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European wealth and private banking: Industry Survey 2003

By Philippe Theytaz and Ian Woodhouse, IBM Business Consulting Services

In the last two years, the wealth management and private banking industry has experienced a greater period of turbulence than at any time in its history. This was caused by a combination of factors: the long US boom and subsequent stock market bubble collapse, the surfacing of major corporate governance issues and bankruptcies of some large well-known corporations, all of which had a major impact on investors' confidence.

The European Wealth and Private Banking 2003 Industry Survey took place in October/December 2002, and included participants from more than 100 leading European wealth managers and private banks. It reveals that the environment has continued to be difficult. Due to market volatility, many clients have stayed on the sidelines. Worse, for the first time, an entire generation of investors lost money in consecutive years. Industry players were unprepared for such dramatic change. Initial responses centered around obvious short-term cost reductions and ways to diversify revenues. Beyond this, there was evidence of significant restructuring as several players withdrew from certain geographic markets, refocused on more attractive client segments and, in some cases, undertook acquisitions to achieve scale benefits.

The survey also reveals significant changes in relative market share and positioning between the individual industry participants, illustrating that some have been more successful in responding to the pressure than others. A particular theme of this report is to better understand the characteristics required to be a successful participant in the future and, more important, how to best respond to and capitalize on the more challenging environment. One hundred five leading wealth managers and private banks participated in this survey from 13 key European onshore and offshore centers.

The survey:

- Asks participants for a wide range of strategic, operational, people and information technology issues.
- Concentrates on obtaining useful operational and systems benchmark data. This industry survey contains only a summary of key benchmark findings. More detailed benchmarking is reserved for participants only.
- Provides meaningful comparison information by analyzing the responses in several dimensions, such as size of assets under management, individual country-specific data, and overall onshore and offshore groupings. It also highlights differences between mature and emerging markets. This enables more precise identification of specific trends to assist industry players to better understand and respond to the trends that are the most relevant to them.
- Details useful insights in respect of information technology. The current difficult times have forced industry participants to give greater attention to obtaining more value from information technology as a key enabler of change and a source of improved performance.
- Focuses on understanding the characteristics of high-performing CEOs and executive teams across Europe. Participants were asked to identify those wealth managers and private banks whom they regarded as being leading players across a number of dimensions. Subsequently, the CEOs of these organizations were interviewed in more depth to gain greater insight into the factors that are driving their success. This information provides unique insights from these highly respected and experienced individuals and

organizations. This helps to provide some useful pointers and road maps of how to address key challenges head-on.

All of the data and insights derived from the survey and supporting benchmarks (which are provided confidentially to respondents) should help industry participants identify and focus on those key strategic, operational, people and information technology issues that will be critical to competing effectively in the more turbulent environment.

Key Findings

A number of themes have emerged from the survey findings. These key topics indicate where respondents believe efforts and resources should be concentrated as individual wealth managers and private banks seek to respond to the industry changes now underway.

1. Participants emphasize the need to adapt to changing client needs.

We asked respondents to rate the top six from a list of 16 external drivers of change. Top of the list was adapting to client needs. Second was the need to get more experienced staff to achieve this supported by more effective use of information technology. Responding to the changing macro-economic environment was also rated highly where participants expect to be increasing their investment performance, adapting to increased regulatory requirements and responding to slower rates of industry growth.

There is now the realization that getting to know the clients, their specific needs and requirements have become essential in the current difficult financial market environment. Faced with more sophisticated client needs, private banks and wealth managers need to compete for more specialist skills and experienced staff to better harness the existing client base and provide an attractive value proposition to potential targets.

We asked respondents to rate the top six from a list of 16 internal drivers of change. The top three were all key client metrics, acquiring and retaining clients as well as enhancing service quality. For the first time, cost optimization was rated fourth, reflecting the pressures within the industry. Other elements identified concerned enhancing value propositions. These were improving brand image and reputation, broadening the product and service range and adapting to open product architecture.

2. Wealth managers and private banks need to work much harder to understand their clients' needs and price for value delivered.

Wealth managers and private banks claim that a key to success is the ability to know the client better and understand their requirements in more detail. Interestingly, responses received indicate that most participants feel they have little or no understanding of their clients' non-liquid assets, their extended business, family issues and personal interests. Worse still, a small proportion has at best limited knowledge of the client risk tolerance, reporting requirements and pricing concerns.

Survey respondents indicated that the industry has a clear problem with pricing. Participants replied that they experience serious difficulty in holding pricing and making their clients pay for value.

This is staggering in an industry that prides itself in its ability to offer product and service solutions based on individually tailored and intimate understanding of each client. We observed that clients' needs analysis is becoming more complex and has to be performed on two levels. At the individual level, the life cycle, wider financial interest and lifestyle issues all need to be considered. At the individual portfolio level, the individual client requirements for risk, time horizon, reference currency and other considerations all need to be factored in as well.

3. Retention and development of client relationship officers is critical. This will be supported by technology-enabled tools.

Respondents told us that more than 50%of the front office staff have a tenure of less than four years in that role. Again, in an industry founded on the trust, service and the quality of personal relationships, such a short tenure is hardly enough to understand one's clients' needs, let alone anticipate them – a key to success in building close customer relationships. A further factor in developing client relationship officers will be to provide them with IT-enabling tools, such as portfolio management /investment advice and financial planning tools.

It is critical, moving forward, that the industry can more systematically retain, develop and nurture the skills and talent base of its key front line professionals. An intricate balance among culture, teamwork and entrepreneurial drive will be required to succeed.

4. Participants expect their revenue growth to be under pressure in the short term, but are more optimistic in a three-year horizon.

Revenue growth has varied significantly, but participants remain optimistic that they will have the ability to go back to double-digit growth by 2005.The gap between the growth of their onshore and offshore revenue is expected to widen significantly in 2005 when private banks and wealth managers expect onshore revenues to grow by 23% and offshore to grow by just 8%.

5. Cost income ratios have fluctuated over time and there are significant differences among players.

Over time, average cost income ratios have varied from between 61%and 70%to 51%to 60%during benign market conditions. Given current conditions, senior executives are rightly concerned about pressure on cost incomes. Even though wealth managers and private banks come in different shapes and sizes, the findings of the survey show that large banks are less affected than their smaller peer group, thus confirming that they are better positioned if the current down market period continues.

6. Focus on improving value proposition via a net work of alliances and by achieving scale.

Respondents want to focus on their value proposition and pull in additional products and services from a network of alliances in order to cover changing client needs. They also expect the industry to consolidate substantially. Moving forward, they see that managing alliances/partners and achieving scale are key success factors together with the need for client relationship officers to be more focused on selling and marketing skills. Participants expect these dimensions to vary in importance depending on the individual countries.

7. There is now increasing evidence of industry consolidation as more players see the need to increase scale.

There has been an on-going debate about the notion of size and scale. Traditionally, there has not been a clear answer as wealth management and private banking business models of a variety of shapes and sizes have proven that they can be profitable. However, our respondents have now told us that in the changing environment, critical size is now more necessary in order to compete successfully in the market. They believe that €13 billion of assets under management will be required for onshore institutions, and €16 billion will be required for offshore institutions by 2005.

This could have major implications for the industry structure in different countries. For example, in Switzerland, a large number of offshore participants do not currently have the critical size and we can raise some doubts about their ability to reach that threshold by 2005. It becomes clear that in these circumstances, larger players can benefit from their size, staying power and ability to invest to take a leading role in industry consolidation.

8. To help offset the challenge of scale, alternative business models are being developed and implemented.

Wealth managers and private banks are now re-examining their traditional value chains and are willing to consider a number of options to reconfigure their existing business model. These have tended to focus around major process improvement programs, divestment, mergers and acquisitions and alliances and joint ventures. In terms of major process improvements, most initiatives have been in the middle and back office areas. More recent evidence is that this emphasis is now shifting to the front office. On divestment, some participants have chosen to withdraw completely from geographic markets and or certain clients segments where they had no prospect of scale or competitive advantage or where the rising cost base was hampering their profitable development.

Mergers and acquisitions activity in private banking has traditionally been limited by the high price that sellers sought. Recent transactions in the sector have shown that prices have come down dramatically and that it is now more of a buyer's market. Despite this, respondents have observed that making acquisitions and mergers successful in this industry is not an easy task.

It is also interesting to notice that some potential candidates for sale are not pure plays in wealth management and private banking. Despite the trend towards consolidation, some participants on sale find that they are unable to exit the industry, as potential buyers do not meet the price they seek. Some of the underlying reasons for this lie in the careful analysis and due diligence about the conditions of the business, the client and product mix, etc. The implication of this is that those participants seeking to grow by acquisition will need to have very strong due diligence and restructuring abilities.

In terms of alliances and joint ventures, there is now a greater trend toward wealth managers and private banks linking with external partners to provide additional distribution and to expand the range of products and services offered.

The next wave of major business process refocusing will occur as players experiment with alternative models whereby more of their existing functions are centralized within the group and/or outsourced to third-party providers. The transformation of the fixed cost base to a variable one is an attractive proposition. Traditionally, outsourcing was considered only for support services but is now moving into mainstream operational processes within the value chain.

To obtain a copy of the survey or to find out how the findings might apply to you, contact the author: philippe.theytaz@ch.ibm.com

For more information:
Visit the IBM Banking Web site

The Future of Insurance e-business Groups

By Matthew Josefowicz, Insurance Practice Manager, Celent

Insurance carriers began establishing e-business groups in the late 1990s, when forward-looking firms began to suspect that the Web might affect their industry after all. Now, many carriers are dissolving their dedicated e-business groups and devolving their functions to IT or to the line-of-business organizations themselves. Of those e-business groups that carriers have not dissolved, many are shifting from being "design, build, maintain" groups to groups with more indirect roles.

Celent believes that the complete elimination of focused e-business groups is a mistake. Carriers would do better to re-focus them on the critical missions of strategic knowledge management and coordination.

History

The late 1990s was a time of fear and uncertainty for the industry regarding the Web. Many firms worried about the threat of being "Amazoned" (losing significant market share to a new online competitor), or more specifically, "E*Traded." Like companies in other industries, a few insurers launched semi-independent "internal dot-com" units to compete with brash upstarts like eCoverage and others, mostly focused on online sales, which is where the action was predicted to be.

These start-up groups were often poorly integrated with the larger organization. They required flexibility and specialized knowledge, neither of which was generally in strong supply in the larger company. In addition, it was easier to recruit "Internet workers" for dedicated Internet groups, which might hold out the promise of an eventual spin-off and IPO, than to hire these employees into a regular insurance company.

By mid-2000 and 2001, several key factors changed the nature of e-business groups at insurers. First, the "dot-bomb" crash made spin-offs unlikely and talent more widely available. Second, more and more insurance carriers realized that the Web was going to be an important part of doing business -- not primarily for selling online, but for streamlining communications and operations across a wide variety of functions.

In order to take advantage of these efficiencies, many more carriers established dedicated e-business groups to evaluate their options and build the needed systems. While some of these groups were primarily strategic and advisory, many more were full "design, build, maintain" groups, offering specialized services to other internal groups, and fully responsible for the creation and management of Web applications, either internally or in partnership with vendors.

By 2002, the Web had become an established part of life and standard way of doing business for most leading insurers. As the Web has become more and more integrated and overall budgets have tightened, some insurers have disbanded their dedicated e-business groups and devolved the functions of these groups to the normal IT organization. This shift has been facilitated by the wider dissemination of Web skills among IT professionals in general.

A New Type of e-business Group

Celent believes that this trend will continue, and that the fully-resourced, "design, build, maintain" e-business groups will continue to fade from the scene.

However, there is a significant trend of carriers re-purposing and transforming their e-business groups into "strategic knowledge management" groups. These groups are typically smaller and higher-level than the "design, build, maintain" groups. Their primary functions are to ensure consistency and interoperability and to foster best practices among the many disparate Web-related projects that may be undertaken throughout the enterprise.

Celent believes that this new role is critical. Carriers should ensure that it is being performed within their organizations. We anticipate that even some of those insurers who have disbanded their e-business groups will form groups of this new type over the next year or two.

A New Role for e-business Groups

Celent recommends that these new groups focus primarily on coordinating five key areas: strategy, education, usability, security, and standardization, or "SEUSS."

Each of these five areas requires some specialized area of expertise that may not be spread throughout the wider organization. Each also requires a unified, enterprise-level view of projects in progress throughout the company.

Some areas, like security and standardization, may seem obvious. Of course insurers should learn from their past mistakes and not build or invest in new incompatible systems. Strategy too, it may seem obvious. Clearly it should be coordinated centrally whenever possible, in order to avoid cross-purpose investments and wasted efforts.

But usability and education, which are equally important to successful Web-based projects, are less obvious. Yet they are so important that Celent recommends carriers include them in their central e-business groups. Usability is a key factor in the success of Web-based systems. Although it is possible (though not ideal) to support internal systems with bad interfaces by providing manuals and requiring work-arounds, Web-based external users (whether they are agents, partners, or customers) demand a much smoother and more intuitive user experience.

Similarly, because education and training is critical for end-users, these things should not be relegated to after-thoughts. The most successful Web-based projects are those that devote the most attention to driving adoption through hands-on training and end-user education.

In addition, it is necessary to educate internal developers and strategists on the overall systems and methodologies that the firm adopted as standards, in order to promote and ensure their usage.

Building tomorrow's e-business Groups

In order to achieve the goals of ensuring knowledge sharing and coordination in the five SEUSS areas, Celent believes that insurers should pay attention to three key elements:

1. ensuring CEO sponsorship and active support
2. getting cooperation from business and IT staffs, and
3. staffing e-business groups with high-level experts.

Current "design, build, maintain" e-business groups can be located in any number of areas, from IT to marketing to individual business lines. But e-business groups engaged in strategic knowledge management must be located as high in the chain of command as possible, preferably reporting directly to the CEO or to another high-level executive. Moreover, the CEO must take an active interest in the activities of the e-business group.

The biggest problem faced by current e-business groups (besides lack of staff) is lack of cooperation and support from the business staff. With strategic knowledge management groups, this problem is even greater. These groups can be viewed as a hindrance to the activities of IT groups or to business groups that have their own priorities and preferences for their Web projects. Since these strategic e-business groups do not bring in revenue directly, they will always stand lower in the pecking order than groups that do, unless they have clear and unambiguous support from above. Without a clear demonstration that the CEO or other equivalent power is committed to coordinated e-business developments, strategic knowledge management e-business groups can find themselves unable to fulfill their mandates.

Not only must e-business groups have support from the highest executive level, but business managers and IT managers must be given proper incentives to cooperate. For example, if a manager is compensated solely on the basis of individual business unit profitability, he or she may choose to forsake longer-term organizational benefits like coordinated Web systems development in favor of shorter-term solutions, even if those are likely to lead to long-term problems. Managers must understand that commitment to enterprise-level strategies, standards, security procedures and common user interfaces will be a significant metric by which they are judged when it is time for reviews and bonuses.

Of course, e-business groups must make every effort to understand the real needs of the various business units, and not just set arbitrary "best practices" from on high. Those that do will be ineffective, and rightly so.

Strategic knowledge management e-business groups will typically be smaller than current groups, with the majority of teams being under 10 people. These experts should focus primarily on evangelizing and organizing within the enterprise, as well as serving as consultants to individual projects.

Insurers may be able to convert their current e-business groups into strategic knowledge management e-business groups, or they can dissolve their current groups and re-constitute a new group.

Conclusion

The shift in focus to strategic knowledge management for e-business groups will not be easy. Priorities, goals, organizations and required skill sets are different for these groups than for the "design, build, maintain" groups that dominated until last year.

Those launching strategic knowledge management e-business groups also face a large challenge in ensuring that these groups and their critical mission are embraced by the larger organization and not just viewed as an irrelevant central bureaucracy.

This challenge can and must be met. For these new groups, the five key areas of focus, which we've called SEUSS (strategy, education, usability, security, standardization), are critical to avoiding past mistakes and ensuring that e-business continues to provide its powerful benefits to the insurance industry without creating another unfortunate "legacy."

For more information:

- Visit the IBM Insurance Web site
- Visit the Celent Web site

Investment Tip for Financial Markets Firms: Put Your Money in on demand

By Daniel W. Latimore, IBM Institute for Business Value

After enduring three years of stagnant growth, watching fee-based business decline and nice earners like commissions and clearing become commodities, investment banks and asset management companies seem to be at the mercy of a sour market. Although the industry has been conditioned to expect a certain amount of volatility, the past few years have whipsawed securities firms more violently than anyone can remember.

With revenues freefalling, firms searched for ways to quickly slash costs. One of the first targets was the most obvious: capacity. Despite these initial cost-cutting efforts, financial markets firms are still struggling to earn acceptable, sustainable margins.

What can these institutions do to gain more control over their own destinies? Begin the journey to an on demand business.

New vision needed

To position themselves to thrive despite the cycles and inherent volatility of their industry, financial markets firms need the ability to operate on demand -- the capability to respond rapidly to virtually any opportunity or threat. This entails:

- Greater focus on what differentiates them from the competition, less attention -- and spending -- on commodity-like functions.
- Heightened responsiveness to ongoing changes in the marketplace, more empowered customers and increasingly complex demands from regulators and stakeholders.
- Variable cost structures that allow firms to accommodate fluctuations in market demand and product preferences while improving financial position through lower cost structures.
- Improved resilience to counteract increased internal and external uncertainty and marketplace volatility -- whether protecting the business from shocks such as natural disasters, privacy and security threats and geopolitical events or addressing everyday challenges like business expansion and credit risk.

The question is: How will financial markets firms reach that enviable position? Two primary paths seem clear -- one involves the industry as a whole and the other is traveled by individual firms. The financial markets industry is moving away from a set of independent, vertically integrated institutions toward a network of affiliated financial institutions. At the same time, individual enterprises are atomizing and reconstructing -- breaking product silos into small, encapsulated business components that can be shared across the enterprise.

In fact, the confluence of these two paths is propelling financial markets firms toward an on demand operating environment where an institution's business structure and supporting business processes become flexible enough to respond rapidly to any customer demand, market opportunity or external threat.

The industry becomes more networked

Although product silos still have a stronghold within most financial services institutions, the monolithic view of the enterprise is fading, as is vertical integration. Whether of their own volition or spurred by new players arriving on the scene with significantly improved value propositions for particular parts of the value chain, companies are beginning to specialize. They are selecting a more specific industry role -- manufacturing, distribution, risk management or processing -- that suits their strengths and turning outside (or internally to other business units besides their own) to supplement weak capabilities.

In most financial services industries, the shift from vertical integration to a networked structure usually begins with distribution as firms seek additional outlets for their manufactured product. Scale-based processors emerge quickly too, assuming responsibility for operations that other firms are choosing to relinquish.

Unfortunately, ill-defined standards and inadequate linkages between enterprises often hamper industry restructuring. Processing standards and interfaces between companies are developed in an ad hoc, one-off fashion, making it expensive to establish collaborative relationships and even more costly to switch providers.

As technology continues to progress, connectivity improves and standards emerge, the industry will have the wherewithal to become more and more networked. Since only a few large companies will be able to span the full range of products in a vertically integrated manner, most firms will focus exclusively on areas where they have comparative advantage. Distributors will own the customer interface, while specialists with deep product expertise will develop new products based on segment-specific customer insights that the distributors provide. Companies will take advantage of scale efficiencies offered by selected processors -- perhaps even tapping into low-cost labor pools overseas. Most critical of all, the customer benefits, as well. With access to best-of-breed products through a variety of distributors and improved customer service, customers are no longer forced to choose between seamless service and a superior product.

The enterprise atomizes

In contrast to the limited influence they have over the structure of the industry itself, financial institutions have direct control over the evolution of their own organizations. To improve efficiency, financial markets firms are already beginning to break out of their product silos by identifying and sharing common enterprise processes such as procurement, human resource management, accounting and elements of the IT infrastructure. They are also beginning to appoint executives responsible for nurturing horizontal competencies such as distribution, manufacturing, risk and processing.

Although institutions are cobbling together an integrated view of the customer, channels are still predominately product-centric and management control remains within business units. With interdependent processes across competencies and business units, financial markets firms are struggling with overwhelming operational complexity. Connections between different areas of the enterprise tend to be static, inflexible and sometimes manual. Without adequate integration, the cost associated with the resulting organizational complexity can sometimes rise to the point where it offsets any benefits gained from shared processes.

Moving into the future, financial markets firms will get relief. Technology advances will ease the friction of enterprise reconfiguration, and financial institutions will become more comfortable operating across product lines. As collaborative capabilities expand, companies will be able to push the concept of shared processes past their initial competency-based structures to a much more granular business composition -- one based on components. A component is a group of cohesive business activities supported by the appropriate information systems, processes, organizational structure and performance measures. Each component serves a unique purpose and collaborates with other enterprise components, using common messaging standards, information systems and service agreements.

Under a component-based structure, the business is divided into autonomous parts that can be optimized individually to produce greater value for the whole. The granularity of the structure enables enterprises to respond rapidly to change, reconfiguring as required. With this business design, competencies -- composed of interlinked components -- provide the general operational framework, not products. Distribution is tuned to targeted customer segments, offering a variety of products through customer-centric channels, all focused on increasing customer loyalty and share of wallet. Reuse of manufacturing capabilities increases, and processing operations achieve enterprise-wide scale economies.

Paths converge in an on demand environment

The flexibility to operate on demand comes as financial markets firms begin to restructure into component-based businesses and learn to leverage best-in-class components from potential sources throughout the networked industry. The seamless connectivity and efficiencies, previously confined within the four walls of the component-based business, are combined with the specialization and scale made possible by a fully networked industry.

In an on demand operating environment, internal components compete on equal footing with external providers. And as the provision of a particular component becomes transparent, choice of provider will eventually migrate to the best value.

One of the prime inhibitors to greater interaction among market participants is transaction costs -- charges associated with activities like setting up a dedicated interface with a new partner or exchanging reams of paper documents to establish a relationship -- and as those transaction costs decline in an on demand environment, firms will reap the benefit of increased flexibility.

On demand financial markets firms can offer their customers a superior value proposition as well. A focused institution provides distinctive products and services that customers value because it targets the right customers in the first place and concentrates on developing a deep understanding of that segment's needs. A responsive firm allows customers to interface with sales and service personnel seamlessly through multiple channels. Plus, it makes customers wait less, with reduced cycle time between customer contact and the organization’s response. Thanks to its variable cost structure, an on demand financial markets firm can share its savings with customers through attractive rates and better-priced products.

To a large extent, technology advances are the key enablers that are making it possible for firms to operate in an on demand fashion. As IT becomes more open, integrated, virtualized and autonomic, it provides new ways of collaborating, eases business integration and reconfiguration and helps firms better manage the rising complexity of managing IT itself. To achieve this state of flexibility, a financial markets firm's IT infrastructure needs to be:

- **Integrated** -- to facilitate transaction and process integration across the enterprise; allow realtime connectivity among partners, suppliers and customers; enable active data mining and decision support.
- **Based on open standards** -- to simplify intra and inter-enterprise systems integration and adapt to technology changes rapidly.
- **Virtualized** -- so that distributed computing resources are shared and managed as a single, virtual resource to increase the utilization of existing assets and lower IT costs.
- **Autonomic** -- with systems that can be managed remotely, have embedded privacy protection and security features and are capable of self-optimization, self-diagnosis and self-healing.

Moving toward on demand

Becoming an on demand financial markets firm is not a grand leap to a final destination point -- it is a journey comprised of incremental, systematic steps toward an on demand environment. Many firms are already busy revamping their business processes and IT through actions such as relocating operations offshore, overhauling distribution networks and outsourcing IT. To date, however, these changes have been primarily cost-driven and frequently undertaken without a larger vision of how they all interact. Without strategic coordination, institutions are unlikely to achieve the goals of becoming more responsive, focused, variable and resilient, the key attributes of an on demand business.

To move steadily toward an on demand environment, firms need a long-term plan that focuses first on reconstructing the enterprise and then helps position the company to respond to industry-level shifts and the opportunities they might present. By restructuring their operating model into a component-based business structure, firms gain more flexibility to tap into best-in-class components that might be sitting outside organizational boundaries. Conversely, best-in-class components that are developed internally may present opportunities for realizing incremental revenue if offered to the marketplace at large.

The organization and culture of an on demand institution will be, by necessity, very different. To operate on demand, traditional barriers must give way to a new corporate mindset. Managing this cultural transition will be a critical part of the on demand journey -- and one that should not be underestimated.

A completely on demand operating environment will probably remain out of reach for most financial markets firms for some time to come. However, incremental benefits can be realized all along the way if institutions learn to apply on demand concepts strategically and systematically. Most importantly, every move toward on demand helps a financial markets firm gain more control in the increasingly volatile securities marketplace.

For more information:
- Visit the IBM Financial Markets Web site
- Visit the IBM on demand Web site

Face the Fact: Banking Fees Are Better for You

By Stephen Bartholomeusz, Sydney Morning Herald

The Reserve Bank of Australia (RBA)'s annual survey of fee income always generates a frenzy of bank-bashing because, since it was first published in 1997, it has shown inexorable and rapid growth. Bank fees and branch closures have been the focus of customer anger and a reliable and fiery ratings booster for tabloid TV and talkback radio.

As the latest survey shows again, however, there are two dimensions to the discussion (although that is often conveniently overlooked because it undermines the view that banks are predatory).

While fee income from households, for instance, rose from $1.2 billion in 1997 to $2.7 billion in 2002, there has been a far, far more substantial fall in bank interest margins.

The RBA says that over the past decade the spread between the average interest rate received by the banks and the average interest paid has fallen from 4 percentage points to about 2.75 percentage points.

The fall in margin between rates for residential mortgages and short-term money markets rates has been even more profound, from more than 4 percentage points to about 1.75 percentage points.
While the Reserve doesn't put a dollar amount on the savings to households from the margin contraction, a study by PricewaterhouseCoopers (PwC), commissioned by the Australian Bankers' Association, does.

PwC says that retail banking customers, both households and business, paid $17.9 billion less per annum through interest margins last year than they did a decade ago. And the banks generated $7.8 billion from fees within their retail banks last year. So customers are $10 billion better off.

The RBA and PwC come to the same conclusion. While there has been an element of substitution of fees for margin, the biggest drivers of growth in fee income have been volume-related: the banks are lending a lot more for housing and credit card-related spending. The RBA says that the growth in fee income from deposits, loans and transaction services last year was 10 per cent, the smallest rise since 1997 and a little below the growth rate in the banks' domestic asset bases. PwC says fee income growth has been slowing since 2000.

Both the RBA and PwC also concluded that the growth in fees from small business, once volume growth was taken into account, has also slowed. The significance of the slowdown, if sustained, is that it suggests that a decade-long restructuring of the composition of retail bank income streams may be ending.

There are explanations for that, with the lesser of them (albeit a significant one) being customer resistance. Traditionally, home lending was the most profitable element of domestic banking and the high margins and super-profitability of home lending enabled banks to cross-subsidize other retail banking services and treat customers uniformly.

The margins -- and the cross-subsidies -- came under pressure from two directions. First there was the emergence of the "monolines," most notably Aussie Home Loans, which used a different business model to undercut the banks. While the banks initially tried to ignore them and preserve their own margins, it was inevitable that they would be forced to meet the increasing competition and suffer substantial reductions in margin and profitability.

As that was occurring, the banks were under growing pressure on the liability side of their balance sheets: where once their retail banking activities were funded almost totally by low-cost (and no-cost) deposits, those deposits were flowing into compulsory superannuation and the sharemarket. The banks were forced to fund their retail businesses from wholesale funds, often offshore. While all this was occurring, bank technology was also evolving rapidly, enabling them to analyze their customer base far more deeply and to provide a range of electronic banking networks. The pressure on margins meant there was a pressing need to reduce costs and the new networks, which diverted basic banking transactions from expensive branches to volume-sensitive electronic platforms, did this.

The other element can be seen in reduced bank headcounts: the banks' profitability has been driven by the volume gains in the system, increased productivity and lower staff levels.

To both recover a portion of the lost margin, banks started to introduce fees and, because they no longer had the capacity to cross-subsidize, they structured them on a user-pays basis. The fees structures were also designed to provide incentives for customers to move to the platforms that were the lowest cost/most profitable for the banks - to shift, for instance, high-volume low-balance customers from branches to ATM and EFTPOS machines.

The overwhelming majority of routine bank transactions are now conducted on the electronic networks, changing the nature of branches and indeed banking. Electronic networks are capital intensive and extremely volume sensitive -- there is a point where they achieve a critical mass of transactions and can become highly profitable.

It is unclear whether the flattening of growth in fee income is due to the maturing of the profile of the electronic platforms or whether the banks are responding to customer resistance to further fee increases -- or both. It suggests that after a decade of complex and controversial transformational shifts in the nature of banking and the behavior of customers the system might now be settling.

While both the RBA and PwC conclude that customers are substantially better off once the erosion in margins and the increase in fee income is netted off, both make the point that not all customers are better off.

As the Reserve says, customers with mortgages who use electronic banking channels and who avoid late payment charges are well ahead. Those without a mortgage, with low balances and high transaction volumes and who use over-the-counter branch facilities are obviously worse off.

With banks fees increasingly transparent, however, customers can see the unbundled costs of their banking and can, to an extent, manage them.

In the past, there were a host of hidden cross-subsidies between various groups of customers which bore little relationship either to their value to the bank or the cost of servicing them. Saying that the growth in bank fees has tapered off, and indeed that the fees only partly compensate the banks for their lost margin, doesn't, of course, indicate that the fees are set at an equitable level.

PwC's study, however, found that the Australian banks fees are set at levels that are roughly equivalent to those charged by the Canadian banks and about half the level charged for the same services in the US.

See? The banks are not using fees to rip off their customers.

For more information:

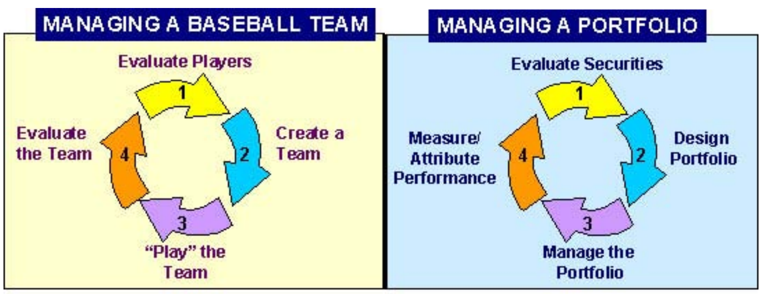
- Visit the IBM Banking Web site

Portfolio Analytics: A Field of Dreams

By Gavin Little-Gill, Analyst, TowerGroup

Snow falls, melts, and my thoughts turn -- to baseball. I am reminded of the baseball obsession that afflicts a segment of the American population, like the old friends who struggled through math classes yet recite batting averages for every member of their favorite team back to 1965. Twenty-five games into the season, the same friends can spout the impact of a double play on the batting average of the player standing "on deck" about to bat.

Baseball is the statistician's dream. Statistics measure players' batting averages against left-handed pitchers, right-handed pitchers, specific teams and pitchers, and during night games. The processes and analytics that go into managing a baseball team remind me of those involved in managing an investment portfolio. In baseball, statistics are applied to the process of choosing players, managing the team and evaluating team performance. Each of these processes can be mapped to the portfolio management process and the analytics used in the selection of securities, the creation of a portfolio, and the evaluation of that portfolio using performance measurement and attribution analysis.



Step 1: Evaluating Players

Step 1 narrows down the thousands of potential players. Baseball teams hire scouts to facilitate this process. Investment management firms use security screening tools and research often provided by institutional brokerage firms (a topic for another day), to narrow the securities population.

In baseball, evaluating players involves reviewing the performance statistics for each player as well as assumptions based on a host of factors such as age, medical history, and physicians' assessments. In portfolio management, evaluation entails review of the historical performance of individual securities (or simulated performance characteristics for fixed income and derivative products) and assumptions based on factors including macroeconomic data, strategies of a company's management, consumer demand and market positioning.

While the tools used by managers to facilitate the security selection process vary widely, the biggest differences exist between equity and fixed income or derivative managers.

Equity managers typically use filtering tools and traditional accounting algorithms like price/earnings ratios that are built into market data or other desktop applications, or proprietary modeling algorithms designed to identify undervalued or growth companies. Managers create portfolios from the "top down," first identifying countries or sectors they believe will "outperform" others and then choosing securities within those sectors. Or they may use a "bottom-up" method, choosing securities regardless of what sector they appear in.

Managers of fixed income securities use traditional duration or convexity (and their related derivatives) analytics to evaluate bonds. In addition, they often use proprietary tools or specialized spreadsheet plug-ins.

These tools facilitate the analysis of products with more complex or scenario-variable cash flow (answering questions such as, "What would happen to the prepayment and subsequent value and the duration of this mortgage-backed security if interest rates were to go down by 1%?").

Step 2: Creating the Team

Managers of baseball teams choose players who add depth to the overall capabilities of the organization, players who offer synergies with other players on the team. They avoid overweighting any one area (the team doesn't need more than a couple of left-handed relief pitchers).

Portfolio managers look at the characteristics of securities relative to benchmark indices, at the correlation coefficients of securities (to determine "How well do they play together?"), and pick securities that in aggregate form a "team" capable of meeting the objectives of portfolio covenants. They are careful not to add too much of any one security and careful not to add too many securities from the same sector or susceptible to the same macroeconomic risks.

This might be expected to be a complex process with extensive use of Monte Carlo simulations, correlation coefficients, and "efficient frontier" hypothesis. Instead, it is more art than science. "Quantitative" investment managers, who use analytics tools extensively to create model portfolios, are the exception rather than the rule. Currently, the trend is to focus attention on comparing portfolios with benchmark indices to ensure that performance does not significantly lag (or vary from) the benchmark. This trend is driven by portfolio covenants and direction that portfolio managers are receiving from trustees and management, who say in effect: "Use your creativity and get the best return for the portfolio -- but make sure you're never in a position to underperform the market if you're wrong."

Step 3: Coaching -- Playing the Team

When they are winning, coaches tend to leave things alone, "let it ride." When the game is close, however, they change the lineup or order of players, shuffle the pitchers or add designated hitters. Sometimes players get hurt and need to be put on the injured list or dropped from the team.

The majority of the investment management market remains buy and hold. This means once the portfolio is created, little change occurs (less than 60% turnover per year). Most of the investment management process involves orchestrating cash flow in or out of the portfolio. Order management systems (OMSs) have added modeling capabilities to address one of the key challenges: managing the proliferation of portfolios. This functionality allows the comparison of actual portfolios to model portfolios and the generation of subsequent transaction "recommendations." OMS vendors are beginning to partner with analytics vendors to integrate risk and portfolio dynamics data into their portfolio modeling capabilities.

A minority of firms, mostly hedge funds, use "alternative portfolio strategies." Strategies include long/short (buy one stock, sell an equal amount of another), quantitative trading strategies designed to identify and exploit arbitrage opportunities (and often generate 100%+ turnover per day), and a host of leveraged portfolio strategies. These strategies require attention to the risk dynamics of the portfolio as absolute exposure by security, sector, currency or country become meaningless (asking questions like "What kind of portfolio exposure or risk do I have if I have bought $1 million of AT&T and sold $1 million of Cisco?"). These firms require and use a variety of proprietary or vendor tools to calculate the investment opportunities and inherent risk in these complex portfolios.

Step 4: Evaluating the Team

Performance measurement tools are fairly straightforward and tell us what happened, rather like the scoreboard in a ballgame. The complexity of performance measurement is associated with the valuation of thinly traded or derivative securities. Performance attribution tools are a little more complicated. They take what happened and apply context, attempting to answer "Why?" Sports reporters typically oversimplify this process and attribute wins or losses to specific events. Portfolio performance attribution often oversimplifies the "reasons" for performance by taking a snapshot of the portfolio and comparing the performance of portfolio holdings relative to benchmark positions, irrespective of time series or transaction-level data. There is no dearth of people available to express their opinions about how a team played or a portfolio manager performed. In baseball, there are fans, sports media and coaches, while in the investments world we have clients, consultants and portfolio managers or investment management firms. Each of these interested parties has distinct needs.

Clients
Like sports fans, the majority of clients are largely interested in the result. How much money did I have, how much do I have today? How you got there, how much risk was assumed to obtain that result, is largely irrelevant. Despite attempts by firms like Morningstar to integrate "risk" into the evaluation process, performance remains a central criterion for evaluating existing and new investments.

Consultants
Consultants dominate the market for institutional assets, directing the flow of new and existing assets. Like sports reporters, these firms add value by offering their own evaluation of the performance of money managers. As such, they make use of performance attribution tools in reporting performance to their clients.

Portfolio Managers / Investment Management Firms
Like coaches, portfolio managers should be evaluating performance based on transaction-level data and tying performance back to "active" versus "passive" investment decisions. Performance attribution is more often a process of looking at a single point in time at security, sector, currency or country exposure relative to the benchmark and the relative performance of each.

Step 5: The Future

Baseball is laden with superstitions among players, coaches and fans. It is the same with investors and their portfolio managers. Despite the vast quantities of data, statistics, and advanced analytical tools available; portfolio management remains more of an art than science. The portfolio analytics market is taking small steps, not great leaps. It is driven by the integration of existing algorithms into peripheral applications rather than the development of new algorithms. What does the future hold?

- Data providers will continue to add more analytics data and algorithms.
- OMS vendors integrate analytics into the portfolio modeling functionality applications (often in partnership with analytics vendors).
- Risk-based portfolio covenants will blur the lines between portfolio compliance and risk management, forcing the integration of risk-based capabilities into compliance tools.
- An increase in subadvising activity by investment management firms and continued efforts by consultants to provide value-added analysis will lead to more active use of tools to monitor third-party investment advisors.

The result will be tighter integration of analytics into existing data, software and services.

For more information:
- Visit the TowerGroup Web site
- Visit the IBM Financial Markets Web site