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Next Generation Private Banking
3rd Generation Operating Models

Introduction

The regulatory landscape coupled with evolving customer needs and behaviours poses significant challenges to private banks to remain profitable in Asia. The industry is following the trend in Europe towards consolidation and operational efficiency with the ambition to lower their operating costs.

Adopting an industrialized business model can help to reduce operating costs and operational risks. External service providers can achieve economies of scale and pass on these cost benefits back to the private banks. Operational risks will become minimal, as the external service providers will invest resources in developing state-of-the-art market practices.

An industrialized model is also very appealing to new entrants in the Asian market. They can gain instant access to efficient business processes without upfront investment. Using an industrialized approach can also help small and medium-sized banks to scale efficiently, allowing them to “rent” transactions such that they will only pay for what they use. This way the bank will be able to fully focus on Front office capabilities without having to worry about Back office operations or IT platform maintenance. This will allow the Front office to concentrate on client-focused activities.

Third generation operating models will consist of service hubs around the globe, connected through a network of excellence, sourcing best-of-breed banking products and services. The banks will maintain integrity of risk management and compliance procedures and profit from maximized Front office effectiveness, a state-of-the-art IT platform, and efficient error-free processes.

This study provides a top-down analysis of the Singapore and Hong Kong banking market to show the vast industrialization potential in Asia.

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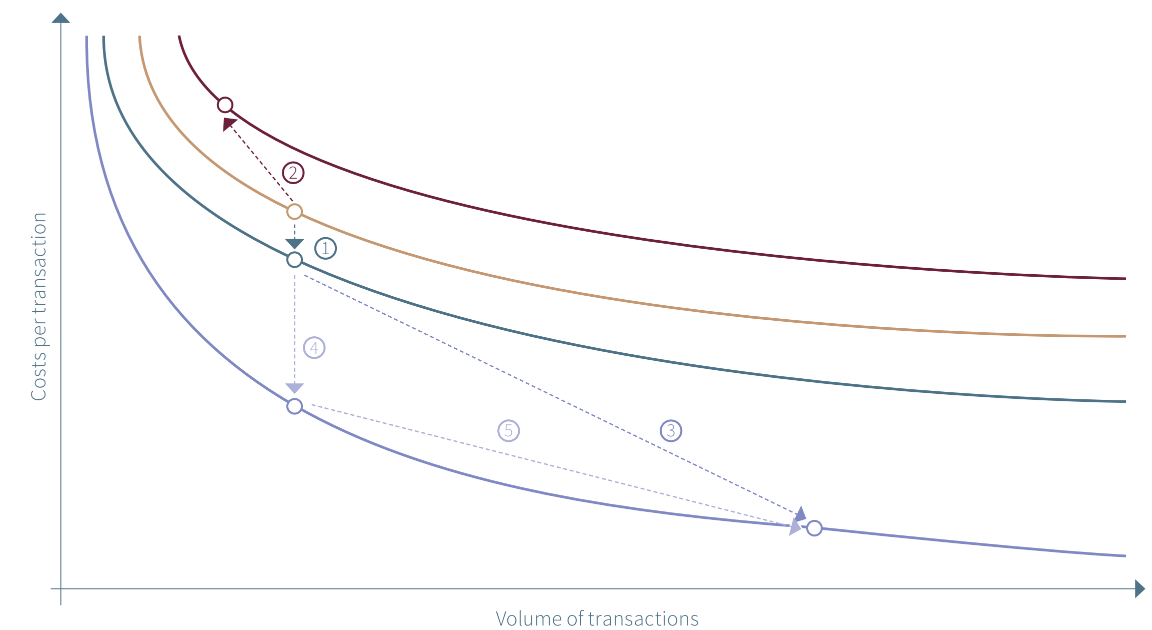
The growth of global wealth accelerated in 2014 with the biggest contribution from Asia wealth. Asian financial centres like Singapore and Hong Kong have benefited immensely from the sustained boom in Asia's economy.

However, growth does not always translate into higher profits in Asia's private banking industry. Even though the industry recovered after the global financial crisis, private banks are facing challenges in dealing with continuously increasing operational costs, compliance with ever-changing and more onerous regulations, and mitigating risks in high volatile markets. Lastly, pricing transparency is increasing rapidly and customers are becoming much more critical about how much value private wealth managers or financial advisors add. Customers are demanding better value for money leading to pressure on basis points charged.

A consequence of these factors is a decrease in profit margins for Asian banks while the market is booming. Increasing demands for transparency, decreasing revenues, and rising costs, will inevitably force the market to become more efficient as seen in other industries. Banks will have to improve their efficiency, operational excellence and Front office productivity and transform their operating model to be sustainable over the long term.

Bigger banks find it easier to achieve lower operating costs. Not only because of the chance to spread overheads over a larger revenue or asset base, but also due to decreasing costs per unit of output with increasing scale as fixed costs are spread out over more units of output (see Costs per transaction vs Volume of transactions in 1). Small and medium sized banks on the other hand find it very difficult to cut operating costs. The only way they can achieve scale is through growth, outsourcing, or M&A.

A good example of this can be seen in Switzerland, one of the earliest and most mature private banking markets in the world. The industry is seeing a wave of consolidation and in the recent years, the number of private banks operating in this market fell to 139 at the end of 2013 from 182 in 2005, which is almost 25%. About one-third are unprofitable, KPMG said in a report in 2014. In general, wealth management is no longer a business model with huge profit margins. The reality is that most banks reeling under losses are finding themselves trapped in inefficient business models. The traditional value propositions are no longer valid and the industry is struggling to adapt. In the face of consolidation, the industry began making a strong push towards operational efficiency and eventually embraced industrialization.



Source: Synpulse based on B-Source, Avaloq

- Bank tomorrow
- Bank today
  Individual software, in-house
- Integrated standard software
- Industrialized Bank (BPO)
  1. Application service provider (ASP)
  2. BPO with highly automated standard back office processes
  3. Sourcing best-of-breed banking products and services

1. **Standardization**
   Globally, cost to income (CIR) ratio is 60% for banks on Avaloq compared to 69% on average
   (Source: Avaloq Intelligence 2014)
2. **Do nothing**
3. **Industrialization**
   Reduce overall IT and back office running costs by 50% and maximize STP rates close to 100%
   (Source: Avaloq Intelligence 2014)
4. **Sourcing**
5. **Economies of scale**

1 The Industrialized Bank leveraging business process outsourcing (BPO).

2. Banking lags behind other Industries in terms of Industrialization

Banks have to ask themselves: How, and in what areas should they achieve competitive differentiation. Does it make sense that banks are spending a large part of their revenues on Back Office & IT services, and is it even justified to maintain Back Office & IT operations at all?

Such non-Front office related costs are a result of largely operational activities and are related to non-value add processes. Managing and controlling these processes leads to operational risk resulting in additional costs. The Front office staff spends already a substantial portion of their total productive time on administrative related activities like client reporting, compliance related activities, and general paper work. Driving their focus away from providing value services to their clients, results in the lack of service differentiation and consequently in commoditization of services.

Industrialization of business processes as a concept has been around for a while but for the private banking industry, it is still a recent phenomenon. Taking a cue from other industries, the private banking industry too has come to realize that it cannot strive to do everything itself and yet remain profitable. After re-evaluating their core competencies, Private Banks can start focusing on their competitive advantages and strengthen its core functions. Industrialization can help to enable key differentiators and high margin processes.

Outsourcing Back office functions like corporate actions or payment transactions is not new and banks have been doing it for the past few decades. However, the new generation operating models are now looking beyond traditional cost-saving opportunities in the Back office. The goal is to identify non-core functions in the Middle or even Front office that are common across all banks. The new generation operating models are therefore based on the industrialization design principle, which is commonly known as 'Value Chain Fragmentation' and described in our previous article on 'Next Generation Private Banking: Agile and industrialized'.

The industrialization process involves careful selection and outsourcing of processes – processes that are repeatable and have no customer touch-points. For example, all banks must onboard new clients, which includes a wide range of customer acquisition activities, such as account opening, Know Your Customer (KYC), anti-money laundering (AML) requirements, processing and delivery of market prices and asset data. Later functions are non-value add processes and have high potential for outsourcing to specialized service providers.

However, industrialization in private banking will not be confined to conventional Business Process Outsourcing (BPO), which mainly dealt with outsourcing non-core functions to low-cost countries (labour cost arbitrage). In this case, highly skilled local talents will industrialize the activities in the Back office and provide increased efficiency, for example in straight through processing (STP).

This new operating model is not just simply about reducing costs, but foresees that banks can leverage a utility model to cost-effectively manage outsourced services and focus freed-up Run the Bank (RTB) resources (cash and personnel) on core business functions. This model is a new form of BPO. It combines 'Software as a Service' (SaaS) and 'Infrastructure as a Service' (IaaS) for entire business processes. Key characteristics of this model are no upfront investment requirement, on-demand scalability, and pay-as-you-go facility (pay per transaction).

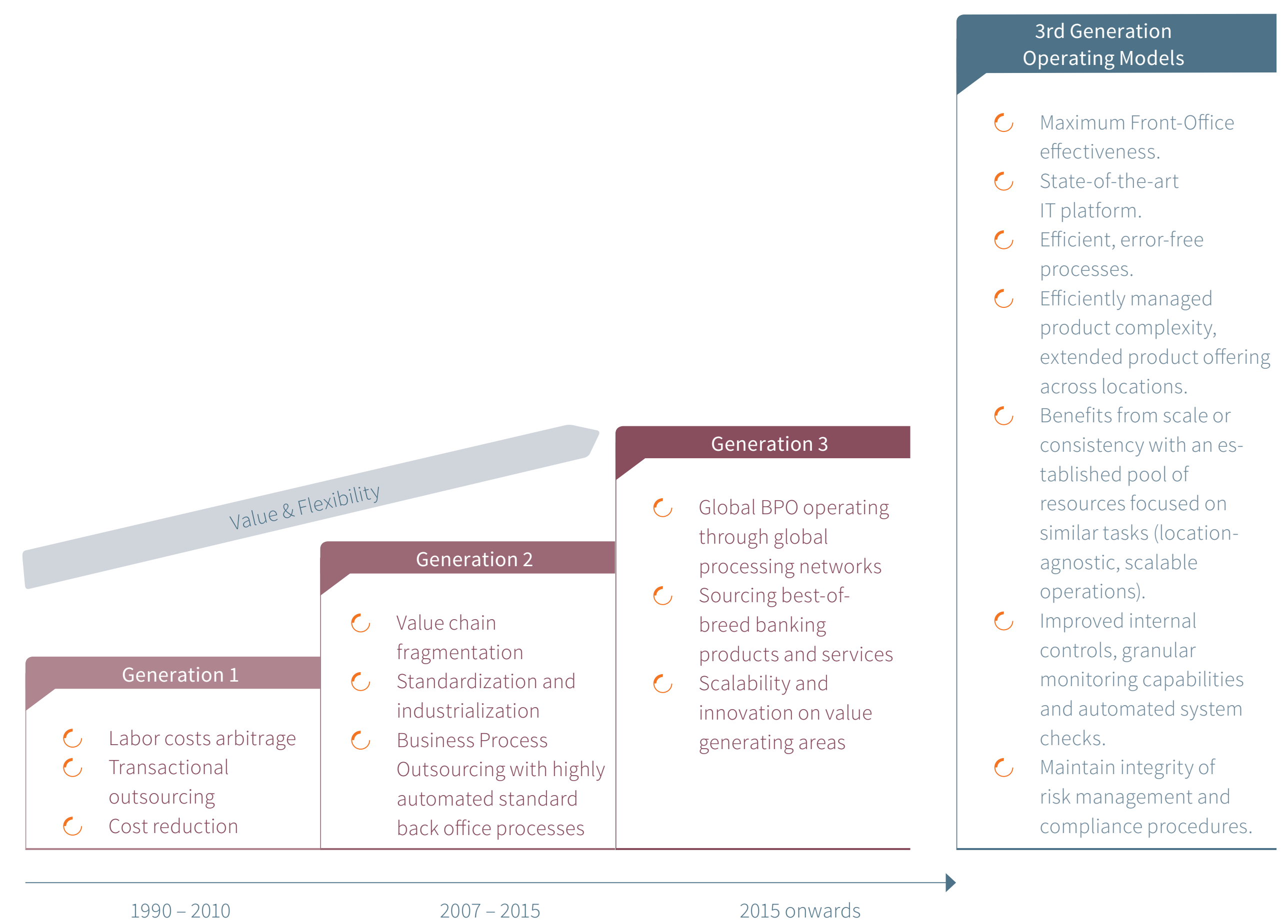
The result is a variable cost structure allowing a degree of flexibility in terms of strategic decisions. It combines standardization, outsourcing and economies of scale (1), which is attractive for small and medium sized banks that are too small to achieve economies of scales on their own and cannot afford an in-house state-of-the-art IT platform.

Sharing an IT platform with a standard core banking software solution means also sharing implementation costs of new regulations and market trends. This releases Change the Bank (CTB) resources that can be re-allocated to control those aspects that are of strategic and critical importance to the business and as such strengthen, and differentiate customer facing core competencies. Next to this, these banks can participate in the continuous evolution and innovation of the standard software community. The newly freed-up resources

and access to innovation allows the banks to intensify the relationship with customers by increasing service quality and creating a digital customer experience.

Latest trends now point to a third generation operating models, which inherits all benefits previously mentioned and adds new advantages (2). It is the idea of a global BPO operating through a global processing network. Banks connect to a network of BPO centres sourcing best-of-breed banking products and services.

Each BPO centre in the network acts as a service hub (centres of excellence) that are location-agnostic, fully scalable (leveraging on a pool of resources focused on similar tasks), improved internal controls, granular monitoring capabilities, and automated system checks. The banks benefit from maximized Front office effectiveness, a state-of-the-art IT platform, efficient error-free processes, and extended product offering across locations with efficiently managed product complexity. They will thereby maintain integrity of risk management and compliance procedures.



Source: Synpulse

2 Evolution of Operating Models. Every generation inherits benefits from the previous generation and adds new advantages powered throught innovation.

3. Industrialization Potential in Asia

To assess the industrialization potential in Asia, we conducted a high-level market study for the two main financial centres Singapore and Hong Kong. We used a top-down approach to calculate the industrialization potential for the two markets.

Singapore is an ideal location for a global financial hub and gateway to Asia. As a result, the asset management industry has grown in the past 10 years as plenty of Western firms look for a foothold to expand into Asia and have set up office in Singapore. In just five years, from 2009 to 2013, total assets under management (AUM) in Singapore grew from USD 0.83 trillion to USD 1.45 trillion, representing a compound annual growth rate (CAGR) of about 10.8% for the period. In the last 3 years, the industry recorded an average AUM growth rate of 10.7% per annum [1]. Consequently, Asia Pacific is set to rise significantly in prominence and experts predict similar growth for the upcoming years. Extrapolating the AUM figures with the same growth rate for the next 7 years until 2020 results in an AUM of more than USD 2.5 Trillion, which is nearly double the AUM of today.

If the private banks do not change their operating model and neither start to industrialize, they would spend USD 9.4 Billion on operational costs by 2020 (4). Latest reports have shown that the Asian banks spend 30% in non-front related activities, which results in USD 2.82 Billion non-front related costs.

Looking at the cost income ratio of the average bank in Asia shows that there is a huge potential for cost savings through standardization, automation, sourcing, and economies of scale. An internal survey of Synpulse reveals that the most efficient private banks in more industrialized markets like Switzerland achieved a cost to income ratios of less than 50% compared to the market average of 70% (3).

These banks were able to reduce their Back office and IT running costs by 50%. They also maximized STP rates close to 100%, which reduced further non-front related costs including the area of Legal, Compliance and Risk Management functions. On an average, Asian banks report CIR figures of around 70%.

Leveraging a 3rd generation operating model can help to radically reduce non-front related costs. We believe that most banks are able to cut these costs by up to 50% until the year of 2020.

> «In 2020 private banks in Singapore are expected to spend USD 2.82 Billion on non-front related activities, which reveals the enormous potential for industrialization. We believe that most banks are able to cut these costs by up to 50% till 2020 by leveraging the 3rd generation operating model.»

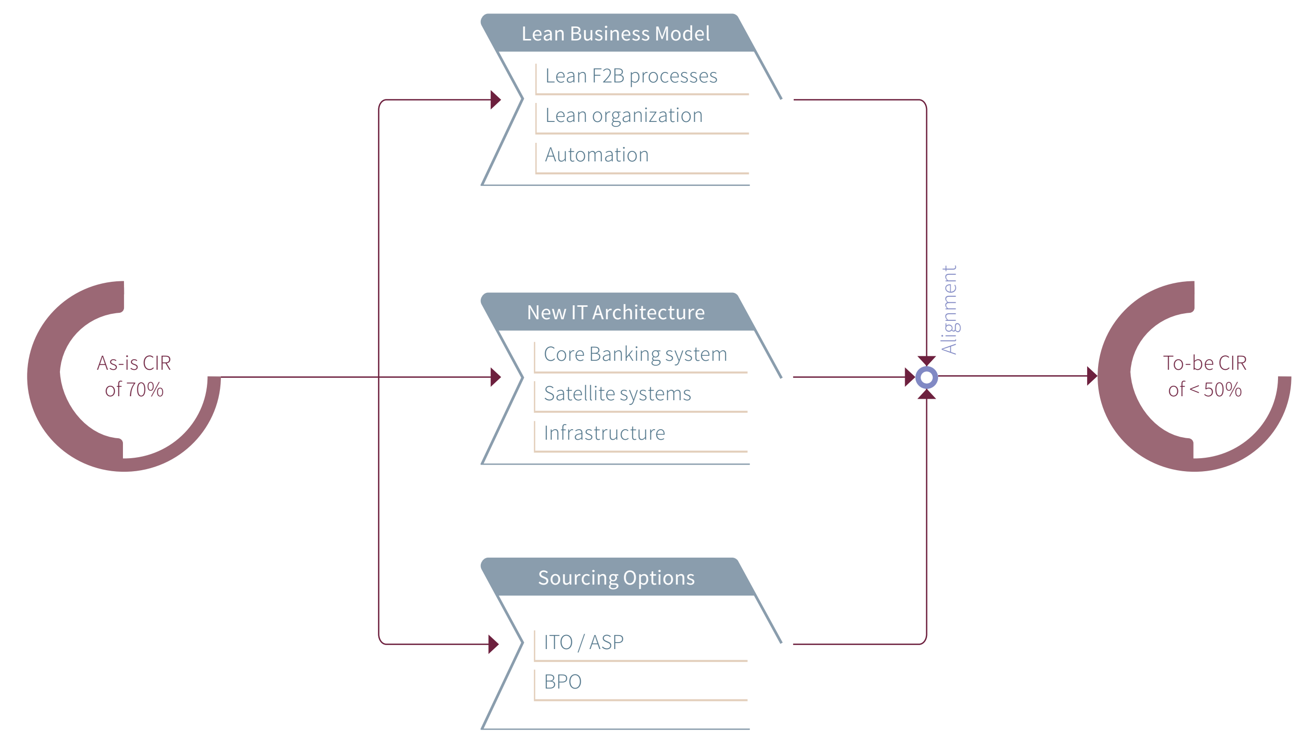
Hong Kong follows a similar growth story like Singapore. The market shows aggressive AUM growth that is in line with a broader recovery from the great financial crisis. However, Hong Kong asset base remains volatile. Regulatory environment is as extensive as in Singapore, but more prescriptive and retail oriented. Fund advisors dominate domestic asset management and private banks contribute a smaller part to the AuM. Cost pressure and operational non-scalability leave Hong Kong private banks at unsustainable cost-to-income ratio of 75 – 88%. Following the same top-down analysis, we predict USD 1.45 Billion on non-front related activities for private banking in Hong Kong by 2020 (5).

Banks in Asia with less than USD 8 Billion in assets reported an average cost margin of 87 bps last year, with average revenue margin of 84 bps. This shows that profit margin will be unsustainable for small and medium-sized banks. High costs owing to consistent regulatory pressures will persist to sustain high growth in Asia. The banks are struggling to keep up with the increasing cost pressure and lack of service differentiation.

[1] *Monetary Authority of Singapore (MAS), Annual Singapore Asset Management Industry Surveys, 2002-2013*

> «We anticipate that in the next 10 years half of the small and medium-sized banks in Asia will either choose the BPO model or go through consolidation (M&A).»

It is only a matter of time before the large players will embrace industrialization in order to achieve sustainable cost-to-income ratios and gain competitive advantage. The small and medium-sized banks will be under pressure to stay competitive.

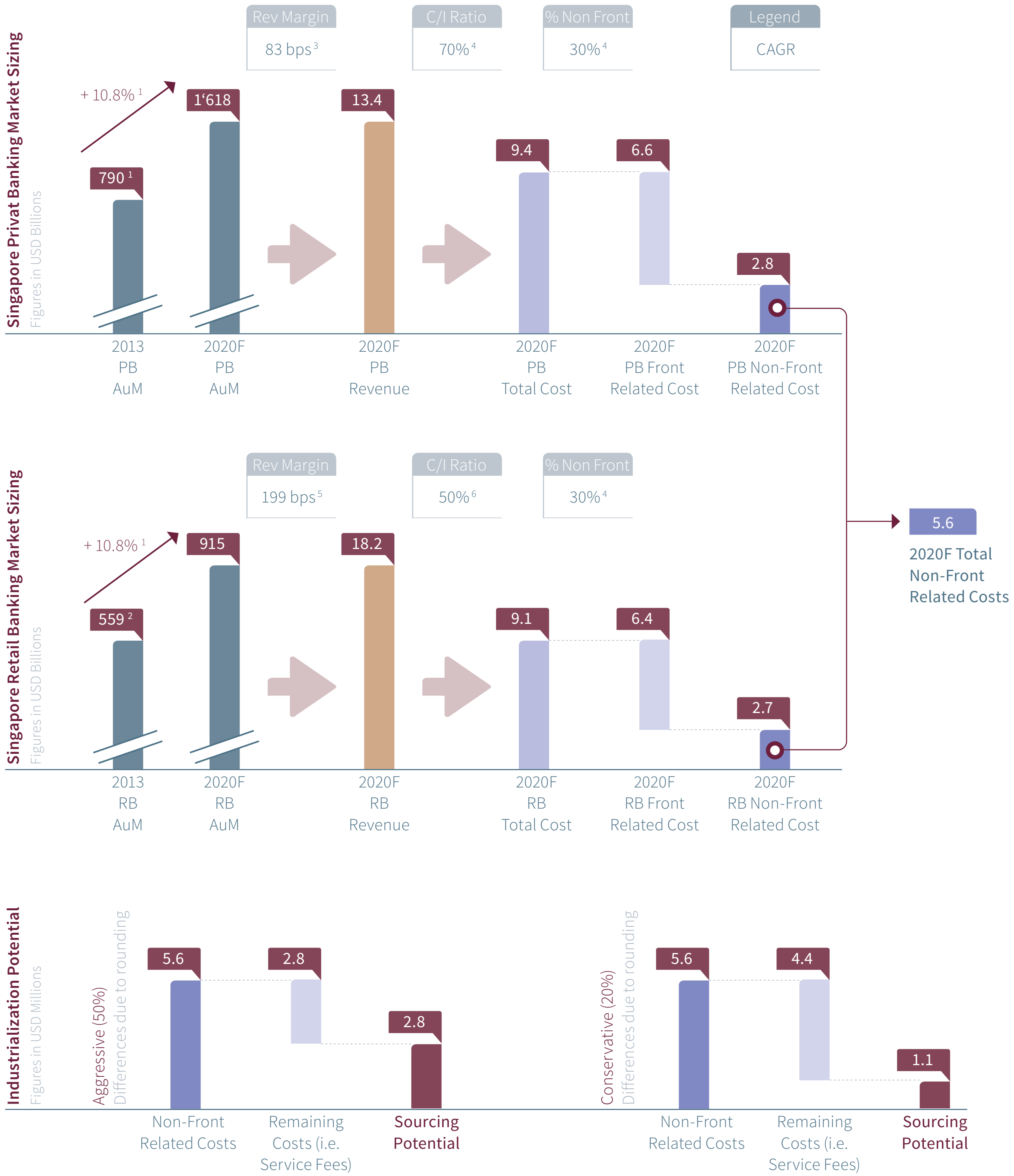


Organization
- Organization and IT architecture needs to be adapted in order to support the realization of the optimal Target Operating Model (TOM).
- A streamlined organization contributes itself to a CIR reduction by clear task-to-resource allocation.

Sourcing Options
- Operational areas that are considered sensitive or control relevant are to be retained in-house while routine MO / BO functions are carved-out for maximum efficiency and scale.

Source: Synpulse

3 Enablers for CIR Reduction.



4 Industrialization Potential for the Singapore Market.

Source: Synpulse

1 MAS 2013 Singapore Asset Management Industry Survey.
2 Retail Banks have 30.7% share, calculated by the average retail banking revenue contribution from DBS, OCBC and UOB, 2012.
3 McKinsey Global Private Banking Survey 2013.
4 BCG Wealth Manager Performance Database, 2012.
5 Average retail banking net interest margin from DBS, OCBC and UOB, 2012.
6 Average cost-income ratio of retail banks in Singapore, DBS, OCBC and UOB, 2012.

5 Industrialization Potential for the Hong Kong Market.

Source: Synpulse

1 HK SFC FMAS Survey 2013.
2 KPMG Hong Kong Banking Survey 2014.
3 McKinsey Global Private Banking Survey 2013.
4 BCG Wealth Manager Performance Database, 2012.
5 HKMA Half Yearly Monetary and Financial Stability Report March 2013, Net interest margins of retail banks.
6 HKMA Quarterly Bulletin June 2013.

4. Conclusion and Outlook

Even with mounting challenges worldwide, Asia, in particular Singapore and Hong Kong are expected to continue their roles as regional and global hubs of the financial industry. New market players will emerge, leveraging technology in a way that delivers financial services at a much lower cost and targeted towards customer needs.

The motivation to combat economic and competitive pressure appeals to the Asian market. To seize the moment, banks should be encouraged to invest into their operating models. By tapping on a streamlined and standardized platform, they will be able to focus on differentiating product and service offering to grow their Asian business and market share.

Industrialization requires a new generation of operating models with state-of-the-art infrastructure and highly efficient and harmonized processes. Key to success is to achieve a high level of automation, running on a standardized IT platform solution and the volume to achieve economies of scale. Big banks have the size to achieve economies of scale in-house, whereby small and medium sized banks will have to go through BPO or M&A/Consolidation.

Innovation, technological advancements, global connectivity and the spirit to continuously improve have resulted in an evolution of operating models. BPO in banking has evolved over time and is now at a mature stage. Significant reduction in non-value add processes, continuous and focused transformation have led to service improvements and differentiation. As such, the new operating model addresses the current banking industry challenges in Asia highlighted in the outline of this study.

By refocusing on core competencies and effective segmentation, the industry can reinvent itself to remain competitive in the face of the changing regulatory landscape and evolving clients' needs and behaviours. Continuous transformation through industrialization lends Asian banks a competitive advantage beyond cost leadership, which will benefit the Asian banking industry.

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6. Synpulse

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Synpulse's clients deserve the best. Since the quality of consultancy is closely related to the level of education, it invests approximately 10% of its financial and human resources in comprehensive further education and development as part of its «Academy Program®». On the principle of «Life-Long-Learning» the program supports its ambitious consultants on their path to senior consultant, manager and partner at the company.

The trust that leading banks and insurance companies have in Synpulse is based on experience and a conviction that its consultants are always able to form teams that are capable of and willing to achieve ambitious goals with expertise and passion.

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