

Winning in wealth management Strategies for building profitable business operating models



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Foreword

The financial crisis has provoked a major turning point for the financial services industry, changing the very basis of competition from growth to profitability. At the same time, the industry has had to withstand significant regulatory change and political pressure. Wealth managers now must deal with a short- to mid-term profitability trap, which seriously challenges the entire industry. Our research will show that clear winners and losers will emerge.

Individual wealth management providers must focus their efforts on key profitability levers and transform their business operating models (BOM) to avoid being caught in this profitability trap, and to succeed in the changing competitive landscape. This structural shift requires a fundamental reappraisal of the strategic drivers of success in wealth management.

This report investigates the root causes of the unprecedented decrease in Swiss-based wealth managers' profitability and explores differences in profitability and key characteristics among individual wealth management providers. Our research concludes with the perspectives on how to build and operate a profitable wealth management institution.

To identify the key characteristics of "winning" wealth management providers, this report will answer the following six key questions:

- How has the profitability of wealth managers evolved over time?
- What are the key levers which have a direct influence on profitability?
- What is the impact of those levers on wealth manager's profitability?
- Which business operating models are predominant in the market?
- What are the common features of "winning" business operating models?
- What are the main strategic initiatives focusing on business operating model transformation?



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About the research

This report summarises the results of a major quantitative study based on an in-depth analysis of Swiss headquartered and often globally active, wealth management providers.

Our research goes beyond simple profit margin analysis. It also evaluates profitability drivers (financials) and profitability levers (non-financials) and examines their impact on wealth managers' value generation by means of statistical analysis.

The empirical work is based exclusively on publicly available quantitative and qualitative data for the period between 2004 and 2008. The selected time period allows for a comparison of Swiss-based wealth managers' pre- and post-crisis profitability levels in order to highlight the characteristics of "winning" players in both a bullish (2004-07) and bearish (2008) market environment.

The scope of our analysis includes 103 wealth management providers in Switzerland, accounting for 73% of the total number of players in the Swiss wealth management market.¹

Scope of this research

Wealth manager selection criteria	<ul style="list-style-type: none">• Our analysis covers pure play private banks, foreign banks with wealth management operations in Switzerland, selected cantonal banks, and asset managers with private banking activities.• Wealth managers were selected based on:<ul style="list-style-type: none">– Client assets in excess CHF 1bn.– Public availability of financial data and information.– Sufficiently granular private banking segment reporting.• Institutions not meeting these criteria (e.g., small banks, smaller cantonal banks and UBS/Credit Suisse) were excluded from the analysis.
Client assets	<ul style="list-style-type: none">• Client assets are defined as the sum of private and Institutional assets in discretionary mandates, assets under advisory and assets only under custody.• For reasons of simplicity, they are collectively referred to as Assets under Management (AuM) throughout this report.
Publicly available information	<ul style="list-style-type: none">• The information used in our research has been retrieved from company reports, SNB filings and FINMA reports.• The data covers the time period between 2004 and 2008.

The selected time period allows for a comparison of Swiss-based wealth managers' pre- and post-crisis profitability levels ...

¹ This research covers 103 of the total of 141 market players; as defined by "Wealth Management in Switzerland", Swiss Banking Association [2009], p.11

Executive summary

Caught in a profitability trap

Wealth management providers are facing significant challenges. The industry's average profit margin decreased by 27% from 2007 to 2008. It is expected to recover in 2009 by a mere 3%–10% and is then expected to continue its recovery in 2010 and beyond. We expect many wealth managers to be caught in a short to medium-term profitability trap if no decisive countermeasures are undertaken, because the financial market upturn does not fully compensate for the industry's hampered revenue generation. In addition, many wealth managers also struggle with an inflexible cost base, which has an even greater negative impact on their ability to restore profitability.

Determine key profitability levers

In order to address the resulting profitability challenge, wealth managers have to identify and address those key profitability levers which directly impact value generation. By means of statistical analysis we have quantified the positive or negative contribution (in basis points) of a pre-defined set of profitability levers to a wealth manager's overall profit margin. Our analysis suggests that the following eight levers strongly drive profitability in a manner that either adds value or reduces it:

- **A clear focus on Affluent/High Net Worth clients and an Institutional client base** are very strong profitability contributors in any kind of market.
- **Producing & offering traditional products** is very market sensitive and has to be managed very carefully
- **Producing & offering market tracking products** is a significant profitability slayer, indicating that the industry is facing a lack of scale.
- **Producing & offering extended services** will, in the near future, also be a key differentiating factor as this represents one of the most powerful means of overcoming clients' trust deficit.
- **Outsourcing single or multiple back office services**, when planned and executed correctly, yields considerable added profitability and is an indicator of operational excellence in this part of the value chain.

- **Maintaining an international footprint** – in the context of a stricter regulatory environment – characterises a profitability cultivator in the near term.
- **Running a proprietary trading function** turned out to be a loss maker over the last two years.

The levers described above form an integral part of a wealth manager's business operating model (BOM) which breaks down the structure of a market player's organization into its elements, covering the entire business value chain (clients, channels, product/services, processes, organization and other elements). Depending on how a wealth management institution combines individual profitability levers to design its business operating model, it may achieve different profitability levels. For the Swiss market, profit margins ranged from 14bps to 54bps in 2008.

Winning business operating models

Our analysis suggests that there are ten predominant business operating models in the wealth management industry. The most successful of these is distinguished by its resilience in the light of the market turmoil in 2008. The model entered 2008 in a strong position, having already performed extremely well in 2007, when it exhibited an absolute profit margin of 58 bps (54 bps in 2008). This model also demonstrated attractive annual profitability growth of 6% (6%) in the period between 2004 to 2007 (2004 to 2008), respectively.

This most successful business operating model's setup can be described as follows:

- Internationally present (domestic and global onshore as well as offshore) wealth manager.
- Focusing on Affluent/HNW as well as Institutional clients.
- Offering custody, advisory and brokerage services as well as discretionary mandates.
- Producing and offering traditional products (own mutual funds, absolute return mandates, managed funds portfolios).
- Outsourcing single or multiple back office services.



Our analysis found no evidence that either a strong focus on client asset growth or the radical quest for more simplicity (equaling the simplest BOM setup) have helped to achieve superior profitability.

We have observed that more than half of the wealth management players in this study face serious challenges to sustainable profit generation. Their models are neither robust, resilient nor flexible enough for the new era. These players therefore have to expect below-average absolute profitability and continued negative profit growth in the near future, unless a strategic operating model change is undertaken.

Eight strategic initiatives to escape the profitability trap

In order to extricate themselves from the short to medium-term profitability trap, wealth managers are forced to transform their current BOM.

Eight strategic initiatives which impact the identified key profitability levers act as catalysts of change:

Strategic initiatives

- Sales & Service Effectiveness.
- Improved Organizational Model Execution.
- Product Sourcing & Management.
- Product Profitability Management.
- Service Delivery Model Effectiveness.
- Proprietary Trading Reorientation.
- Operational Excellence in Back Office.
- On/Offshore Business Model Redefinition.



Wealth managers in the profitability trap

Ever since the outbreak of the financial crisis, wealth managers' revenue generation has been severely hampered by political and regulatory pressure, an unfavourable shift in private clients' investment behaviour and a considerable trust deficit. Also, an inflexible cost base has prevented many market players from fully absorbing the revenue shock. We argue that wealth managers cannot rely solely on bullish market conditions to restore their profitability margins. The industry will thus be stuck in a short- to mid-term profitability trap if no countermeasures are undertaken.

Aggressive growth in boom times

Wealth management has been a lucrative business in the past decade. The industry saw the glory of growth and prosperity during the period 2004 to 2007, which was characterised by surging asset prices and growth in measurable wealth in the global financial markets.

Throughout these boom times, many wealth managers implemented aggressive growth strategies and experienced a surge in the volume of client assets. The race to capture asset growth was run mainly in the belief that asset size was the most powerful driver of profitability.

Figure 1. Average profitability of Swiss wealth managers



○ = CAGR 2004-2007
 ○ = One-year growth rate (2007-2008)

* Client assets are calculated according to the strictest definition, namely client portfolio holdings in domestic branches

** 2009 estimates are calculated based on figures for the first half of 2009. Due to limited availability of public data, a restricted sample of wealth managers has been considered for this estimation

Source: Deloitte Research [2009]

2 Profit margin equals the difference between revenue and cost margin; revenue margin denotes the ratio between total operating income [net interest income, commission and fee income, net trading income and other ordinary income] and total client assets; cost margin denotes the ratio between total operating expenses [personnel and other operating expenses] and client assets

3 Our research suggests that Swiss wealth managers' operating revenues totalled CHF 49.6 bn in 2008 as compared to CHF 61.3 bn in 2007. This corresponds to a decrease of 19%

Consequently, revenue margins rose from an average 108.1 bps in 2004 to 113.6 bps in 2007. At the same time, the industry reduced its cost-margins from 73.1 bps to 68.4 bps. This heady mix translated into attractive profit margins,² which grew at an annual average rate of 9% over that period [see Figure 1].

From boom to doom

However, the global financial crisis triggered a rapid and unprecedented decline in profitability. Our research suggests a staggering 27% decrease in the industry's average profit margin from 2007 to 2008.

Client assets held by wealth managers declined by 26% over the same period, reflecting the drastic asset attrition observed in the financial markets in 2008 (the SPI for example fell by 34% in 2008).

This reveals that the industry's heavy reliance on commission- and fee-based revenues has elevated its aggregate exposure to financial market cycles. In addition, high risk aversion on the part of investors drove down transaction volumes; further slashing wealth managers' commission/trading income.

However, our data suggests that the resulting drop in operating revenues was comparatively less dramatic than the decline in the size of wealth managers' client assets (19% reduction in operating revenues³ as opposed to 26% asset attrition). Revenue margins therefore increased by 6% in 2008.

Many private banking clients have seen their investments decline. In consequence, a significant number of these automatically slid into more unfavorable fee schemes.⁴ This side-effect protected wealth managers' revenues from shrinking even further.

In addition to declining revenues, costs did not develop favorably. In the pursuit of asset growth, many wealth managers expanded their presence to international business locations.

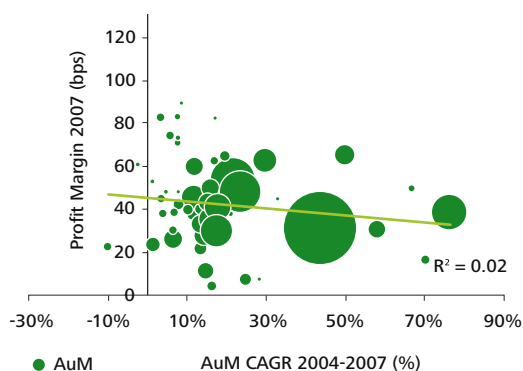
Some established booking centers, others local onshore business and many expanded their range of services, such as complex products offering. These undertakings, combined with the decline in the size of wealth managers' client assets contributed to the 28% increase in cost margins between 2007 and 2008.

Focus box 1: Asset growth alone does not equal profitability

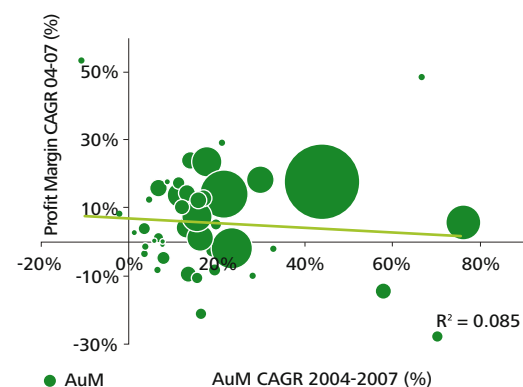
Prior to the market turmoil, the industry considered asset size and asset composition as the most powerful value drivers. As a consequence, many wealth managers focused strongly on acquiring new offshore clients and invested heavily in their international presence. However, our research suggests that banks with particularly aggressive asset growth between 2004 and 2007 did not exhibit significantly higher profitability in 2007 [see Figure 2]. On the contrary, wealth managers with aggressive asset growth faced a lower absolute profit margin and profit margin growth compared to players with low or moderate asset growth. Chasing growth therefore captured headlines but – even in booming markets – did not necessarily result in higher profitability. Further analyses indicate that aggressive growth strategies on average resulted in a simultaneous decrease in both cost and revenue margins, revealing a trade-off between asset growth and profitability realization.

Figure 2. Asset growth and profitability

No correlation between AuM growth and absolute profit margin



Weak correlation between AuM growth and profit margin growth



Source: Deloitte Research [2009] based on company data [N=103]

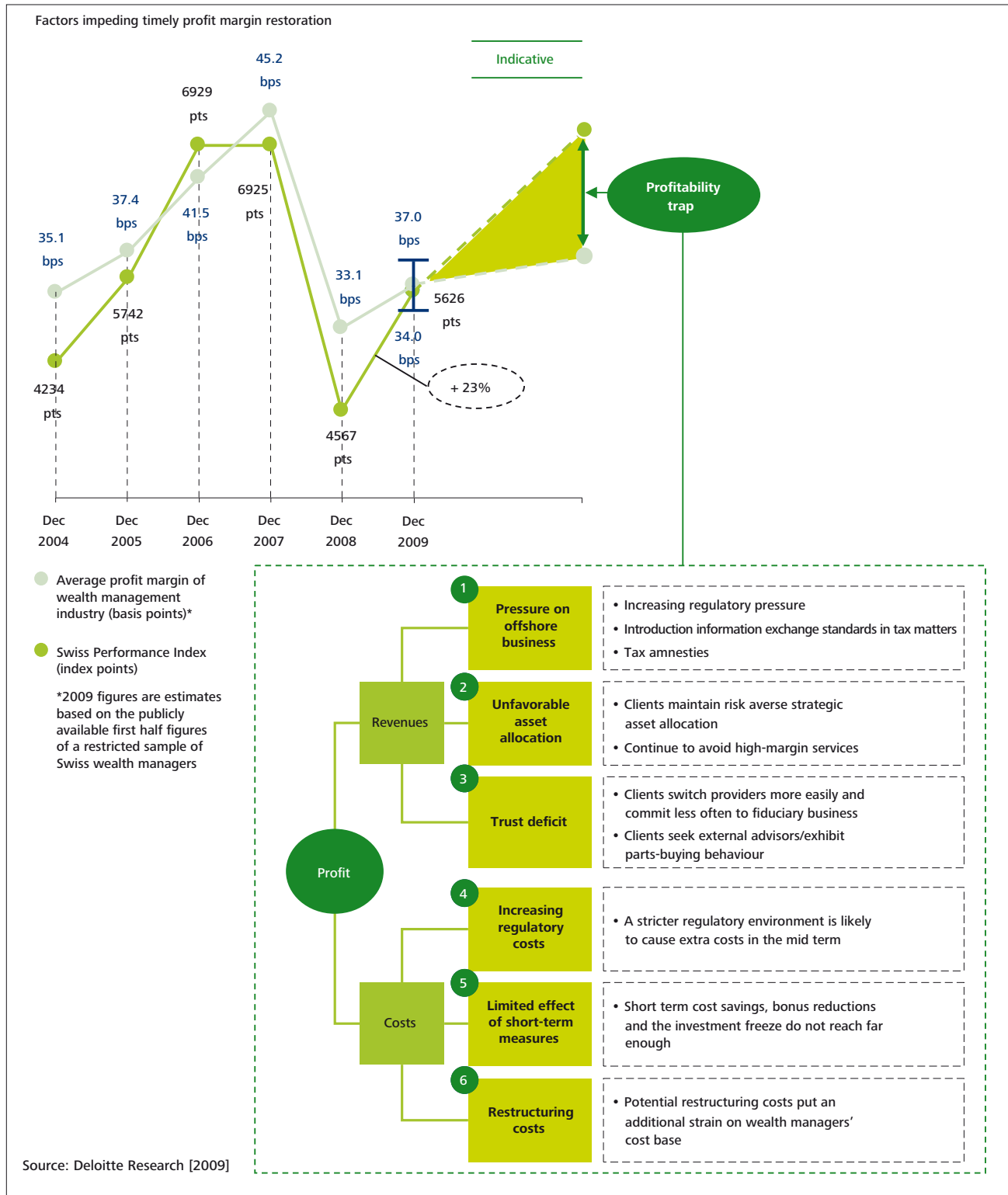
Caught in the profitability trap

Despite recovering capital markets – there has been a 23% increase in market capitalisation between December 2008 and December 2009 – we argue that in the short- to medium-term the wealth management industry's profits will remain significantly below the record levels seen in 2007. We expect profit margin for 2009 to be between 34 and 37 bps. This implies a raise of around 3-10% and puts the industry back on the profitability level of 2004 [see Figure 2 & 3]. Even though asset revaluation will continue to have

a positive effect on wealth managers' asset based fees and indirectly on commission incomes, several distinct factors in the market [see Figure 3] are *impeding wealth managers from fully restoring their historic profit margin levels*. We therefore expect many institutions to be caught in a short- to medium-term profitability trap *if no swift countermeasures are undertaken*. First, the hindering factors will put additional pressure on many market players' future revenues. Second, they will hamper wealth managers from re-shaping their cost base in order to accommodate their revenue challenge.

⁴ Private banks often charge their clients periodic fees as a percentage of the assets held in their accounts. Typically, the higher the size of the assets held in an account, the lower the percentage used to express these fees

Figure 3. Hindering factors



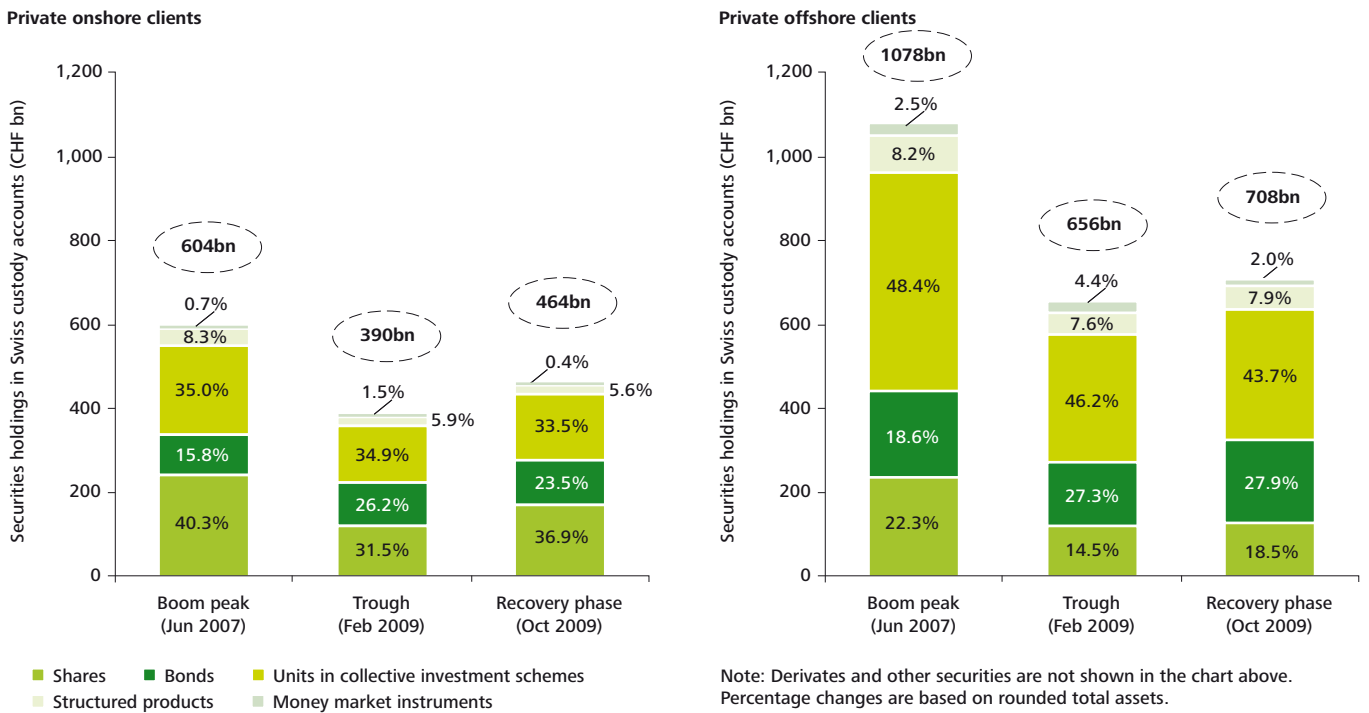
Hampered revenue generation

[1] Recent political and regulatory pressure on Swiss wealth managers with a material share of offshore business and on the Swiss offshore private banking hub has forced the industry to reduce its revenue projections. There are three factors driving this development. First, client acceptance criteria have become more rigid, preventing wealth managers from “on-boarding” offshore client segments that represent an unacceptable reputational risk due to their country of residence. Second, existing service models for offshore clients need to be modified to cater for the new realities. Third, the offshore client segment’s product and service needs are slowly converging towards those of the slightly profitable domestic onshore clientele.

As a consequence, and particularly in terms of the newly-accepted OECD transparency and information exchange standards and tax matters, the impact of increasing regulatory pressure is considered to be one of the biggest threats to offshore revenues. Other significant threats emanate from tax amnesties in major European countries and from the increasing pressure on the part of European governments for the implementation of an automated administrative assistance system with regard to tax issues. In the near future these developments could well drive assets back onshore.

[2] Investors remain wary of investing in complex products with attractive revenue margins for wealth managers. Since the outbreak of the market turmoil in 2007, private clients have gravitated towards secure/ simpler asset classes. Money market instruments served to park liquid assets temporarily during turbulent times [see Figure 4].

Figure 4. Shift in client’s wealth allocation



Source: Deloitte Research (2009)

Simultaneously, asset volumes of equities and products with more favourable revenue margins (e.g., structured products and collective investments) plummeted, due both to asset devaluation and net new money outflows. This has had a significant effect on the wealth management industry's bottom line. However, non-resident account holders were more prone to invest in products with higher margins for their wealth managers than onshore clients, highlighting the importance of the non-resident business on overall revenue generation.

More recently, private clients have started to re-direct their assets from money market investments towards equities and bonds.

The rebound in the capital markets has reduced the attractiveness of near cash instruments. Instead, it fuelled private clients' desire to benefit from revaluation of more risky asset classes. However, Figure 4 highlights that the investment funds, and in part, the structured products industry too, have suffered from shrinking asset volumes even in the course of recovering capital markets.

On and offshore clients' volumes held in these asset classes have decreased between the climax of the crisis and November 2009 (with the exception of structured products for offshore clients). Investors' newly found appetite for risk does not automatically imply an increased willingness to invest in complex vehicles.

[3] Wealth managers are still confronted with a considerable **trust deficit**. Our discussions with High Net Worth private clients have revealed that many remain sceptical about their wealth managers, irrespective of the current rebound of most capital markets.

Private clients often see their relationship managers as too sales-oriented, are unsure whether they are receiving objective advice or best-in-class products and therefore take investment advice with a pinch of salt. Investors typically react by retaining the financial decision making, engaging independent financial advisors to better "manage" their wealth managers or even by avoiding the market entirely.

"Sticky" costs

[4] Wealth managers' **cost side will generally not be able to fully absorb the revenue shock** in the near future. Risk management and compliance costs have increased substantially over the past few years and are expected to grow even further as a result of increasing regulatory requirements. The financial crisis and recent massive investment frauds are driving a new wave of regulations. The financial services industry is likely to face increased capital requirements and it will need to adapt its compensation models to the changing risk environment.

Moreover, wealth managers' costs will also increase due to the unrelenting international pressure, forcing market players in major offshore locations to take a critical look at their compliance. Many wealth managers will need to make significant investments to ensure that their products and services are in line with tightening regulation. In reaction to changes in public opinion, some players have already started to establish improved onshore offerings. These often result in higher costs both in terms of infrastructure and resources required to fulfil the need of onshore clients for frequent contact with their advisors.

More recently, private clients have started to re-direct their assets from money market instruments towards equities and bonds.

[5] Whilst **cost reduction initiatives** aiming at a quick reduction in personnel expenses and bonuses – as well as minor headcount cuts – are effective near-term, they may not suffice to fully overcome wealth managers' current cost disadvantage. To unlock longer-term cost savings that contribute to closing the profitability gap, wealth managers need to review all aspects of their businesses.

[6] **Restructuring** decisions need to be assessed carefully, as corresponding programmes are generally accompanied by major challenges. These are likely to put an additional strain on wealth managers' cost base. If not managed effectively, restructuring efforts may further deplete wealth managers' short- to mid-term profitability.

Restoring profitability is likely to prove difficult for many wealth managers as the ripple effects of the financial crisis have further added to the complexity of their markets and propositions. External and internal factors driving wealth managers' profitability have changed rapidly. This "game change" looks set to continue since multiple market parameters, including the changing regulatory environment, volatile capital markets, wealth growth, customer behaviour and technology adoption will lead to even shorter market cycles and will impact wealth managers' ability to generate sustainable profits.

In light of the expected "game change" Swiss wealth managers have considered retreating from the Swiss market [see Focus box 2]. We therefore expect a noticeable consolidation wave in the near future.

For most of the market participants, however, a structured approach towards managing the rapidly increasing complexity of their business has become a crucial prerequisite for extricating themselves from the imminent profitability trap. The following section elaborates on how complexity can be managed as one of the most effective strategic instruments to achieve sustainable profit generation.

“We reckon it’s no longer a solution to sit out the bad times in the belief that our revenue issue will vanish into thin air when markets pick up again.”

Head of Private Banking, Swiss wealth manager

Focus box 2: Opting out has become an option

As a result of the turmoil in the capital markets and of their sluggish recovery, retreating from the Swiss market has become an option for a considerable number of foreign banks with Swiss wealth management operations.

Figure 5. Drivers of market consolidation



First, several institutions savaged by the capital markets meltdown need to divest in order to survive. Second, maintaining wealth management operations in offshore destinations is no longer politically feasible for some newly state-owned global players (given the fact that their government is leading the international efforts against tax evasion). Third, the decision to opt out is driven by the fear of reputational damage, implementation of a refocusing strategy or simply a wealth manager's inability or unwillingness to bear the additional cost burden caused by soaring regulatory requirements.

Source: Deloitte Research [2009]

Managing complexity to focus on profit

Wealth managers need to manage complexity by focusing their efforts on selected key profitability levers to restore their pre-crisis profitability levels. In 2008, wealth managers with their own traditional and market tracking products and a dedicated proprietary trading function exhibited a profitability disadvantage vis-à-vis their peers. In contrast, market players with a clear focus on Affluent/HNW clients, a strong Institutional client base, an extended service offering, outsourced business processes, and an international footprint experienced superior profit margins.

Identifying key profitability levers

Senior executives cannot influence and control every aspect of the complex wealth management business. The key to managing complexity in challenging markets thus lies in identifying the internal levers which directly drive profitability.

The limited ability of wealth managers to grow without compromising profitability imposes a need to widen their previously narrow perspective in their quest to restore profitability. Instead of zeroing in on plain asset growth, revenue and cost targets, wealth managers should improve their understanding of relevant non-financial and internal factors that drive profitability.

It is critical that wealth managers address the complexity of their business operating models (BOMs) holistically. A wealth manager's BOM [see Figure 6] determines how the chosen business strategy will be executed.

The business operating model breaks down the structure of the wealth manager's organisation into its elements and components, allowing the impact of the chosen strategy to be seen in a structured manner. It therefore addresses all the relevant strategic questions covering the entire business value chain from clients to physical sites.

As will be substantiated in this report, a significant share of the profitability differences between individual market players can be explained by the specific design of their business operating model along the different BOM components.

Given a wealth manager's strategic intent, which of the profitability levers should senior executives address as a priority in order to improve profitability?

To answer this question, we followed a three-step process. **Step one**, we identified all profitability drivers and levers [see Focus box 3.0 and 3.1] that can be determined with company information available in the public domain.

Figure 6. Profitability drivers, profitability levers and strategic key questions

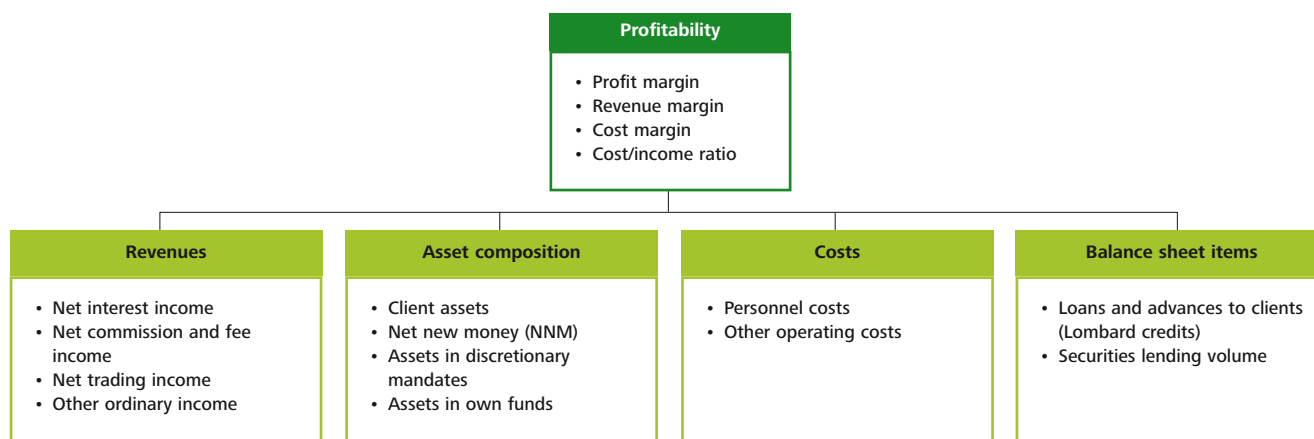


Source: Deloitte Research [2009]

It is critical that wealth managers address the complexity of their business operating models (BOMs) holistically.

Focus box 3.0. Definition of profitability drivers and levers

Figure 7. Publicly available financial information on profitability drivers



Source: Deloitte Research [2009]

Focus box 3.1. Definition of profitability drivers and levers

Figure 8. Publicly available non-financial information on profitability levers

BOM elements	Profitability levers	Key questions analysed
Clients	Focus on Affluent/HNW clients	Focus on Affluent/High net worth clients?
	Focus on V/UHW clients	Focus on very/ultra high net worth clients?
	Serving Intermediary clients	Specific value proposition for Intermediary clients exist?
	Serving Institutional clients	Specific value proposition for Institutional clients?
Products/ services	Producing and offering traditional products	Mutual funds, absolute return mandates and/or managed fund portfolios produced and distributed?
	Producing and offering market tracking products	Index funds and/or exchange traded funds produced and distributed?
	Producing and offering alternative investments	Structured products, quantitative products, private equity and hedge funds produced and distributed?
	Producing and offering extended services	Complex financial planning requirements of clients addressed and/or lifestyle products offered?
	Degree of openness of product architecture	Relative penetration of own products in client portfolios?
Process	Standardised advisory process	Standard advisory process with corresponding system support introduced?
Organisation	Outsourcing single/multiple back office services	Specific parts or all back office functions outsourced?
	Degree on organisational independence	Subsidiary of a Swiss/foreign bank or truly independent?
	Listing on Stock Exchange	Wealth manager or parent listed?
	Running a proprietary trading function	Trading on own account covering a variety of strategies, such as index, statistical, merger and volatility arbitrage as well as fundamental analysis and macro strategies?*
	Maintaining an investment banking function	Own investment banking division (covering M&A, ECM, DCM and/or Financing business)?
Technology	Core banking solution	Core banking solution sourced externally or built in-house (package solution)?
	Application service outsourcing	One or multiple applications sourced to an external ASP?
	IT outsourcing	Specific parts or entire IT infrastructure (hosting) outsourced?
Physical sites	Maintaining an international footprint	<ul style="list-style-type: none"> • Domestic onshore and offshore business only? • Domestic on/offshore and European onshore business? • Domestic on/offshore as well as selected global onshore business? • Truly global onshore business?

* Proprietary trading related to market making and product management is not considered here (out of scope)

Source: Deloitte Research [2009]

Step two, we determined the degree of interconnectivity between identified profitability levers by means of a cross-impact analysis. The aim of this step was to eliminate those profitability levers which exert uncontrollable influence on other levers in the system, and those levers which did not influence profitability at all. These types of levers are called “critical”, “buffering”, and “reactive”.

Step three, we investigated the net effect of each lever on an average wealth manager’s profit margin for the years 2007 and 2008. For this purpose, we applied statistical methods to the publicly available financial and qualitative data of 103 Swiss-based wealth managers in our research.

Finding the golden nuggets – the eight “active” profitability levers

Levers exhibiting a strong influence on profitability while not having uncontrollable effects on other levers represent the most favourable starting point for management to find a way out of the profitability trap.

We identified these so called “active” levers by applying a sensitivity network [see Figure 9].

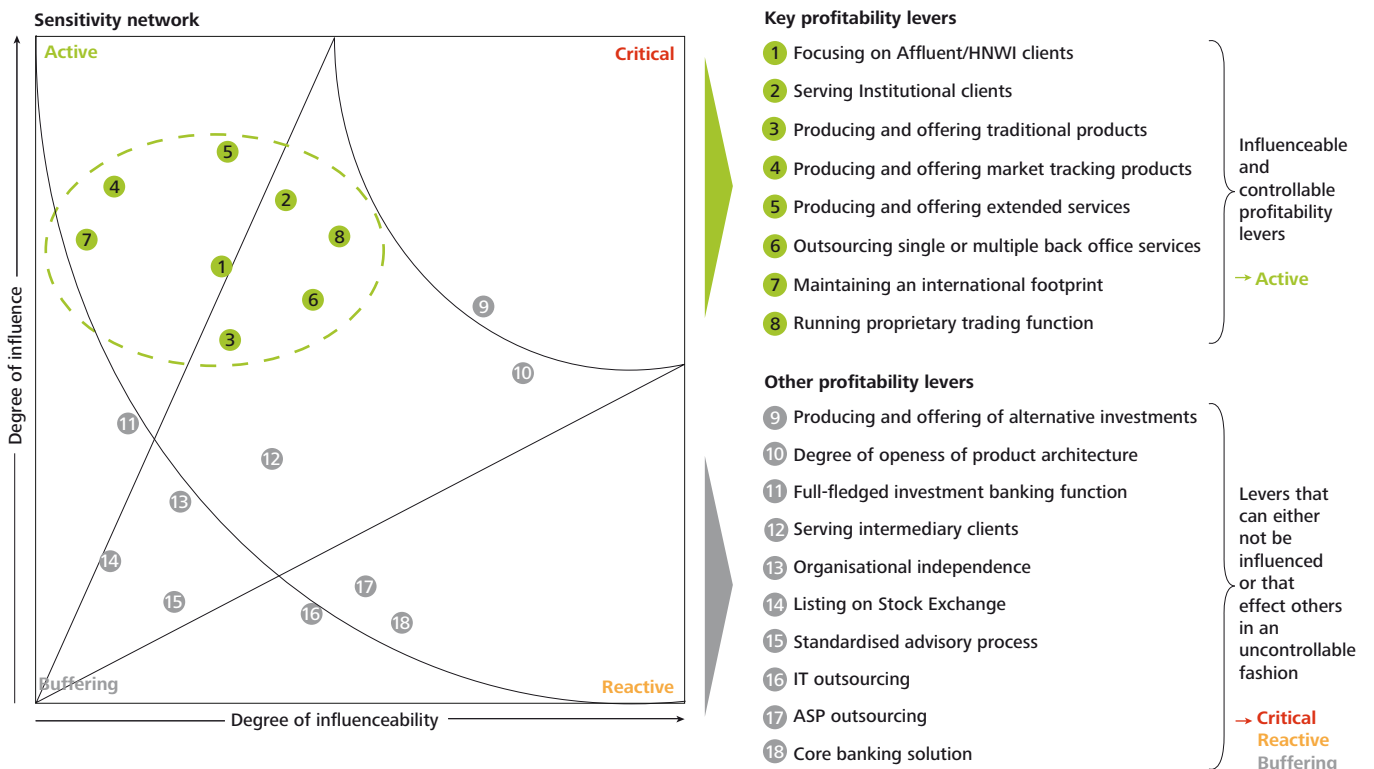
Our analysis highlights that all “active” levers relate to three distinct BOM elements of a wealth manager: they determine which client segments a wealth manager intends to focus on (levers 1-2), specify what kinds of products and services are offered (levers 3-5) and define the internal organisation (levers 6-8). These three BOM elements therefore represent the most critical areas for consideration by a wealth manager when reconfiguring a BOM setup.

The subsequent analysis focuses on the selected eight “active” levers in order to identify their impact on profitability.

“The active levers explain 48% of variation in profitability across different market players.”

Regression equation, R^2 adjusted = 0.48

Figure 9. BOM profitability levers in the sensitivity network

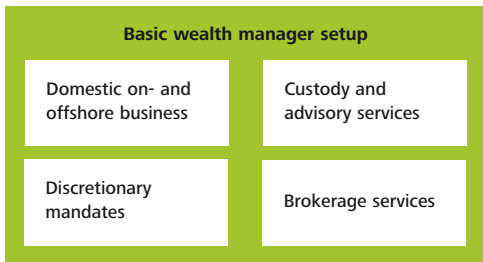


Source: Deloitte Research [2009]

Maximising profitability through effective combination of profitability levers

How can wealth managers combine and configure “active” profitability levers to maximize profitability? Based on the results of our analysis, we argue that the most profitable wealth managers succeeded in adding those profitability levers with a positive influence on profitability (called profitability cultivators) to the basic wealth management setup [see Focus box 4], while avoiding or resolutely reengineering levers with a negative impact on profitability (called profitability slayers).

Focus box 4: Basic wealth management setup



The basic wealth manager setup describes a synthetic structure that excludes the eight levers under analysis which are common to most players in the Swiss wealth management market. It depicts a simplified model bank focusing on domestic on-/offshore business with Affluent, HNW or UHNW private clients. The model bank offers custody, advisory and brokerage services, as well as standardized and individual discretionary mandates. However, it does not produce its own investment products.

Statistical analysis⁵ of financial and qualitative data of more than 100 Swiss wealth managers has shown that institutions with a basic wealth management setup but no further implemented profitability levers yielded an average profit margin of 26.7 bps in 2008 (46.6 bps in 2007).

Figure 8 highlights the effect of individual levers on Swiss-based wealth managers’ profitability. In 2008, players with a strong focus on the Affluent/HNW client segment, an Institutional client base, an extended service offering, outsourced business processes and an international footprint achieved a 49.6 bps profitability bonus in excess of the standard 26.7 bps profit margin that resulted for wealth managers with a basic setup.

In contrast, players who implemented every single profitability slayer but no profitability cultivators experienced a total 44.4 bps profitability “malus”. Those wealth managers were confronted with a negative overall profitability of -17.7 bps (26.7 bps minus 44.4 bps).

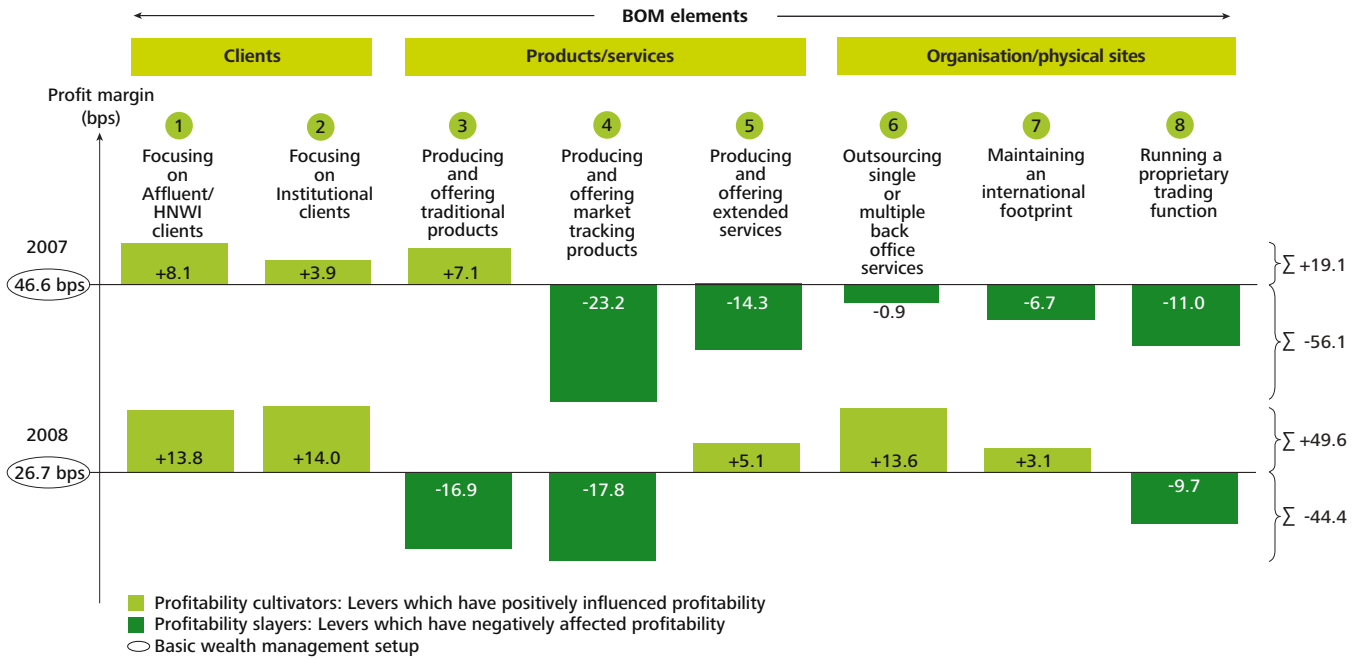
However, individual levers not only differ regarding their overall impact on profitability, but also regarding their impact on revenue and cost margins [see Figure 9].

Therefore, wealth managers formulating and executing their strategy should think carefully about why certain levers have either a positive or negative effect on revenues and costs.

To facilitate this process, the rationale behind the effects of each “active” profitability lever on revenues, costs and profitability is discussed in detail in the following section.

⁵ Deloitte Research [2009], based on regression analysis; mathematically, the “average” profitability for the basic wealth manager setup represents the constant in the regression equation

Figure 10. How wealth managers cultivate or slay their own profitability



Source: Deloitte Research [2009]

Figure 11. Profit, revenue and cost margin impact of the "active" levers

BOM profitability levers		Observed financial impact*					
		Profit margin (bps)		Revenue margin (bps)		Cost margin (bps)	
		2007	2008	2007	2008	2007	2008
Clients	1 Focusing on Affluent/HNWI clients	+8.1	+13.8	= +3.8	+2.5	- -4.3	-11.2
	2 Focusing on Institutional clients	+3.9	+14.0	= +5.4	+11.9	- +1.5	-2.1
Products/services	3 Producing and offering traditional products	+7.1	-16.9	= +12.2	-7.4	- +5.1	+9.5
	4 Producing and offering market tracking products	-23.2	-17.8	= -18.5	-9.1	- +4.7	+8.8
	5 Producing and offering extended services	-14.3	+5.1	= -5.4	+15.4	- +8.9	+10.3
Organisation	6 Outsourcing single or multiple back office services	-0.9	+13.6	= -2.2	-2.5	- -1.3	-16.1
	7 Maintaining an international footprint	-6.7	+3.1	= -2.9	+18.0	- +3.8	+14.9
	8 Running a proprietary trading function	-11.0	-9.7	= -6.6	-0.2	- +4.4	+9.5

□ Positive impact (profitability bonus)
□ Negative impact (profitability malus)

(+): relative advantage if compared to control group
 (-): relative disadvantage if compared to control group

* Note that the decimal places of certain revenue and cost margin figures in this table do not add up to total profit margin due to rounding differences

Source: Deloitte Research [2009]

Clients

[1] Superior revenue margins with Affluent/HNW clients:

In 2007, wealth managers focusing on low- and mid-end private banking clients achieved on average both a higher profit and a higher revenue margin than those who served mainly Very and Ultra High Net Worth Individuals (V/UHNWI). Revenue margins tended to be lower for wealthier clients as these, often, have greater bargaining power and financial sophistication, follow a more product/deal-driven approach and are characterised by higher price sensitivity. Many of the wealthiest clients can also be expensive to serve. In 2008, focusing on low- and mid-end clients led to an even greater positive effect on profit margin (+13.8 bps).

[2] Intergroup synergies in serving Institutional clients:

Serving this client segment had a positive effect on revenue margins (+5.4 bps in 2007 and +11.9 bps in 2008) as similar or identical products and services can be sold to a wider range of clients. In 2007, this went hand in hand with an increased cost margin (+1.5 bps) because in general the average time spent with Institutional clients is on average slightly higher compared to private clients.

This reduces the number of clients per relationship manager which in turn limits the wealth manager's effectiveness in leveraging expertise. Therefore, a greater number of relationship managers are required to serve Institutional clients. The slightly higher cost margin also suggests that infrastructure and fixed costs may not have been distributed effectively enough between asset management and private banking. In 2008, a slightly improved cost margin (-2.1 bps) could be observed. We argue that this is mainly due to an improved cost distribution between the asset management and private banking entities described above.

Products/Services

[3] Margin disadvantage for traditional in-house products:

In 2007, wealth managers producing traditional products achieved a positive financial outcome as they realised a more attractive revenue margin on in-house investment funds than on third party funds. In addition, absolute return mandates and managed fund portfolios yielded a higher revenue margin than non-managed mandates.

In 2008 however, the positive effect turned into a clear profitability disadvantage of -16.9 bps, triggered by a considerable outflow of in-house funds and a shift of client assets into less profitable mandates (e.g., clients invested less in absolute return mandates and managed funds portfolios). However, despite the market turmoil, no significant correlation between profitability and a wealth manager's degree of **open product architecture** (i.e., the degree to which the provider pushes proprietary products into clients' portfolios irrespective of the availability of better performing alternatives in the market) could be established by our analysis. Moreover, a private bank's interest in selling index products is limited. The rationale is that they can generate higher revenue margins with in-house funds (200+ bps) compared to a per annum Total Expense Ratio (TER) between 30 and 40 bps for ETFs.⁶

[4] Lack of scale of low margin market tracking products:

Wealth managers producing and offering market tracking products displayed a significantly lower profit margin than their peers without such offerings. Our research suggests that Index Funds and ETFs represent a relatively low revenue margin business. Despite its attractiveness for clients, this business could not (yet) generate a critical business volume and did not yield sufficient additional revenue for sales force to cover the costs that result from producing and selling these products.

[5] Cost-effective charging of extended services:

In 2007, delivering extended services, such as financial planning, family office services and lifestyle offerings, had a negative impact of -14.3 bps on the overall profitability. One year later the situation changed significantly (+5.1 bps), driven by a combination of higher demand and new revenue generation.

To overcome the recent trust deficit exhibited by their clients, many wealth managers decided to increase the depth and breadth of their advice-based services. This led to an increased demand for those types of products. Furthermore, following the financial crisis, less risky lower-margin products became more popular. To limit the damage to their profitability, a number of wealth managers who used to provide extended services as a courtesy to their clients, began to charge for that service.



⁶ Source: Deloitte Research [2009] based on EDHEC European ETF Survey [2008]

Organisation

[6] Maturing business process outsourcing (BPO)

solutions: In 2007, wealth management providers engaging in BPO benefited from a cost margin advantage (-1.3 bps) as compared to institutions that did not outsource their business processes. This relatively low advantage highlights the fact that the BPO concept has not yet exploited its true benefit potential. In the underlying business cases, certain players did not consider hurdles such as high shut down costs, redundancy operating costs and migration cost overruns – all on the outsourcing party side. These have hindered maximum benefit-realisation on the cost side. If planned and executed correctly, the expected benefit from BPO is considerably higher, as can be seen in a cost margin advantage of -16.1 bps and a profit margin advantage of +13.6 bps in 2008. The revenue decrease of -2.2 bps (-2.5) for wealth managers relates to the fact that high-margin, complex and hard to standardize products are usually no longer processed by the outsourcing provider.

[7] Increasing importance of international presence:

Wealth managers with a focus on domestic Swiss on- and offshore business achieved a considerably higher profit margin (+6.7 bps) in 2007 than players with an international footprint. The cost advantage for wealth managers without an international footprint arose from their avoidance of costly branch expansions outside Switzerland, e.g., banking license expenses and costs related to regulatory as well as compliance requirements. This becomes obvious when looking at 2008's cost margin disadvantage of +14.9 bps for players with an international footprint. Prior to the financial crisis, revenue margins tended to be higher offshore as such clients were generally less price sensitive and less focused on performance. As a result, our data suggests that players with an international footprint had a slight revenue margin disadvantage of - 2.9 bps in 2007. In 2008, this revenue disadvantage turned into a clear advantage and grew to a total +18 bps. Wealth managers with the ability to capture repatriated onshore assets have proven to be the beneficiaries of recent asset outflows from Swiss wealth management market. The pure offshore players' disadvantage regarding revenue margin, on the other hand, arose due to clients' reluctance to invest assets offshore in 2008.

[8] Loss-making proprietary trading: The last key profitability lever included in the analysis relates to proprietary trading activities. The observed revenue margin difference of -6.6 bps in 2007 between players with and without proprietary trading resulted directly from drying-out and falling markets for complex derivatives and structured products.

Several market players were forced to write-down positions on their own books. Interestingly, the more trading-oriented market players managed to recoup their revenue disadvantage already in 2008. For the period in scope of this research, these players achieved only a slightly lower revenue margin (-0.2 bps) than their peers without proprietary trading desks. This striking change is suggestive of wealth managers' swift measures to resolve their valuation and risk identification issues brought to light in the course of the market turmoil.

However, wealth managers with a proprietary trading desk exhibited (in both 2007 and 2008) a significantly higher cost margin than their peers.

We argue that the resulting cost disadvantage is mainly driven by higher investment costs into a complex and expensive infrastructure ranging from IT to employment of specialised traders. Particularly interesting is the fact that the cost disadvantage of wealth managers with proprietary trading has increased from 2007 to 2008. This demonstrates that most wealth managers started building up relevant proprietary trading capabilities before the outbreak of the market turmoil. The associated investment costs do not seem to have been fully amortised by 2008.

Concluding appraisal of key profitability levers

Based on our previous analysis and interpretation of key profitability levers, we can draw the following conclusions:

- **A clear focus on Affluent/High Net Worth clients and a strong Institutional client base** is a very strong profitability contributor in any kind of market.
- **Producing & offering traditional products** is very market sensitive and has to be managed very carefully.
- **Producing & offering market tracking products** is a significant profitability slayer, indicating that the industry is facing a lack of scale challenge.
- **Producing & offering extended services** will, in the near future, also be a key differentiating factor as this represents one of the most powerful means to overcoming the trust deficit.
- **Outsourcing single or multiple back office services**, when planned and executed correctly, demonstrates considerable added profitability and is an indicator for operational excellence in this part of the value chain.
- **Maintaining an international footprint** – in the context of a stricter regulatory environment – characterises a profitability cultivator in the near term.
- **Running a proprietary trading function** turned out to be a loss maker over the last two years.

Our research has demonstrated that the key to leading-edge profitability generation primarily lies in the effective combination and design of key profitability levers. Therefore, the next section investigates ten distinct profitability lever combinations that have been adopted by a large number of Swiss-based wealth managers. Each of these lever combinations represents a unique business operating model and contributes significantly to explaining variations in profitability across different market players. Our goal is thus to identify those business operating models yielding the highest absolute profit margin and profit margin growth (“winning BOMs”).

“Had we known earlier how little we actually make with these products after considering all related costs, we would have intervened much more decidedly.”

CFO, medium-sized Swiss Private Bank

Winning business operating models

Our research suggests the existence of ten predominant business operating models in the market. A “winning” BOM is characterised by above-average absolute profitability and by profitability growth in both a bullish and bearish market environment. However, we found no evidence that either client asset size or a simple BOM setup contributes decisively to winning in the market. Of all models under analysis, only BOM type 3 outperformed its peers in 2008 thanks to its crisis-resilient setup. This model represents roughly 22% of the analysed market players.

Identifying the winners

Wealth managers seeking to maximise profits should build their models around profitability cultivators while minimising the negative effects associated with profitability slayers. Yet, which BOMs did actually maximize profitability during the bull market in 2007 and the following bear market in 2008? Just as importantly, which BOMs will emerge as winners in the future?

Figure 12 highlights that BOM 3 is the most commonly observed model in the Swiss wealth management market. It has been adopted by over 22% of the banks under analysis, ranging from small (CHF 2 bn AuM) to mid-sized private banks (CHF 25 bn AuM).

BOM 9, on the other hand, is the largest in terms of client asset size, representing 15% of the total AuM.

The eight “active” levers represent the foundation of the following analysis. We identified ten major clusters of banks in the Swiss wealth management market. Each of these clusters exhibits a unique combination of these “active” levers as depicted in Figure 12. Their individual lever combination builds on the basic wealth manager setup which is common to all players [see Focus box 4]. This BOM has been adopted by a relatively small number of banks with AuM ranging from CHF 10bn to CHF 150bn.

Finally, it should be noted that all BOM types diverge with respect to how many profitability levers they have implemented. This is an indicator of the BOM’s complexity.

Figure 12. Business operating models identified in the Swiss market

Business operating model description		Profitability levers											
		Percentage of banks included in BOM cluster (2008)	Percentage share of total market AuM represented by BOM cluster (2008)	Number of implemented profitability levers	Clients		Products/services			Organisation			
Affluent/HNWI clients	Institutional clients				Traditional products	Market tracking products	Extended services	Back office outsourcing	International footprint	Proprietary trading			
1	Pure play private bank with truly open product architecture (advisory focus)	16.7%	2.3%	1	●								
2	Pure play private bank with traditional product offering and BPO	11.1%	3.0%	3	●		●				●		
3	Internationally present wealth manager with own traditional products and BPO	22.2%	7.2%	5	●	●	●				●	●	
4	Private bank for Very/Ultra wealthy clients with truly open product architecture and focus on extended services	9.3%	0.5%	1					●				
5	Wealth manager with broad own product/service offering and BPO	7.4%	8.1%	4		●			●	●			
6	Internationally present private bank for Very/Ultra wealthy clients with broad own product/service offering and BPO	5.6%	13.5%	4			●		●	●	●		
7	Internationally present wealth manager with broad own product/service offering and BPO	7.4%	14.6%	5		●	●		●	●	●	●	
8	Wealth manager with very broad own product/service offering and BPO	7.4%	4.3%	5		●	●	●	●	●			
9	Internationally present wealth manager with very broad own product/service offering and BPO	7.4%	15.1%	7	●	●	●	●	●	●	●	●	
10	Internationally present wealth manager with very broad own product/service offering	5.6%	31.4%	5		●	●	●	●			●	

Analysed on individual WM player level only

Most used lever
 Least used lever

● Implemented profitability lever
 Most common BOM
 Largest BOM in terms of AMA

“Private bank” = Domestic onshore/offshore player with Affluent/High Net Worth clients
 “Internationally present” = Player with domestic, global onshore as well as offshore business
 “Wealth manager” = Focus on private (Affluent/HNW/UHNW) and institutional clients

We classified each business operating model into one of four distinct clusters (winning, catching-up, stagnant and struggling) [see Figure 13] according to absolute profitability in 2007 and 2008, respectively, and profitability CAGR between 2004 and 2007 or 2004 and 2008, respectively. This approach is based on the rationale that winning BOMs are characterised both by above average absolute profitability and by superior annual compounded profit margin growth during the period under analysis. We argue that using absolute profitability as a basis for comparison accommodates the fact that profit maximisation should be the overarching goal of most wealth managers. On the other hand, annual compounded profitability growth, serves as a proxy for sustainable profit generation over a given time period and acknowledges the dynamics behind wealth managers’ profit generation.

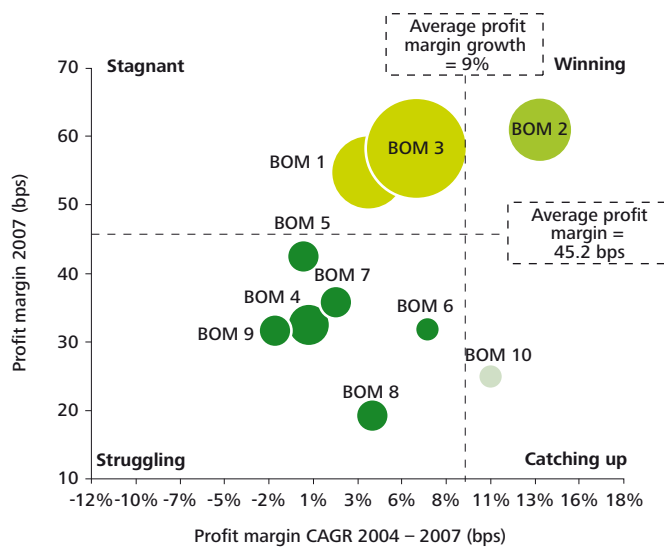
Winning models – BOMs 2, 3, 7, 9

The most successful model (BOM 3) is characterised by a superior robustness in terms of sensitivity to market turmoil. With a profit margin of 58 bps, it was already a top performer in 2007. Its setup turned out to be very favourable once again (54 bps) in 2008. Its focus on more profitable, geographically diversified client segments was rewarded, and it managed to avoid other elements that have a detrimental effect on profitability. Moreover, BOM 3 benefited from an efficient back office operating model.

BOMs 7 and 9, which were somewhat struggling in 2007, became winning models in 2008 as they managed to increase their average profit margin by 10 bps. These models achieved a clear advantage over their peers by focusing on the more stable Institutional client segment, charging for extended services instead of providing these as a mere courtesy to clients, increasing back office efficiency, and leveraging their international footprint.

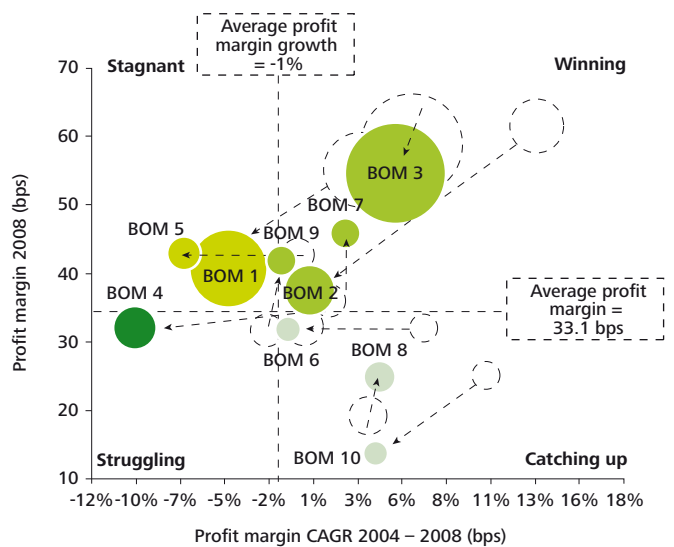
Figure 13. Business operating models in the Swiss market

Bullish market – BOM clusters 2007



Bubble size indicates number of wealth managers included in BOM

Bearish market – BOM clusters 2008



() BOMs in 2007

Bubble size indicates number of wealth managers included in BOM

Source: Deloitte Research [2009]

Contrary to these relatively robust models, **BOM 2** was a top performer only in the booming market. In 2008, this model faced a profit margin decline of 24 bps, equalling approximately twice the extent of the average profit decline in the Swiss wealth management market. Its very favourable lever combination in 2007 (worth 61 bps) turned out to be less advantageous in 2008. This model's focus on Affluent/High Net Worth clients made it vulnerable to overreactions of this client segment in the course of the market turmoil. Affluent clients exited more quickly than UHNW individuals from high margin products such as mutual funds and structured products. On the other hand, the model's traditional product offering could not easily cope with the changing market environment.

This fact had a noticeable impact on profit generation: between 2004 and 2008, the model's profit margin grew by only 1% [see Figure 13].

Catching-up models – BOMs 6, 8, 10

BOM types 6, 8 and 10, are positioned in the "catching up" cluster. The profit margin of **BOM 6** remained stable (32 bps) as the implemented levers – extended services, back office outsourcing and international footprint – turned out to be a backbone for profitability generation in a changing market environment. The profitability slayer 'traditional products' did not have as great an impact, as this, **the most frequently used lever**, punished the vast majority of Swiss-based wealth managers in the same way.

BOM 8, otherwise similar to BOM 6, realised additional benefits due to its Institutional client base. The latter registered fewer asset outflows and more stable investment behaviour than the private client segment. However, BOM 8 was punished as a result of its unprofitable production and provision of market tracking products.

BOM 10 remains one of the least profitable models and suffered from a profitability decrease from 25 bps to 14 bps. The simultaneous production and offering of both traditional and market tracking products in combination with a lack of focus on profitable private client segments and back office efficiency weighs too heavily against it.

Struggling models – BOM 4

BOM 4 faces a profitability growth challenge and the greatest negative profit margin growth in the period under consideration (profit margin CAGR 2004-2008 equalled -9%). This setup indicates that such a simple lever combination is not as well suited as its peers to the rigours of an increasingly competitive environment. Most notably, the model's reliance on domestic on-/offshore business represents a major challenge in the light of the increasing regulatory and political pressure. Also, this model failed to achieve any economies of scope with respect to focusing on the more profitable Affluent/HNWI client segment and back office efficiency.

Stagnant models – BOMs 1, 5

Although **BOM 5's** profit margin was above average (43 bps) in 2008, it did not manage to grow its profitability between 2004 and 2008 (-6% profit margin decrease). The model's underlying profitability lever combination was therefore not robust enough to withstand the negative effects of the 26% decline in asset prices [see Figure 1]. In consequence this setup is generally more likely to be successful in booming markets than in turbulent markets.

The case for **BOM 1**, with its very simple lever setup, is very different. Focusing exclusively on Affluent/High Net Worth clients and disregarding any other profitability cultivators turned out to be an insufficiently diversified strategy in an environment of decreasing markets.

Varying degrees of resilience across different models

Across the 103 Swiss headquartered and globally operating wealth management businesses analysed, the market meltdown in 2008 had an uneven impact. This led to a polarization in prospects between potential winners and losers.

Figure 13 illustrates that, whilst the entire industry was affected by the financial crisis, individual BOM types demonstrated varying degrees of resilience. This finding is best explained by comparing absolute profit margins for 2007 and 2008, and profit margin growth for the period 2004-2007/2008. BOM 3 ranks highest within these two categories and can be seen as a very robust business operating model generating constantly high profit.

In contrast, BOMs 1, 4, 5, 6, 8 and 10 demonstrated some weaknesses around their setup, having been "struggling", "stagnant" or "catching-up" in both 2007 and 2008. Those models represent 52% of the providers under analysis, which is a clear indicator of the challenge the wealth management industry faces in terms of sustainable profitability generation.

In summary, our analysis has demonstrated that differences in profitability across individual wealth managers can largely be explained by the characteristics of their business operating model. Each business operating model can be characterised by its unique profitability lever combination and design, which in turn represents the outcome of a wealth manager's chosen strategy.

To address potential profitability issues, market players therefore need to transform their existing business operating models by means of changing or adapting particular key profitability levers. The following section presents eight distinct strategic initiatives that support wealth managers in this transformation process.

Transformation agenda

A fundamental business operating model transformation is required for players with stagnant, struggling or catching-up models. Depending on a market player's strategic intent and current BOM setup, specific strategic initiatives allow them to implement, improve, avoid or reengineer relevant key profitability levers and to manoeuvre to a more attractive profit margin.

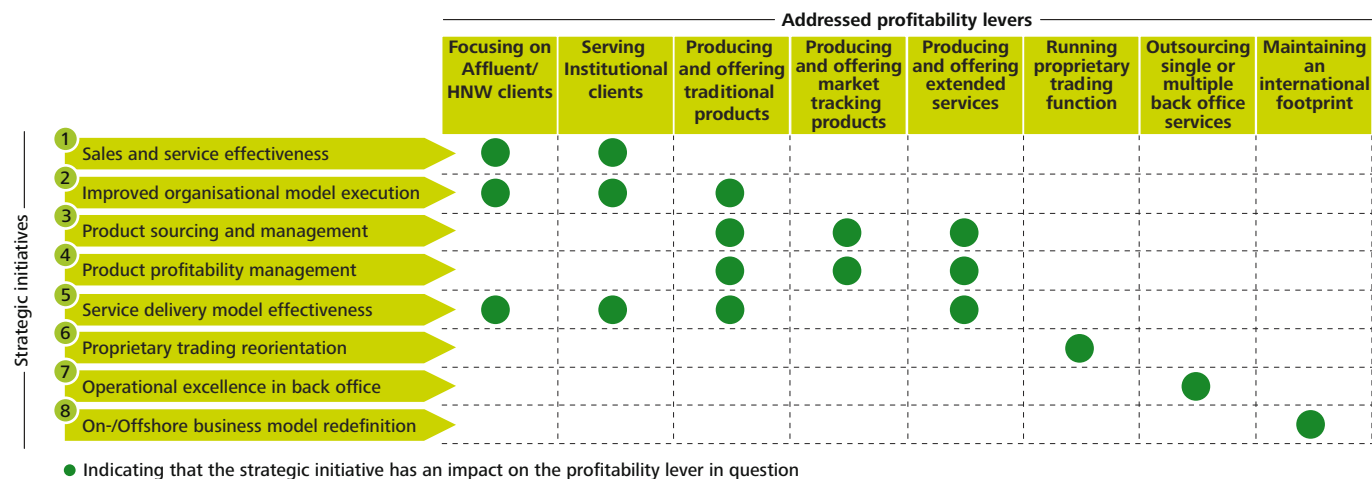
Business operating model transformation – the key to success

Wealth managers will have to transform their current business operating model setup in order to extricate themselves from the profitability trap. Depending on their strategic intent and on the profitability levers that need to be addressed, the transformation focus will vary between the different players. Such transformation usually includes a high degree of complexity, which is best managed by applying a structured approach. To identify, select and plan appropriate strategic initiatives, wealth managers should better understand their current BOM setup, assess how well the latter is aligned with their strategic intent and compare their actual profitability against that of their peers (competitors in the same BOM cluster).

These considerations support wealth managers in determining if the implemented BOM, the chosen strategic intent, or both, need to be revised.

Wealth managers can select, plan and execute different strategic initiatives for each lever that has to be addressed [see Figure 14]. These initiatives aimed at manoeuvring to a more attractive industry profit margin level are formed around individual BOM elements and their corresponding "active" profitability levers. The underlying logic behind this approach is that the BOM concept, with its capability-based view (CBV) of strategy, acts as the most powerful catalyst for profitability generation.

Figure 14. Strategic initiatives



Source: Deloitte Research [2009]

1. Sales and service effectiveness

The market turmoil has proved the need for wealth managers to focus on changing the skills and attitude of private bankers in their interaction with clients. This client focus consists of three main capability components: customer orientation, customer interaction and customer enablers. Of these, customer interaction is likely to become the most crucial factor. As revenues decrease, sales and service effectiveness become even more important.

In this context, a complementary approach to improving the sales effectiveness of relationship managers is to focus on the time they spend with clients, using the following three-step plan:

1. Increase the overall amount of time spent with clients ('sales capacity').
2. Allocate time more effectively across the client base.
3. Maximise the effectiveness of time spent with a given client.

Optimizing the client-facing time is a very strong revenue enhancement lever as research shows that there is a reasonably strong, positive relationship between the time spent with clients and assets under management growth.

2. Improved organisational model execution

Wealth managers serving not only private but also Institutional clients face important organisational choices. Success – **on both the cost and revenue sides** – is driven more by better execution of a specific model than by selection and structure of the model itself.

The range of models includes:

- **Sovereign model:** Private client and Institutional asset management are kept entirely separate. This typically enables greater private client product customisation and a closer relationship between client, relationship manager and portfolio manager.

- **Private client integrated model:** The private client asset management unit reports to the private client division, with strong functional coordination between private client business and Institutional asset management.
- **Asset management integrated model:** Asset management is centralised, with dedicated private client asset managers who liaise closely with the private bankers.
- **Manufacturing-distribution model:** A centralised asset management function serves the Institutional and private client distribution channels.

3. Product sourcing and management

On the product origination side, the product development area is of specific interest. A disciplined, well-executed product development process is key to a successful product launch. Manufacturing costs can be significantly reduced. However, this requires a change in the product development process via focus on the following key areas:

- Process governance has clear ownership and end-to-end accountability.
- Only business case driven product ideas are pursued addressing a critical mass of clients.
- Product developing ideas receive input from all relevant sources – the clients, the front line and marketing.
- Strong focus on commercial aspects instead of risk, infrastructure and legal issues dominating go/no-go decision.
- Performance tracking of post product launch.



4. Client and product profitability management (CPP)

Many wealth managers pursued an undisciplined “product rush” in the belief that product diversification and customisation would drive volume and thus margin expansion would be a key competitive differentiator. Overall, however, the impact has too often been disappointing [see Figure 11].

Against this background, it is crucial to track performance as mentioned above, whilst also using a profitability calculation framework which makes it transparent why certain product/service offerings are not profitable (enough) and why they should therefore no longer be produced (or maintained). Such transparency adds considerable value as wealth managers often lack the required knowledge, process and system support to account for true product, client and relationship manager costs.

Actual resource consumption by any of these is in many cases unknown. This poses a considerable challenge for the management, as strategic as well as operational decisions related to clients and the product/service offering can only be undertaken on a partially informed basis. The optimal outcome of a more structured form of client and product profitability management is therefore a clear view on client, product, relationship managers and business line profitability and a better idea of the root causes of identified revenue and cost issues. This also provides a sound basis for the implementation of continuous profitability monitoring/steering further down the line.

5. Service delivery model effectiveness

The financial crisis caused a trust deficit that triggered a fundamental shift in client behaviour, putting a strain on every wealth manager’s future revenue generation potential. The key point here is to reshape the service delivery model from the product/service offering perspective.

Therefore, wealth managers need to act decisively and pro-actively to implement a host of measures which restore clients’ trust in their business:

- Successful wealth managers increasingly see themselves as partners to their clients. They seek a professional and emotional lock-in by adapting pricing schemes to hourly billing based mandates or the introduction of participation schemes.
- Products and services offered to the client need to be less complex and more easily understandable. Leading wealth managers enhance their client support by more frequent communication, by a concisely-defined investment timeframe and by refocusing on the client’s risk/return profile.
- By simplifying product description, increasing price transparency, emphasizing managed accounts and following a “client first” approach they move towards greater product transparency.
- Wealth managers need to aim at realistic performance. The key to positive, realistic investment performance lies in counteracting both excessive performance expectations and speculative investment behaviour of clients with substandard risk ability.
- To achieve optimum client service levels, players need to improve their understanding of their clients’ buying behaviour and correctly align the service model. Relationship managers need to demonstrate a willingness to go the extra mile.

6. Proprietary trading reorientation

The reorientation of the proprietary function starts with the alignment/reduction of trading limits. In wealth management, this is a direct consequence of a clear focus on the core business. The strategic intent of a long-lasting, sustainable investment philosophy of private banking does not operate well in conjunction with large volatile trading positions within investment banking. Thus, the necessary strategic fit of private banking business with proprietary trading has a direct input on investments into the complex and expensive trading infrastructure. This alignment and rightsizing covers not only information technology, but also organisation and people.

7. Operational excellence in back office

One of the most effective disciplines that characterise wealth management operational excellence leaders is back office outsourcing. As our analysis concluded, there is a benefit to be achieved by outsourcing back office services. In 2008, this benefit was worth approximately 13 bps. However, wealth management providers should **not automatically infer** that outsourcing their operational and support infrastructure is the answer. The most appropriate way to assess outsourcing as a strategic initiative is to formulate a robust operational and support strategy, shaped by the business strategy and founded on rigorous and comprehensive analysis.

The operational strategy should examine the complete spectrum of potential operational models, of which outsourcing is only one. For some functions, processes, or geographies, value creation may be best achieved by rebuilding and re-engineering internally; for others, it might be to look at opportunities for cross-product or cross-geography shared service facilities, utilising the best internal infrastructure to enhance service and eliminate duplication.

8. Onshore/offshore business model redefinition

International efforts on a macroeconomic level towards stricter regulation of cross-border banking and planned tax amnesties as well as similar measures such as “voluntary disclosure” in various countries will lead to strategic challenges for wealth management providers. Regardless of past and expected future international initiatives, private banks are used to dealing with new regulations, as the banking industry has always been one of the most regulated economic sectors. In consequence, regulatory management should already be a core element of a wealth manager’s corporate strategy, as there is constant uncertainty about future changes.

Against this background the entire business operating model needs to be redefined with respect to on- and offshore wealth management. Figure 15 summarises the most important strategic questions in this specific context.

Despite differing initial situations across the sample of wealth managers investigated, we argue that the starting point for **most** models is a decisive step towards changing their organisation with the aim of overcoming the **deep-seated lack of private client trust** towards their wealth management providers. Frustrated and disappointed clients now expect solutions better tailored to their needs, honest communication and a readiness to change.

The key to success: Informed choice and correct execution

To move away from the profitability dilemma, a combination of different strategic initiatives is necessary. As different BOMs stem from varying initial situations wealth managers will prioritize differently in order to address their profitability ambitions. Once again, a successful outcome is highly dependent on making an educated decision on strategic initiatives, and executing them correctly.

Figure 15. Strategic questions for on- and offshore wealth managers

Onshore business		Offshore business	
1	<ul style="list-style-type: none"> How attractive is the onshore market (potential, structure, and environment)? 	1	<ul style="list-style-type: none"> What are the key risks serving offshore clients with undeclared money per country of residence?
2	<ul style="list-style-type: none"> To what extent can a private bank capture offshore money outflow of own client portfolios? 	2	<ul style="list-style-type: none"> What is the policy of treatment for such existing clients going forward?
3	<ul style="list-style-type: none"> Which capabilities do already exist in the domestic onshore market which can be leveraged most effectively into other onshore markets? 	3	<ul style="list-style-type: none"> How must the offshore business be set up in order to match with the requirements of lead¹ and host² regulators?
4	<ul style="list-style-type: none"> If partnering with a third party in the country of client residence, are there any improvement areas to be considered? 	4	<ul style="list-style-type: none"> Which markets and clients can be served in the context of the off-shore service offering?
5	<ul style="list-style-type: none"> Is the product and service offering in the target market enough competitive in order to gain sufficient profit margins? What is the degree of separation of on- and off shore private banking from an organizational perspective, including people, processes, information and systems? Are on- and offshore clients in the non-domestic country treated as integrated business/market? 		

[1] Regulating authority in the country of residence of the wealth management provider
 [2] Regulating authority in the country of residence of the client

Source: Deloitte Research [2009]

Conclusion

Wealth management markets have become more complex in recent years and the capital markets' meltdown in 2008 had a strong negative effect on the industry's asset base and, in consequence, revenues. It has thus become a challenge for wealth managers to run their businesses profitably. Our research shows that profit margins decreased on average by -27% in 2008 and we expect profitability to recover only partially in the near future. First, the ripple effects of the political and regulatory pressure on Swiss offshore business, continued risk-aversion on the part of private clients, as well as an unprecedented lack of private client trust all hamper the industry's revenue generation. Second, many wealth managers struggle with an inflexible cost base. Despite recovering financial markets, these two effects keep them in a short-to mid-term profitability trap if no immediate countermeasures are undertaken.

To address the increasing market complexity, extricate themselves from the imminent profitability trap and emerge as winners, wealth managers have to identify the key profitability levers which have a direct impact on their value generation. This research shows that only a few of the vast universe of profitability levers are directly and measurably driving differences in profitability.

Our analysis suggests that focusing on profitable client segments, avoiding or reengineering value destroying products/services and optimizing the internal organisation measurably increases wealth managers' profitability. In contrast, a very opportunistic and unfocused client take-on approach, the offering of overly complex products and trading facilities as well as a heavy reliance on Swiss domestic on- and offshore business reduce a wealth manager's average profitability.

In general, "winning" wealth managers reconfigure their business operating models around the few BOM levers, which have a direct and positive impact on profitability. Our research highlights that winning models are superior with respect to robustness and flexibility, promising both above average absolute profitability and profitability growth.

Depending on their current situation and strategic intent, wealth management providers can choose between several transformation strategies to address potential profitability issues. Each of these strategies aims at changing one or more BOM elements and components in order to build a clearly defined and more resilient business operating model.

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