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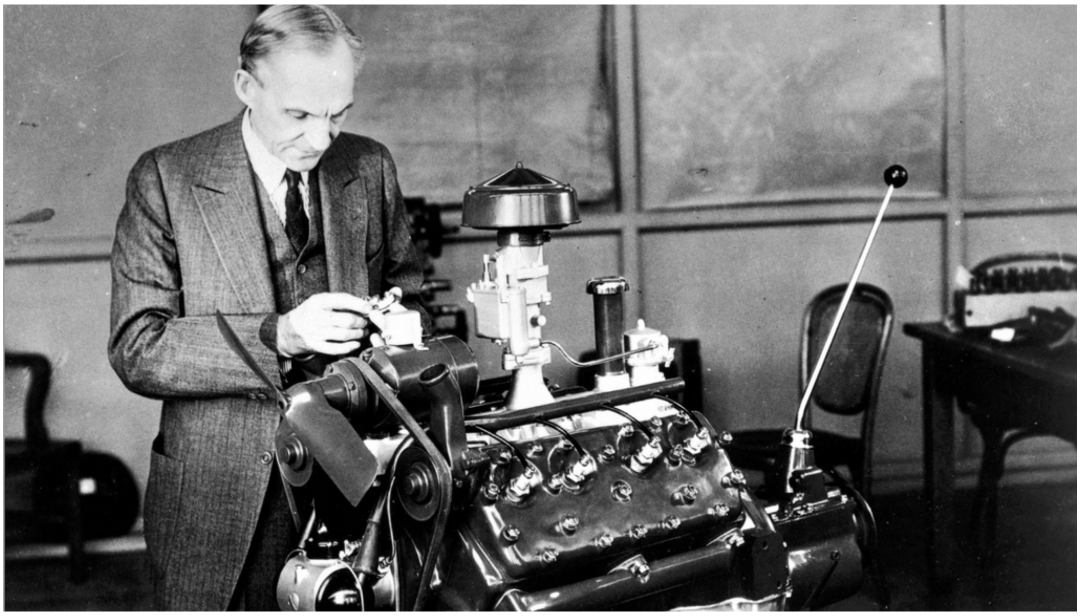

"There is one rule for the industrialist and that is: make the best quality goods possible at the lowest cost possible, paying the highest wages possible"

Henry Ford

Henry Ford's Business model was simple. Pioneering a model of 'mass production', Ford created the Ford Motor T using an easy design, that was mass produced and sold at a low cost. When introduced in 1920, the Ford Motor T's popularity exploded, and the profits rolled in. This allowed Ford to cut his prices and establish a $5-dollar wage for his workforce.

Business Models have changed massively since Ford's time. Business models that don't mainly focus on selling cars anymore: concepts like Car2Go – that focuses on mobility instead of car ownership – or ZipCar – based on car sharing are the future.

At the same time, organisations are now spread out across the globe, with their supply chains in various parts of the world. Yet the interconnected nature of the world poses a direct threat to traditional business models.

A staple of this new world is the rapid progress in new technologies ranging from Machine Learning to online-streaming services. New technology is powering new data, which in turn leads to faster processes and better decision-making. Furthermore, this has fuelled a competition boom in many sectors with the more established firms nervously looking over their shoulder at the hungrier and brasher younger firms snapping at their heels.

In this white paper, we will examine what this new business model is and how corporates and insurers can build a 'Connected Business Model' in the age of disruption.

2017 – A Seismic Shift?

2016 was a year of shocks and corporations are bracing themselves for more potentially seismic shifts in the geo-political landscape in 2017. The latest Cambridge Centre for Risk Studies' Global Risk Index report predicts that in 2017, the global economy will face an expected loss of US$1.17 trillion as a result of increased risks.

Boardrooms, risk managers, treasurers, credit managers, financial directors and insurers operating in an environment of low interest rates and fluctuating currency adjustments are favouring tighter operational practices, cost cutting and are concerned about the bad debts of their suppliers and clients.

"A resurgence in economic confidence was experienced by credit professionals in the final quarter of 2016", according to the UK's latest Credit Managers' Index (CMI). Yet bad debt remains a risk with only 13% of credit managers expecting a decline in 2017. The survey also found 32% of respondents saw bad debts increase across 2016, with only 13% expecting bad debts to drop in 2017. 20% expect debts to continue rising, but most worryingly a further 28% remain unsure about how debts will change, and are budgeting for rises.

Economic volatility and changing patterns in consumer behaviour are forcing a re-think of business models. Do we reinforce our high-street presence or go completely digital, manufacture cars to sell or rent, sell newspapers for free and live on advertising revenues alone or go down the pay wall route?

Survival of the Fittest and Cheapest Firm

Underneath the glitz and glamour of leading sectors such as Live Sport and Entertainment, there is an on-going guerrilla war, with the result poised to shake-up the traditional business models.

The BBC is the leader in UK entertainment, a position it has held for over a century. A position solidified by its widespread adoption of the latest technology whether it be the Wireless or Television, supported by a revenue source from a licence fee. In 2017, the BBC faces competition from Netflix who can offer

similar entertainment, online and at a cheaper price, £84 to the BBC's £149.

Likewise, Sky has dominated the market for live Premier League football for decades. Furthermore, it has seen off the challenge of former rivals, Setanta and ESPN. Yet in 2015, Sky lost the viewing rights for the Champions League and certain Premier League Football matches. Also, some consumers are reportedly switching off Sky Sports in favour of streaming live football on software such as Kodi.

How do we explain the process behind this battle between established and rival firms? One answer lies in a theory called 'Disruptive Innovation'. A theory that contains crucial lessons for corporates seeking to help influence their boardroom's decision-making process.

'Disruptive Innovation'

So, what is exactly, 'Disruptive Innovation'? Coined in 1995, by Clayton M. Christensen, the phrase seeks to describe how a smaller company with fewer resources challenges a more-established firm. This challenge occurs in two situations: 'low-end', focusing on consumers who desire a 'good-enough product' and 'new market-foothold', turning non-consumers into consumers.

According to Christensen, the theory goes as follows. The established firm (Company A) becomes too focused on improving its product/service for its most profitable consumers at the expense of the other consumers.

This leaves a gap in the market, for a new firm (Company B) to target those overlooked consumers and delivering what those consumers require, at a lower price, becoming 'disruptive'.

Meanwhile, Company B is ignored by Company A's in its drive to maintain its profitable core market. Thus, Company B can move 'upmarket' and deliver the same performance as Company A's customers are used whilst keeping the overlooked consumers.

As a result, the mainstream consumers start adopting 'Company B's offering' in their droves, creating 'disruption'.

The tale of Blockbuster

Does this theory work in practice? You, bet it does. Take the case study of Netflix with Blockbuster. In the 1980s & 90s, Blockbuster was the video-rental giant, allowing consumers to rent the latest

Hollywood films to watch at home.

In 1997, Netflix was launched as a mail-order DVD service that allowed its consumers to order DVDs to their home. This service only appealed to 'movie-buffs' and not the mainstream customers that used Blockbuster.

The dawning of the 21st century, saw Netflix move to an on-demand streaming service whilst continuing its mail-order DVD service. The move was a masterstroke as when broadband bandwidths increased, Netflix was in a unique position to merge all its services into an online-library that contained all the same titles, that Blockbuster offered but at a cheaper price. Thus, Netflix captured Blockbuster's core customers who viewed the online streaming services, as an 'upgrade'.

A New Business Mentality?

The tale of Blockbuster has lessons for Corporates. Christensen believes that 'disruptor firms' such as Netflix will always have a different business model to the incumbent firm. With that knowledge, incumbents can respond.

So, what can Corporates do to respond to the changing business environment? Firstly, they can create a new division focused on Research & Development, like Apple, Google and Microsoft.

Yet, Christensen believes the only thing that stops incumbents from responding to disruptors is that the process of listening to core customers becomes so institutionalised, that it is hard to move resources to focus on challenging the disruption. When they do, it is too late to respond. In some cases, the consumers may not necessarily know what they want. As Henry Ford once said 'if I had asked people what they wanted, they would have said faster horses'. Sometimes, the times call for visionary leadership.

It is understandable to adopt a cautious enterprise risk approach in today's rapidly changing business environment, but such an approach can hamper growth and progress. A balance should be reached between managing risk volatility and embracing opportunities.

A Dynamic Approach

What is required is a shift away from a 'bottom-line profit' focus towards using profit as fuel for driving innovation in new areas of the business. Such a move will create profitable opportunities and future proof the business from obsolescence.

Yet, a change in mentality must be complemented by a change in behaviour. Through dynamic investments in data management, firms can overcome their fragmented nature. Thorough integration of diverse information held in different departments or systems would yield numerous benefits. One of which, would be bringing all information together into a single view for the consumer.

As Global Treasury Intelligence explains: "While analysis tools may require a financial investment, and buy-in from the board, their impact may be more easily understood than a change in company culture. However, one of the reasons that silos exist in companies is because individuals and departments lack the appropriate mechanisms and incentives to share data.

"It is in the treasurer's – and ultimately the company's interest to ensure all departments are linked and sharing their data. A smart risk culture will become essential in order to thrive during geopolitical and economic uncertainty, and the best way for a company to increase its tolerance to financial risk."

So, what are the key drivers of successful adaption to change in the current business environment? Russell Group believes they are as follows:

1. Adaptability is more vital to success than ever. Modern enterprises succeed when they adapt to industry and marketplace shifts and incorporate new technology into company culture and regular operations. It's not only about technology, however, as equally important is bringing together the power of technology with a culture that embraces collaboration.

2. Improving the customer experience is the ultimate goal of the great digital transformation. Customers are more critical and discerning than ever; they'll turn away from brands that don't align with their values and needs. Keep customers involved and engaged with your brand. Every touch point matters. The recent experience of United Airlines ejecting a passenger from a flight, which was all captured on social media and then afterwards using the CEO to insult the customer when the public responded unfavourably is a perfect example.

3. The advent of augmented reality (AR) and virtual reality (VR): These technologies were once restricted to gamers, but they're now easier to implement than ever before. The mainstream shift toward AR and VR provides new ways to connect with customers and offer unique, memorable interactions. The popularity of AR and VR also opens the gates for workplace gamification. Some shrewd observers predict that AR will replace mobile phones within the next ten years.

4. Big data and analytics: There is a spiralling amount of insightful data in the world, but few companies are using theirs to maximum effect. Analytics can drive business growth by showing how your customers think, what they want, and how the market views your brand. In today's age of connected digital transformation, almost everything can be measured. All-important decisions should be supported by the application of data and analytics.

5. Digital transformation is driven by

the Internet of Things (IoT). As Russell Group, has explained in previous white papers, the IoT offers transformative insight into customer mind-sets. The IoT also changes how daily life operates by helping create more efficient cities and leaner enterprises. We can be sure that businesses and connected individuals alike will continue to benefit from an estimated 50 billion IoT Sensors by 2020 and more than 200 billion "things" on the Internet by 2030.

6. Smart machines and artificial intelligence (AI) - as exemplified by the recent stunning success of a machine against the world's second best Go player - will transform business models. Machines are beginning to learn from their mistakes and adapt to their environments. AI has long been considered the realm of 'I Robot' dystopian fantasies, but as technology improves, AI becomes a reality. The fear is that advanced learning machines will replace low-skill jobs, but traditionalists have probably been decrying the impact of technology since the first potter's wheel was built circa 3,500BC in Mesopotamia. There is every chance that new AIs will be able to work collaboratively with humans to solve intensely complex problems.

7. Destroying silos. The role of the CEO and his risk management team has changed significantly over the past decade. With the rise of new roles like the Chief Digital Officer, the Chief Customer Officer, and Chief Innovation Officer we are seeing a rise in the importance of digital transformation across the entire organization. Traditional solutions are now becoming multidimensional. Focus on breaking down silos, allow innovation more room to flourish and build collaboration across the enterprise.

One myth that can be laid to rest is that new technology such as Machine Learning can only apply to big companies. The point is, however, that the software algorithms are all free to use, they can be easily downloaded from the Internet.

All you have to pay for is the hardware resources, so if you buy cloud company resources from Microsoft Azure or Amazon you pay the hardware resources, if you buy the server then you pay for the server. The technology franchise is being expanded rapidly.

What Machine Learning does is remove linearity assumptions. Machine Learning explores the vast area of non-linear models - a much vaster data set of models, which makes it a more powerful tool.

According to Jason Cabral, Chief Actuary, Markerstudy, speaking at a recent TOM event in the Lloyd's building: "Machine Learning is transforming well-established industries, for example, the way Netflix replaced Blockbuster. Netflix applied software that works out 'because you like that, then you might like this' so the company looks at what you're watching, when and how that can help them to be more profitable.

"Netflix have said that its modelling decreases customer churn by several percentage points and saves the company about $1 billion a year! Similarly, for insurance companies' pricing it will give them another tool.

"The applications and benefits for insurance companies using Machine Learning tools are huge. When my business got information from Experian about credit scores, CCJs and other data fields that had to be filled we had about 1000 factors to test and that took us 3 months to test those factors manually but using a Machine Learning tool it took us about 3 hours."

To conclude and once again quoting Henry Ford: "We don't want tradition. We want to live in the present and the only history that is worth a tinker's dam is the history we make today."

The future has arrived probably more quickly than many people realise and it will be those that learn to adapt, collaborate and integrate across silos who will survive.

If you would like to learn more about Russell Group Limited and its risk management solutions, please contact sbasi@russell.co.uk or rborg@russell.co.uk