

Business Model Innovation for Swiss EAMs

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The profitability of wealth managers has been in constant decline over recent years, particularly in Europe. A study¹ by Deloitte states that while the overall market size for private banking services from European millionaire households grew by more than 60% between 2000 and 2015, wealth managers' profit margins fell by 40%. This is despite the industry's efforts to use industrialization and M&A to improve profitability. The Deloitte report suggests that the industry faces a stark innovation gap. More – and urgent – action is needed.

Deconstructing private banks' revenue components shows a distinction between two major contributors – management fees (discretionary management or advice fee) and fees for custody services. This has strategic implications for the EAM (external asset manager) industry. EAMs incurring margin pressures on custody services will typically seek to pass this on to custody banks. The custody banks in turn may look to offset this through economies of scale and taking into account the effort involved in serving the individual EAM. Conversely – for the time being at least – EAMs are better able to defend their advice fee if they are able to offer continued benefits to clients in the form of independence and performance.

Similar to private banks, EAMs are beginning to face stronger competition from FinTechs, new players and private banks that are in the process of changing their business models. Secondly, and core to this paper, is the need to remain relevant and attractive to future generations. Both of these factors mean there is a need for new business models.

This white paper arises from a workshop conducted during a focus course for EAMs: "Options for the future". The workshop authors touched several times on the importance of innovation. Here, we provide more insight into how to be innovative.

To demonstrate the importance of innovation, we have constructed an example model in the next section. From this basis, we created four potential business models by considering why, what, how and for whom EAMs need to evolve. This is not intended to suggest that these are the only appropriate paths. Rather, it provides food for thought to help Swiss EAMs continue to generate value for their clients.

¹"Innovation in Private Banking & Wealth Management, Embracing the Business Model Change", Monitor Deloitte, 2018

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Introduction

Swiss EAM market and definitions

The EAM business model is triangular, whereby end-clients' assets are held (custody) with a traditional bank. The client relationship and portfolio management are delegated to an EAM through a power of attorney. Framework agreements are put in place to regulate the relationship between the bank and the EAM.

Against this backdrop, debate has raged since the beginning of the Fintech boom as to whether or not private banks and traditional EAMs will fall victim to pure Robo-players. Some believe that the client advisor can be replaced by Robos. Others strongly disagree.

We are confident there is a middle way. We advocate the usage of technology to engineer efficiency and new

services, while recognizing the important role of the client advisor and relationship manager. That said, it is obvious that the role will change over time as technology intensifies.

Our conclusion is based on our view that banking - and especially private banking, which relies heavily on trust - is in line with Satya Nadella's thinking in his book "Hit Refresh"². He describes it as an aggregate of empathy, shared values, safety and reliability. While technology can support and enhance safety and reliability, it cannot ultimately be empathetic or have its own shared values.

Business model innovation

The University of St.Gallen conducted empirical research to identify the core of any revolutionary business model innovation³. The result was a set of 55 principal business models. 90% of all successful business models are premised on a (re)combination of these, and all 55 patterns can serve as blueprints for business model innovation.

² "Hit Refresh", Nadella, Satya, Harper Collins Publ, 2017

³ "The Business Model Navigator", Grassmann, Frankenberger, Cisk, FT Publishing, 2014

Constructing your business model elements

THE WHO:

Customer: understand precisely which customer segments are relevant to you, and which are not.

THE WHAT:

Value proposition: define your products and services and how you cater to your target clients.

THE HOW:

Value chain: the process by which your offering is produced, which capabilities and resources are required and how they are coordinated.

THE WHY:

Profit mechanism: a clear understanding of cost structures and revenue streams.

Example 1:

Aikido business model – radically different from the industry standard

Although the idea to offer something fundamentally distinct is simple in theory, its implementation can be a challenge. Aside from finding the right product, does the company have the brand, reputation and trust to successfully broaden its scope? Depending on the organization's position, combining the proposition with other business models such as franchising, cross selling and open business may be appropriate options.

Who

For the purpose of this example, we define the client segment as future generations of clients called "Millennials". Many EAMs currently lack strong inroads into this segment. We began by asking ourselves in which other services Swiss Millennials may potentially be interested, and which do not create conflicts of interests for an EAM.

One trend heavily associated with the Millennials is "access over ownership", which is the preference to pay for use instead of owning material assets such as cars, pools or household appliances. This sharing economy has two parties: people owning something that is being offered to share and people paying for use or share.

What

The client would issue to the EAM a power of attorney related to the assets. The EAM then seeks to source sharing revenues on the client's behalf, providing an opportunity for "sharing optimization". Offering such services would entail a detailed assessment of the items the client is willing to share, each item's revenue potential and the best channel through which it should be provided.

How

The EAM should have a strategic collaboration with a leading sharing platform such as Sharoo to gain market intelligence on products likely to be successful, related prices and other relevant parameters. Based on this, the EAM could establish a checklist and sharing catalog for the client to self-assess whether or not any given item is a sufficiently attractive proposition. If the client decides to proceed, it would be followed by a specific contract between the client and the EAM regarding the "Sharing-As-A-Service" service, including details of access to the items and the pricing model.

Why

By generating a new, relevant income stream for its clients, an EAM can participate in earnings. Given the relatively high upfront investment for the EAM (general service offering, product due diligence etc), a fixed fee component – which can be a step-up model – may be appropriate in addition to a share of the revenues earned for the client. The EAM must be confident of generating sufficient profits to justify the upfront investment in implementing the model. We therefore position this as an add-on service to the core investment management offering, believing the model would work in the mid-to-long term. It also helps the EAM to enhance its differentiation.

Example 2:

Platform business model – efficient, modular and flexible

Creating an open platform as a business ecosystem can be a challenge as it involves constructing a series of interconnected, cohesive modules with a shared vision and strategy. The primary challenge is to start with an open architecture that is flexible and capable of evolving, and for EAMs to adopt new modules and expand existing ones. A further challenge is the resource intensity, which makes it interesting mostly to:

- larger EAMs that would like to scale up their own development and progress to other players in the market; or
- a joint venture that allows multiple parties to share the development burden.

Also important is the creation of networks with different specialists and networks to create an impact whereby the whole is greater than the sum of its parts.

The platform business model is often combined with digitalization and the open business concept, which refers to the inclusion of outside partners into usually closed value creation processes such as research and development. Such collaboration is a key determinant of future growth and competitive advantage that enables all participants to benefit.

Who

This type of business model serves EAMs, not necessarily private clients. The idea is that individual EAMs can compete with traditional private banking services from established banks by offering an all-around service. And do so with greater flexibility and faster processing times while maintaining a lower cost structure. The sales approach may also give rise to fewer conflicts of interests by applying different compensation systems or a more transparent decision-making process.

What

There are multiple options in implementing a platform business model. The heart of the concept is to use

economies of scale without compromising the individual nature of solutions. All while maintaining flexibility via an open API architecture. Each EAM can choose which resources to bundle for any given client.

How

The platform manager defines clear interfaces and which services are offered in conjunction with the individual EAM. Certain services such as research and investment selection can be bundled and distributed to the entire EAM network. Other activities such as reporting or portfolio management can be supplied by other service providers within the network. This approach enables EAMs to focus on managing the client relationship and the core competencies they offer to clients as well as to other EAMs on the platform. Key is that the various EAMs compete only in a negligible manner with each other and are compensated fairly within the platform. For this to succeed, EAMs must be willing to compensate the platform for the support and opportunities they receive. The platform itself may be organized as a cooperation or association.

Why

EAMs must offer a distinguishable service based on a competitive cost structure. This necessitates the efficient allocation of resources to research, process, client interactions and investment decisions. A single EAM will rarely – if ever – have the financial, managerial, specialist or knowledge base that can be obtained by collaborating with an expert network and combining resources. Teaming up with complementary EAMs can therefore solve the innovation issue and burden, with expanded services being distributed across multiple players. EAMs can also diversify their exposure to banks while also influencing the progress of the platform through interactions with the platform provider.

Example 3:

Solution provider/open business – a one-stop-shop with a structured value chain and collaborative mindset

Offering comprehensive services across a wide range of financial topics may be daunting, especially for start-ups or small companies. A lack of resources and/or skills can limit the quantity and quality. But by carefully structuring the value chain by collaborating with other parties, even small players have the opportunity to compete with market leaders. Crucially, small businesses are far more agile and can achieve much great client centricity.

Who

This business model focuses on private banking clients who are domiciled in Switzerland. Private banking goes far beyond growing wealth and should be understood as a philosophy. Clients' needs are highly complex, characterized by a strong interconnectivity between various financial topics such as investing, financing, pension and taxes, among others. One client segment is executives and entrepreneurs who have very limited time and therefore rely on a strong partner when it comes to their finances. Another segment is retirees or people close to the end of their career who are seeking to optimize their financial situation.

What

With such clients being particularly demanding, a comprehensive, high quality offer is paramount. The principle underpinning this business model is to operate as a private banking boutique offering all possible services around personal finance. These range from traditional themes such as investment advisory and asset management, through financial planning, property financing and tax advice, to more exotic topics such as art banking. The clear mindset is to find a solution no matter what the client's need.

How

As sufficient resources or expertise rarely exist in one organization to cover all aspects mentioned in the "What", EAMs should focus on their core competencies and instead coordinate other specializations. Specifically, whereas advisory services such as investing in and financing a property are needed, for instance, or private or vested benefits accounts are offered in-house, other subjects are covered via a network of external partners. This enables the boutique to maintain low overheads, with subject matter experts being paid only on demand and directly by clients directly.

Most value is created at the interface with the client, which makes these interactions key to success. The value chain must be organized cleverly, with client interactions being as individual as possible while products and processes are commoditized to increase efficiency. If a client is interested in purchasing an apartment, for example, they remain in exclusive contact with the EAM throughout the process. The EAM is in continuous exchange with a number of banks, gathering offers and negotiating the best possible terms for the client. Processes for file transmission, mortgage application etc are standardized. Accordingly, in the case of investment advisory, the bank will advise and support the customer in reaching a decision. The depository bank can be chosen by the client and merely figures as a custodian with no direct interaction with the client and is once again a standardized part of the value chain.

Why

For the client, having one strong partner who covers all financial topics and understands one's personal situation and needs is comforting and saves considerable time. In addition, the EAM can secure a more attractive solution for the client by negotiating with various banks, insurers and other parties. The EAM's relationships with financial institutions can secure institutional prices for the client, rather than regular fee structures. Last but not least, ensuring the alignment of the various services significantly reduces complexity for clients, enhancing the competitive edge of this business model.

Offering such a wide variety of services means considering a number of revenue streams. First, wealth management and investment advisory portfolios generate management fees that are charged to the customers on a quarterly basis. Second is income from billable hours for services such

as mortgage structuring or property financing. Finally, banks or partners may pay commissions for referring clients. Whenever such a referral premium is obtained, the client's charge for billable hours is offset to ensure fair and independent business conduct. Full disclosure of payments from other financial institutions paired with predefined hourly rates lead to a highly transparent pricing model.

Example 4:

e-channels – a no-frills flat rate for core investments together with add-on service modules

e-channels include apps and webpages with integrated chat functions. They can help keep infrastructure costs with a direct broker or e-bank and the service and advisory cost to a minimum. Further, this EAM business model can offer add-on service modules for multiple linking points (e.g. inheritance planning, taxes, risk management) from its own network of experts on demand. The low-price flat rate (e.g. 0.30% p.a. for the no frills flat rate and an additional 0.20% for risk management add-ons or other features such as smart-beta optimized portfolios or semi-liquid alternative strategies and a fixed amount for other services) combined with e-channels opens the door to price sensitive and well-informed clients.

Who

The focus of this business model is on young and middle-aged clients who are domiciled in Switzerland and a handful of pre-defined countries within the European Union (MiFID II compliant). Most clients are price sensitive and more critical of bank fees and the overall banking system since the financial crisis of 2007 to 2009. Clients' needs are not (yet) complex and are characterized by low interconnectivity. The main interaction between the client and the EAM will take place via e-channels. The business model offers a wide network of financial experts covering financial planning, financing, pensions, taxes, etc where add-on services are required by the client. The typical investment size may be in the range of up to CHF 1 million. To avoid losing potential young customers, no hard minimum investment sum should be set – which is the approach of many Swiss and European e-brokers and direct banks in recent years.

What

The idea is to offer a core asset management service at a low cost with a range of add-ons for a further fixed price. The add-ons could be the following or an additional percentage p.a.:

- risk management tool (e.g. standardized CTA approach)
- or

- an extra-yield add-on with covered call-writing strategies (standardized to the relevant ETF) or
- an add-on for a smart-beta overlay (standardized)
- an add-on for semi-liquid alternative strategies.

The extra service add-on for the services outside core asset management can be purchased on a flat fee or percentage basis.

Within the core asset management functions, add-ons can be implemented or withdrawn every month at the client's request. These could include saving plans or other retirement-related saving structures.

How

e-channels generate transparency and give the client the chance to keep themselves up to date. This business model does not need more than four to five experts (2 members of the board, 1 project manager, 0.6 compliance specialist and 0.4 risk officer) and 1–2 administration professionals.

Hence, the core asset management function is offered in-house while add-on services are covered via a network of external partners. This set up enables the EAM to use this business model to offer an attractive service to cost sensitive and well-informed clients.

Why

Today's asset management prices remain on average far too high, with standard management fees of 0.8% to 1.5% p.a. plus excessive costs from products including retrocessions (from 0.4% to 0.9% p.a.). The new business model will prove the opposite by using e-channels and a standardized but flexible asset management approach. Pioneers such as VIAC or REVOLUT have already paved the way.

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