Product profitability in Wealth management and Private Banking

Unlocking profit opportunities with enhanced reporting capacity

In light of ongoing industry challenges, managing profitability remains a priority for wealth managers. Product mix optimization stands out as a key enabler for top and bottom-line improvement. To unlock its potential, best-in-class wealth managers are developing methodologies for monitoring and steering profitability across the product portfolio. In our view, given shift driven by MiFID II and evolution in clients’ expectations, Product Profitability should be top priority on the agenda of Wealth Management CFOs.
Profit in the wealth management industry remains under pressure

Client wealth levels suffered significant decreases following the recession in 2007-2008 that led to significant declines in wealth managers’ Assets under Management (AuM) and profitability. However, despite notable recovery in AuM since then, wealth managers are struggling to recapture the high profit margins they experienced in the past. Indeed, as illustrated in Figure 1, pre-tax profit margins remained between 17bps and 19bps while AuM grew by approximately 70 percent between 2008 and 2015.

Figure 1: AuM and pre-tax margin evolution

<table>
<thead>
<tr>
<th>Year</th>
<th>AuM (indexed at 2008)</th>
<th>Revenue margin (in bps)</th>
<th>Cost margin (in bps)</th>
<th>Pre-tax profit margin (in bps)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>100</td>
<td>17</td>
<td>82</td>
<td>14</td>
</tr>
<tr>
<td>2009</td>
<td>115</td>
<td>14</td>
<td>67</td>
<td>17</td>
</tr>
<tr>
<td>2010</td>
<td>124</td>
<td>17</td>
<td>67</td>
<td>19</td>
</tr>
<tr>
<td>2011</td>
<td>131</td>
<td>19</td>
<td>65</td>
<td>18</td>
</tr>
<tr>
<td>2012</td>
<td>142</td>
<td>18</td>
<td>61</td>
<td>19</td>
</tr>
<tr>
<td>2013</td>
<td>157</td>
<td>18</td>
<td>59</td>
<td>17</td>
</tr>
<tr>
<td>2014</td>
<td>169</td>
<td>19</td>
<td>57</td>
<td>19</td>
</tr>
<tr>
<td>2015</td>
<td>169</td>
<td>19</td>
<td>58</td>
<td>19</td>
</tr>
</tbody>
</table>
There are many reasons why wealth managers' profitability remains under pressure:

• **Clients have grown increasingly conservative and price sensitive.** Indeed, following the financial crisis, many investors have downgraded the risk profile of their portfolio and moved into low-cost, index-based products, being reluctant to move back into the types of high-risk asset classes, such as equities, that tend to carry high operating revenue and margins.

• **Additional regulatory pressure has constrained industry development.** In recent years, a number of new regulations have been introduced and had a multitude of consequences for wealth managers, such as:
  – Reduced financial resources (lending capacity, deposit-taking capacity) to comply with new capital requirements
  – Reduced product scalability due to additional administrative burdens
  – Increased transparency on the types of services provided and the associated pricing

• **Intensified competition has pushed wealth managers to add even greater value.** The removal of banking secrecy in offshore centers such as Luxembourg and Switzerland, the automatic exchange of information and the recent developments in the FinTech space resulted in: (1) a reduction in the competitive advantages of established players, and (2) lower industry barriers to entry. Intense competition and more transparent product offerings (particularly on prices) have empowered customers to compare offers from different firms. These developments have sparked greater competition and created a need for wealth managers to clearly demonstrate how they add value.

**Industry forces induce a shift in product offering and pricing model**

As the likelihood of returning to pre-crisis margins is remote, wealth managers need to reinvent and rationalize their advisory product shelf. Moreover, the greater transparency required under MiFID II will push the wealth management industry product offering and pricing model to change toward “under contract arrangements” with separate and explicit charges for advice requiring banks to distinguish the product manufacturing costs from distribution, sales, and advisory costs.

This shift raises a number of questions, which can be broadly broken down into three main categories: (1) pricing-related questions, (2) manufacturing-related questions, and (3) distribution and product mix-related questions. Figure 2 presents some examples of questions on the agenda of decision makers in each category.

**To optimally manage their product mix, decision makers need financial reporting at product level**

To answer the questions raised by the ongoing shift in the product offering and pricing model, wealth managers are increasingly looking to understand the factors that contribute to greater profitability. With a view to clarifying which products add to profit margins and

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**Figure 2: Examples of questions on the agenda of decision makers**

**Pricing**

• How should fees be adapted in response to the market shift in pricing model?
• How can clients be provided with greater transparency on product pricing?
• What are the key components of product pricing?
• Are existing products correctly priced?
• How to best price new products?

**Manufacturing**

• How can product manufacturing costs be optimized?
• What are the main drivers of the bank's products costs?
• Which products are the most expensive to make?
• Which products are the most scalable?
• Would it make sense to outsource the production of some products (make or buy)?

**Distribution/product mix**

• What percentage of relationship managers' time is spent on selling and managing WM products?
• Which products are the most expensive to sell? What are the underlying reasons (i.e., pre-, on- or after-sale)?
• Which products are key drivers of the bank's profitability?
• Are some products unprofitable?
The underlying drivers, **best-in-class wealth managers are developing methodologies for reporting profitability across the spectrum of products.**

The challenge, however, is that it can often be difficult to obtain a clear picture of product profitability:

- Tying back revenues to the underlying products is constrained by complex aggregation methods across various income streams from fees, interest income, trading and other sources.
- On the other hand, 50 percent to 70 percent of wealth manager costs are typically not directly product-related (e.g., client acquisition costs, relationship management costs, overheads and other costs) and need to be allocated based on ad hoc methodologies.
- Moreover, the cost and revenue data relating to services provided to individual clients is often difficult to consolidate from the various accounting and management information systems that cross different businesses and functions. Thus, the true operating earnings for various profit centers are often hard to ascertain given complex, incomplete, or sometimes inaccurate cost and revenue allocations.

In light of these challenges, wealth managers often have to arbitrate between sophisticated models (based on bottom-up allocation methodologies), which are more insightful but require higher investments upfront, and tactical solutions (based on top-down allocation methodologies), which are less insightful but are easier to establish and maintain.

**Developing a product profitability reporting capability means following a process**

Regardless of the type of model chosen by the wealth manager (sophisticated vs. tactical), developing a product profitability reporting capability usually means following a three-step process typically lasting between 6 and 12 months (see Figure 3): [Diagram]

**Figure 3: Product profitability reporting capability development process**

<table>
<thead>
<tr>
<th>Design</th>
<th>Implementation</th>
<th>Integration</th>
<th>Maintenance and evolution</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Evaluate data availability and gather business inputs</td>
<td>- Specify the reporting target solution</td>
<td>- Test the implemented reporting engine</td>
<td>- Ensure the alignment of the allocation methodology with the bank’s evolution</td>
</tr>
<tr>
<td>- Define a revenue and cost allocation methodology at product level</td>
<td>- Implement the reporting target solution</td>
<td>- Go live with the target solution</td>
<td>- Enhance the report to cope with new requirements</td>
</tr>
<tr>
<td>- Develop a prototype</td>
<td>- Run the prototype on a recurring basis</td>
<td>- Implement TOM</td>
<td></td>
</tr>
<tr>
<td>- Define target solution TOM</td>
<td></td>
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**Key challenges**

- Top-down vs. bottom-up
- Multiple reporting needs
- Need for prioritization
- Availability and quality of data
- Complexity vs. reporting frequency and speed
- Integration in production environment
- Need to adapt to change
- Need to manage complexity
- Governance

6–12 months
1. Design phase: The key objectives of the design phase will be (i) the definition of a methodology for allocating revenue and costs at product level, and (ii) the implementation of a prototype for the purposes of producing a pilot product profitability report. The main purpose of the pilot report is as the creation of a communication tool that can be used to validate the overall framework (e.g., product structure used, P&L structure used, etc.) and the proposed methodology with key project stakeholders. Once the pilot report has been formally approved, the project team in charge can proceed with the implementation phase.

2. Implementation phase: The main objectives of the implementation phase are to (i) specify the reporting capability target solution from a business, functional and technical point of view, and (ii) implement the specified target solution. This second phase is considered complete when the implemented solution is ready to be tested and released in a dedicated environment.

3. Integration phase: The key objectives of the integration phase are (i) to test the implemented reporting solution to ensure that it is consistent with the specification, and (ii) to integrate the solution into the wealth manager’s production environment.

It is important to note that the prototype developed during the design phase will typically be used to generate product profitability reports on a recurring basis throughout the subsequent phases. In this way, wealth managers can start sharing product profitability results after only a few months and thereby improve the extent to which the ultimate report may be used as a basis for action.

Steering product profitability and laying the foundations for future strategic decisions at management level

The ultimate purpose of developing a reporting capability to track profitability at product level is to identify high-impact opportunities to invest, divest, and reduce costs where appropriate. Product profitability reports may uncover a broad range of opportunities that could be seized to increase profitability.

As shown in Figure 4, wealth managers may wish to follow a five-step approach as they identify and implement profit-enhancing strategic actions.

1. The first step is to leverage profitability reporting to identify areas of the business where there is room for improvement. This starts with a set of qualitative and quantitative observations listed and grouped into major functional segments that provide an assessment of the current state of the business. Typically, a product profitability report will be assessed with reference to two main dimensions:

   - **Product mix**: Analysis of overall profitability through an assessment of resource allocation across products.

   - **Individual product P&L**: Analysis of individual product profitability through an assessment of resource allocation along the value chain.

Figure 4: Recommended approach to identify and implement profit-enhancing strategic actions

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Assess current state
Leverage product profitability reporting to identify profit-enhancing strategic avenues

Develop a target state
Develop strategic vision of a future state by defining specific and measurable objectives

Assess gaps
Identify gaps between the current and target states needing to be filled to achieve the vision

Identify strategic actions
Identify areas of improvement corresponding to the possible gaps identified

Develop a roadmap
Identify areas of improvement corresponding to the possible gaps identified
2. The second step focuses on developing a strategic vision of the future state of the business. This phase often involves multiple functional departments across the organization (e.g., front office, operations, risk, compliance, and legal) so that diverse, often conflicting, perspectives are taken into account and significant stakeholders are engaged. Setting specific and measurable objectives during this phase is of particular importance because it may establish clear points of reference and guidelines throughout the following steps of the process.

3. The third step consists of comparing the analysis of the current state of the business with the target state vision and determining gaps that need to be addressed to reach the target state. This step is crucial because it links the observations identified in previous steps to strategic actions in the following steps. Gap definitions need to be very specific and broken down by functional areas as much as possible to help involved parties identify the root cause of the issues.

4. The fourth step focuses on the identification of possible strategic actions that may be executed to close the gaps and achieve the target state. Strategic action selection is based on specific objectives, potential scope, timing, and required return on investment. Examples of high-level profit-enhancing strategic actions identified by wealth managers based on observations made regarding product profitability reports are presented hereunder:
   • Product rationalization and harmonization across markets and segments
   • Product standardization (e.g., decreased number of options/flexibility)
   • Automatization/rationalization of middle and back office processes
   • Alignment of product distribution channels with customer behaviors
   • Frontline staff efficiency optimization through advanced analytics

5. Lastly, the fifth step consists of developing a set of practical activities to be performed and milestones to be reached to effectively implement the initiatives previously identified. The focus should be on both quick wins as well as on long-term sustainable initiatives to make profitability an ongoing process. The roadmap should strike a balance between complexity and risks versus the magnitude of the transformation, and evaluate improvements against the transformation timeline. Clear owners and accountable parties should be identified and empowered to enable effective delivery in line with expectations. During this phase, the creation of a “transformation summary dashboard” that tracks accomplishments against objectives on a quarterly or monthly basis can help monitor progress and prioritize remediation actions as needed.

Key takeaways

• Profit in the Wealth Management industry remains under pressure
• Product mix optimization stands out as a key enabler for top and bottom-line improvement
• Best-in-class wealth managers are developing methodologies for monitoring and steering profitability across the product portfolio
• In our view, given shift driven by MiFID II and evolution in clients’ expectations, Product Profitability should be a top priority on the agenda of Wealth Management CFOs.