traditional players. When forming any type of new partnership or alliance, we often advise our clients to think through five key considerations before jumping into a new relationship:

- 1. Motivations:** Take the time to fully understand the objectives, motivations and exit strategy of your potential partners before getting into the details.
- 2. Alignment:** Ensure that the partnership aligns to — and helps advance — your corporate and growth objectives.
- 3. Willingness to commit:** While long-term tie-ups can lock down competitive advantages, they can also lead to long-term challenges.

4. Operational realities: Carefully consider how the relationship will operate at a functional level and what governance and operating models will be required to support that.

5. Success factors: Understand what it takes to sustain a mutually beneficial relationship over the long term.

We recognize that — in today's environment — few companies have the capacity, capability and resources to truly tackle the issues that are fundamental to our industry, our customers and our continued social cohesion. Clearly, partnerships like Blue Marble will be key.

KPMG strongly supports the goals and objectives of the Blue Marble consortium. We believe that the experience represents a strong and compelling new model for financial services organizations of all types to truly engage with the world they work in, renew their relevance in the market and help solve some of the world's most intractable problems. ■

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About Joan Lamm-Tennant

Joan Lamm-Tennant is the CEO of Blue Marble Microinsurance Inc., a corporate entity formed by six leading insurance and reinsurance groups along with Marsh & McLennan Cos. and reinsurance intermediary Guy Carpenter to create markets delivering risk protection to the underserved in developing countries. Prior to taking her role as CEO of Blue Marble, Joan was the Global Chief Economist and Risk Strategist of Guy Carpenter & Co. LLC, the reinsurance and risk advisory

operating company of Marsh & McLennan Cos., where she served as an advisor to C-suite executives and board members of Guy Carpenter's most significant clients. Her expertise includes emerging market strategy, enterprise risk modeling, implementation of risk-based decision processes and high-value strategies resulting in capital efficiencies and profitable growth.

Publications

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The Pulse of FinTech: 2015 in Review March 2016

'The Pulse of FinTech' is a quarterly report created by KPMG Enterprise and KPMG FinTech along with CB Insights (the 'go to' name for insights related to venture capital investment). The series analyzes the latest global trends in venture capital investment data on the FinTech sector.



Evolving Banking Regulation Part Five: Conduct and Culture February 2016

In this latest edition of *Evolving Banking Regulation*, we focus on the commercial and regulatory pressures affecting banks in the conduct and culture space.



Risk governance: Benchmarking analysis of SIBs

January 2016

An assessment of risk governance at systemically important banks (SIBs) finds that the board risk committees face significant challenges in analyzing the entire array of risks that face the entity. And more specifically around automation of stress-testing and aligning their risk appetite with business goals.



Insurance M&A trends

January 2016

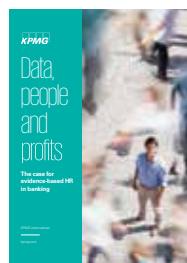
Underlying market conditions will drive further consolidation and exits, and when combined with a diverse group of potential buyers, create an ideal deal environment in 2016. Our overarching view is based on targeted M&A to support growth and exit of non-core businesses.



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January 2016

Examining the capital markets' changing attitudes toward data management as a function and the adoption of new technologies and models around cloud and big data.



Data, people and profits

November 2015

Looks at applying evidence-based approaches to the HR function in order to drive improved organizational performance.



Accessing hedge funds through managed accounts: The future is now

November 2015

The hedge fund industry is changing — with institutional investors, in particular pension funds, becoming an increasing proportion of assets under management.



A New World of Opportunity: The insurance innovation imperative

September 2015

In our recent survey of insurance executives globally, 83 percent said that their ability to innovate is tied to their future success. To achieve this, insurers will need to tap into new sources of innovation, accessing fresh ideas from both inside and outside their organizations.

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We welcome the opportunity to discuss how KPMG member firms can help you achieve your business objectives.



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