Operational excellence in private banking – Hallmarks for success in 2010

By Dr. Daniel Kobler
and Dr. cand. Jochen Brellochs
Deloitte Consulting GmbH
Switzerland

The business of wealth management is gradually growing more complex. A typical player today is challenged by multiple client requirements, business locations, booking centers, operating models and platforms. Across the entire industry, competition intensifies and consolidation progresses, legal and regulatory requirements increase while technology adoption is a high priority on executives' agenda. This business complexity, in turn, leads to higher costs, and control over these costs emerges as a key success factor of the future.

It is against this background that wealth managers become more proactive and focus on operational effectiveness and efficiency. The main rationale is to reengineer the cost side of the business, to construct a lower, more flexible, variable and scaleable cost base. In addition – just as important – another aim is to improve the quality and effectiveness of client service delivery. As a result, private banks around the world will need to forge the hallmarks of *operational excellence* in the areas of outsourcing/offshoring, process and service innovation, internal control, and financial and management reporting.

This article explains why these areas are important, quantifies their expected impact and identifies the hallmarks of success in tackling these issues.

Outsourcing / offshoring

The demand for *outsourcing* is growing within the wealth management industry, as the large variety of associated benefits is increasingly recognized. Primary purpose is to reduce the cost of operating administrative processes. Vendors report they reduce cost for many processes by 10 to 20%. Outsourcing is particularly economically attractive for key product fields with increasing complexity, e.g. alternative investments or separate accounts (figure 1). These require high administrative capabilities and expertise that wealth managers may not have. The outsourcing of non-core operations also frees up scarce internal resources and allows more efficient resource allocation to revenue generating core activities. Front office outsourcing, on the other hand, is limited by the unique nature of private banking, e.g. the high relevance of client confidentiality and banking secrecy. Overall, our project experience and discussions with senior private bankers have demonstrated that, within the value chain, the activities listed in figure 1 are already outsourced or will be in the near future.

As second main benefit, *outsourcing creates more flexible cost structures:* Vendor pricing is generally variable, and the responsibility for investments in new systems is transferred to the vendor. Consequently, outsourcing is more cost-effective than the alternative of upgrading and expanding existing systems, in particular where private banks face capacity constraints when assets, volumes and the number of accounts and products are growing. From our experience, outsourcing is a strategic reaction to cope with an increase in business volume. Without the critical scale in non-core areas, such infrastructure investments would significantly extend a product's lifecycle phase until profitability. Finally, outsourcing increases private banks' flexibility to respond to changes driven by the environment, e.g. regulatory or technological developments.

For the more aggressive wealth managers, *offshoring* is an accepted business practice. It delivers impressive savings, mainly by capitalizing on cheap labor, and expands accordingly. However, private banks must ensure that cost savings are tapped without risking service quality – otherwise the harm would greatly outbalance the desired benefits. Where offshoring is ap-

Figure 1: Private banking outsourcing potential

Value chain activity	Main activities	Outsourcing potential	
Front office	Product sourcing, e.g. alternative investments	most prevalent	
	Tax advice		prevalent
Middle office	Global custody	most prevalent	
	Investment research		prevalent
	Trust administration		prevalent
Back office	IT management & support	most prevalent	
	IT operations	most prevalent	
	Settlement	most prevalent	
	Securities processing	most prevalent	
Support functions	Finance, e.g. hosting MIS		prevalent
	HRM, e.g. recruiting, education & training		prevalent

Figure 2: Sample of innovation objects and their estimated benefit

Innovation area	Innovation object	Estimated benefit	
Front office / client relationship management	More standardized approach regarding customer acquisition, customer service and customer retention will increase customer contacts (CC) and assets under management (AuM) as well as reduce customer losses (CL). This is supported by a range of related analytical and research tools.	R I I	CL ≤ 15% CC ≤ 20% AuM ≤ 7%
Front office / client relationship management	More effective availability of relevant customer, trade and product as well as research information could reduce sales planning time. Hence, this saving in time could be adopted for relationship management (advisory and sales). Consequently, IT infrastructure must be adapted accordingly.	R I	Sales planning time ≤ 20% Relationship management time ≤ 20%
Back office services	Stronger customer orientation and clearly defined processes of back office services in the area of administration of securities and investment funds reduce processing time and error rates significantly. This is supported by a sophisticated IT infrastructure.	R R	Error rate ≤ 40% Processing time ≤ 40%

Benefit index: R = Reduce / I = Increase

plied rigorously, strategic implications become visible: Major financial institutions have over 2.5% of total headcount offshore, while industry leaders operate with over 10% of total headcount in lower cost locations. Our studies show that financial institutions could tap cost savings of up to 40% compared to the same business processes onshore. We estimate that total savings could even be tripled if best practices of operational excellence were consistently applied.

Process and service innovation

In the struggle for growth in mature markets, a key hallmark of success to deliver sustainable revenue increases and enhance customer experience is the ability to identify and *execute process/service innovations over pure product innovations.* Many wealth managers realize the large opportunity both to cut cost and raise revenue through more effective product management. There has been a vast cumulative expansion in product and service ranges in recent years. Numerous wealth managers pursued an undisciplined "product rush" in the belief that product diversification and customization would drive volumes and margin expansion and be a key competitive differentiator. Overall, however, the impact has too often been disappointing: revenue realization was incremental, client targeting weak and sales effectiveness low; higher costs, caused by misaligned resources and blindfold customizations of products and the resulting need for complex support infrastructure created a *"vicious circle"* (figure 3). Handling the fallout from this product rush is therefore a key innovation object.

Process and service innovations, in general, focus on the way work is performed – making it better, faster and cheaper. They aim at simplifying operations and giving customers what they really want. This encourages wealth managers to embrace the so-called "open architecture" approach where best-practice products are sourced both in-house from various parts of the bank as well as from third-party providers. In our consulting work for leading wealth managers, we identified several crucial innovation areas; they are located particularly in the front and back office and focus on the customer's attention, skyrocketing operational performance (figure 2; the data varies significantly between private banks, universal banks, cantonal and regional banks and so on).

Internal control

An avalanche of regulation is sweeping across the financial services industry. Consequently, the breadth of compliance now being demanded from wealth managers has become very significant:

The "virtuous circle": Process and service innovations create value by attracting customers through a virtuous circle of simplicity and efficiency. Product innovations often do just the opposite, driving customers away by increasing complexity and costs (see figure 3).

Lasting innovation: The most successful financial institutions should embed process and service innovation into the very fabric of the organization – from strategy and processes to people, systems and business partners – actively developing good ideas that are difficult for other companies to copy, thus achieving a sustainable competitive advantage.

Sarbanes-Oxley, Basel II, the EU's new Markets in Financial Instruments Directive (Mifid) and local regulations such as the SFBC's requirement to establish an internal control system (ICS) are the most prominent examples. Compliance to these regulations is demanding, not only in terms of resulting costs, but also of required resources and expertise. Deloitte Touche Tohmatsu estimates that between now and 2010 many wealth managers may see an average 20 to 30% increase in expenditures for internal control.

In order to contain this growing cost pressure, *wealth managers have started to think about ways of increasing both efficiency and effectiveness of their overall control environment.* However, only those private banks which gear their ICS to a few basic principles will achieve significant operating efficiency enhancements:

- Firstly, internal control should be carefully embedded into an overarching risk management system, which allows to coordinate internal control duties effectively with other risk management functions such as risk controlling or the early warning system. That way, cost intensive control redundancies are identified and remedied more easily.
- Secondly, internal control should be viewed as a key management tool, instead of being entirely confined to the compliance function. This approach leads to an increased risk awareness within the organization and facilitates a systematic risk recognition and assessment process, which in turn allows focusing control activities on key risk areas with high P&L impact. However, line management will perform its control duty only effectively if provided with meaningful management information (MI). Therefore, successful private banks will simultaneously improve their overall MIS when establishing their ICS.
- Thirdly, control costs should be balanced carefully with expected benefits in order to avoid losing business opportunities and to ensure flexibility in daily operations. An alternative means to improve flexibility is using preventive and automated controls instead of solely relying on detective and manual controls. For instance, Deloitte Touche Tohmatsu estimates that up to 30% of the total time required to perform internal control activities may be saved if a private bank consistently exploits the potential behind control automation.

Reporting

A key operational driver of success in 2010 will be the finance function's ability to produce more reliable and timely MI as well as comprehensive external reporting. Even though most finance executives and COOs display increasing confidence in the quality of their MI, the trend towards wider use of in-depth profitability and investment suitability key performance indicators (KPIs) as well as of share-of-wallet considerations requires further improvements in the arena of MI. This concerns in particular the need to increase the explanatory power of MI by means of incorporating more independently gathered data and aggregated account reporting tools – a world-class MI should not solely rely on feedback from relationship managers and own estimates. Further, there are notable efficiency improvements to be achieved through stricter automation of the MI process.

Another area of concern to finance executives is the lack of comprehensiveness of their external reporting. A hallmark of success is likely to be a private bank's ability to effectively protect its reputation with the aid of more transparent and extensive financial reporting, covering a clear strategy statement, information on corporate governance, risk management and on other relevant KPIs.

The trends and operational challenges identified in this article are likely to affect the vast majority of private banking firms. But only the best will profit from them. Private banks that start building the four excellence qualities (outsourcing/offshoring, process and service innovation, internal control as well as financial and management reporting) into their corporate DNA are the ones most likely to come out on top in 2010.

www.deloitte.com/ch/oe

Figure 3: Connecting innovation to growth