Reshaping the FS Scenario: driving forces

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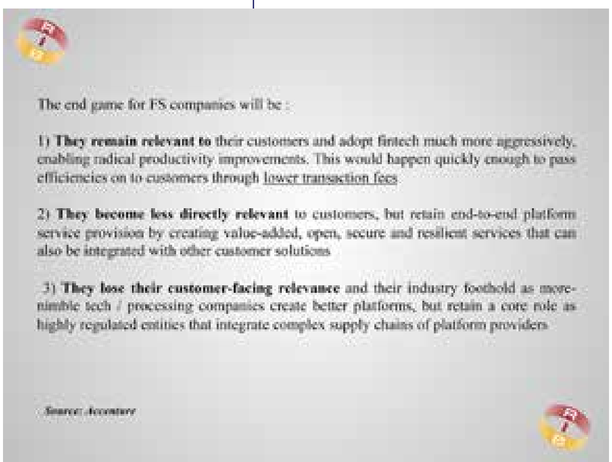
My introduction to the discussion will be short and provocative.
Strong winds are reshaping the scenario of the financial services industry. This trend will pose threats for all of us, but will also create opportunities, hopefully again for all of us.

I tried to identify some of the factors affecting the ecosystem of the financial and insurance services industry, the list does not want to be exhaustive but just a kick off for the discussion.
My point is that a convergence process is strongly redefining the boundaries of the players in the FS arena: different financial intermediaries are converging in terms of becoming customer centric organization and in how they define and price risks.
The driving forces at work are:
- technology,
- regulation,
- capital markets access.

Let me now just detail a little bit more...
Technology overall is enabling solutions based on a dramatic decrease of the cost structure of FS (financial services) companies (cloud storage, cloud computing…) creating dramatic problems for existing legacy systems.
We are using here the term "Technology" in broad terms and as a set of forces disrupting the FS scenario, including the shared economy, on-demand services, big data, data analytcs, Internet of Things…

In effect it is really a past view to consider Technology/Digitalization only as a tool to be more cost efficient or as a pure enabler of new distributions channels. Digitali-

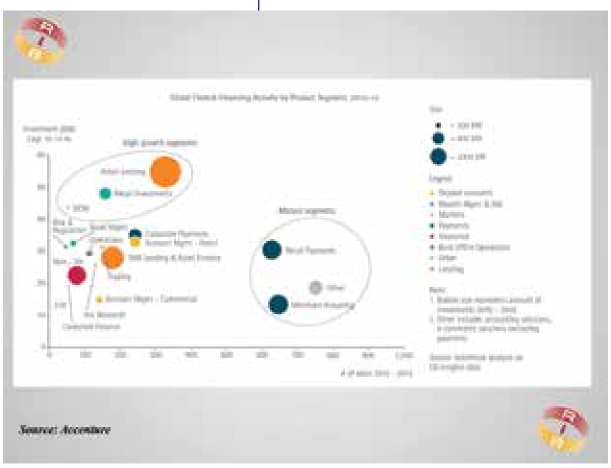
zation should be really seen as a force changing the behavior of the customers, who are really fast evolving in sophisticated social ecosystems (Google, FB, Amazon…) which are redefining the customer experience around the periphery of financial services.
To counter this challenge, many banks are beginning to break down their internal business and technology silos, migrating legacy and transaction systems to more responsive solutions, and exploring better ways of sharing customer data. Some banks have migrated some of their legacy systems to the cloud, with employees accessing a large range of data repositories. Other banks are implementing service-oriented architectures that enable interoperability and link their front-end systems and customer interfaces to common data sources and applications. Fintech companies (start-ups) are redefining from scratch the marketing and the back office technology.
The end game for FS companies will be (following the results of a research by Accenture):



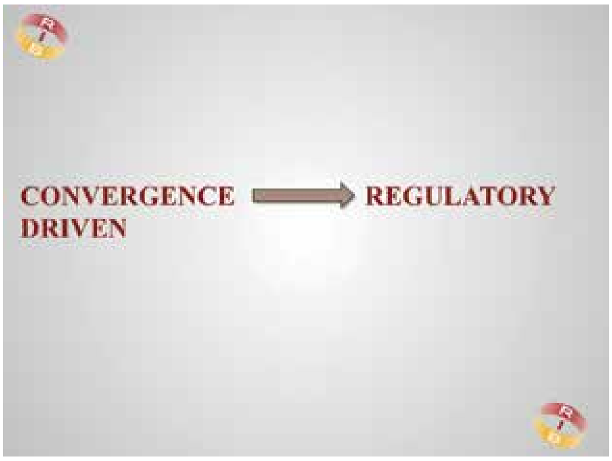
• They remain relevant to their customers and adopt fintech much more aggressively, enabling radical productivity improvements. This would happen quickly enough to pass efficiencies on to customers through lower transaction fees;
• They become less directly relevant to customers, but retain end-to-end platform service provision by creating value-added, open, secure and resilient services that can also be integrated with other customer solutions;
• They lose their customer-facing relevance and their industry foothold as more nimble tech/processing companies create better platforms, but retain a core role as highly regulated entities that integrate complex supply chains of platform providers.

INSURANCE IS RAPIDLY EMERGING AS THE NEXT BIG THING IN FINTECH

In the first quarter of 2016 more than 45 insurtech deals were sealed, with funding totaling $650 million, according to researcher CB Insights.
Why such a big interest in insurtech?
One of the reasons is that the fintech market is maturing. The illustration (again from Accenture) shows that in the clamor for funding, early investment targets such as retail payments and merchant acquisitions are being overtaken by new growth sectors, particularly retail lending and retail investments.
According to CB Insights and Accenture Analytics, 56% of the recipients of these investments are focused on the distribution part of the value chain.



Partnerships are the key to their strategy. For example, AXA, the French multinational insurance firm, has significantly boosted its digital capabilities by forming a strategic partnership with Facebook. The deal gives AXA access to dedicated Facebook resources in innovation, analytics and mobile, thus furthering its ambition to become what the group's COO calls "the leading digital and multi-access insurer." Facebook, for its part, furthers its ambition to build major partnerships with international companies, and expands its footprint in the French market.



Regulatory and competitive pressure in the industry are reshaping the structure of the financial system, where markets and new entrants will play a more significant role at the expense of banks.

Basle 3, Basle 4, Solvency 2 are the new regulatory frames. With the words of Giorgio Gobbi (Head of financial stability, Banca d'Italia) "… the policy reaction to the global financial crisis which started in 2007 has been no less far-reaching. After almost a decade, financial regulation has been greatly reformed, new authorities have been created, supervisory practices have been fundamentally innovated."

But this time it is different. No compensation, in terms of monopolistic rents, has been granted in return for a tighter regulation.

In Europe banks are redefining their role in the new financial system, similarly to what happened to the US banks in the 1980s and '90s. From the policy maker's perspective, with banks receding, a transition to a more market-oriented financial system is much needed to sustain growth.

Banks would continue to offer information-sensitive credit contracts, while market-based financing and alternative lenders would represent a valuable alternative for large corporations and for standardized credit products.

For European Insurance Companies this is creating an opportunity, similarly to the US market they will have the option to invest their Reserves in Debt Instruments (public and private) issued by large and mid-sized corporations or originated by specialized players (credit funds , P2Plenders…).

GREAT OPPORTUNITIES, HOWEVER, ALWAYS COME WITH GREAT RISKS

Insurance companies will have to jump on the learning curve fast enough to avoid to underwrite only undesired assets refused by capital markets or banks…

For banks the "originate and distribute model" is a controversial but establi-

shed business model. Convergence between the insurance industry and the capital markets actually got its start about ten years ago. Convergence started quite slowly with the introduction of CAT bonds, which were directed primarily at the catastrophic risks associated with natural disasters affecting the U.S. Since their introduction, CAT bonds have gained support from both investors and insurance buyers. Today, the array of alternative capital market approaches, known collectively as insurance-linked securities (ILS), continues to expand and mature.
There is little question that the interest in ILS has become a major part of today's insurance/reinsurance landscape. What's drawing the investment community towards CAT bonds and other forms of ILS?

Taking some ideas from Artemis , we could have several drivers for the growth of the market:
- Number one on the list is probably the lack of competitive investment vehicles. With interest rates continuing at historically low levels, most institutional investors are looking for better yields.
- Number two on the list investors are also extremely interested in opportunities to diversify their portfolios, especially for zero beta investments. Typically the zero beta products are investments that have no correlation with the overall financial markets.
- Finally, the lack of a major CAT loss that could deplete both the investors' earned interest and principal has also served to generate attention in the ILS market.

Fitch Ratings has spent significant time developing a list of factors that will affect reinsurers' ability to attract the highest quality business that is being placed into the global reinsurance market.
Some of the factors that Fitch indicates are important:
• Scale - helps reinsurers to provide a reach that smaller competitors cannot match. Additionally, it provides the means to access business in regions where relationships and feet on the ground are major pluses. It will also allow reinsurers to see more business, so they should be able to make better decisions where to deploy capital.
• Diversity - this is closely related to scale, since only the largest reinsurers are actually global and have diverse lines of business that will allow them to move their capital to areas of the market where softening has not been as severe.
• Financial strength - a key asset to any reinsurer, large or small. It is critical in supporting new expansion efforts or new diversification efforts, thus allowing reinsurers to pull back some capital to deploy in other more profitable lines of coverage. This will essentially make a reinsurer more resilient in the short run.
Fitch points out that those reinsurers that do not have these three qualities will be the most exposed to the continuing softness in the market, or the further pressure from the alternative capital market. Competing on price often works to the capital markets' advantage since they frequently are able to price their products more competitively due to the efficiencies inherent in the ILS space. This is the exact approach that the smaller, catastrophic property reinsurers have noted since the advent of CAT bonds, which currently account for about 20% of that market.
Again from Artemis: "Agents and brokers who have accounts that utilize significant amounts of reinsurance need to be aware of the advancements that are being made in the ILS market. The old days of competing on price are disappearing. Capital market professionals believe it is only a matter of time before reinsurance and ILS will be used in the same manner that reinsurance is purchased in layers today. It will not be uncommon to find excess limit programs that are made up of a combination of reinsurance and ILS. The genie is out of the bottle, and the capital markets appear to

be willing to embrace the convergence with the insurance/reinsurance concept. As a result, agents and brokers who are interested in a long-term view of the insurance industry would be well advised to monitor this situation closely as it will remain extremely fluid for some time."

CONCLUSIONS

Many thanks for the attention.

I recognize I have been provocative on some of my comments but my enthusiasm is mostly driven by the fact that since RIB has had the privilege to host some of you in this wonderful location years ago, many of our past discussions are now facts in our day to day business and the speed of change is accelerating. It is an interesting period to be in business for all of us.

Buon lavoro a tutti!