IBM Institute for Business Value

From complexity to client centricity

With simple smart service

IBM Institute for Business Value

IBM Global Business Services, through the IBM Institute for Business Value, develops fact-based strategic insights for senior executives around critical public and private sector issues. This executive report is based on an in-depth study by the Institute's research team. It is part of an ongoing commitment by IBM Global Business Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to *iibv@us.ibm.com* for more information. Additional studies from the IBM Institute for Business Value can be found at *ibm.com/iibv*

By Srini Giridhar, David Notestein, Shanker Ramamurthy and Likhit Wagle

Nearly 90 percent of bankers in our global survey believe that transforming from the status quo is critical to profitability. Tomorrow's banks must become more client centric by leveraging sophisticated insights to improve risk management, pricing, channel performance and client satisfaction. Simultaneously, banks in mature markets should reduce operational complexity, which we estimate costs them approximately US$200 billion annually.[1] In emerging markets, where wealth is growing at nearly US$900 billion annually, banks should focus on wealth management, innovation and inclusion of the underbanked and unbanked.[2]

To grow and prosper in today's ever-changing world, banks too must change. They need to move beyond any existing organizational silos, infrastructure complexities and other constraints – and toward an operation centered on the client.

How will banks achieve this transformation for the new tomorrow?

Based on our most recent banking industry research, surveys and interviews, we believe that sophisticated insight is a key differentiator (see sidebar: Research methodology). Insightful banks worldwide will continuously tailor their services and distribution networks to changing client needs. To succeed in the volatile, ever-changing marketplace, banks must not only avoid excessive risks, but also rebuild and strengthen client trust and mindshare. These conclusions are a natural evolution from our prior research studies on themes relating to globalization, simplification and specialization.[3]

Further, banks need to focus on the underlying economic fundamentals of the mature and emerging markets. For instance, banks in mature markets must address the cost of complexity in their operations. We estimate complexity costs the industry up to US$200 billion annually and constrains pre-tax profits by nearly 20 percent.[4] On the other hand, future growth and profits for banks in emerging markets are dependant on financial inclusion of the unbanked and underbanked along with a focus on the lucrative wealth management business, which is growing US$900 billion annually.[5] In the near term, we believe banks in emerging markets that invest in client insight could potentially grow their wealth management business annually by an average of US$150 million each for the next few years.[6]

> *"We look at our lines of business and operations more closely than in the past. If our products and services increase our risk profile or do not meet our stringent rules on cost of capital, we will divest this operation."*
>
> Senior executive, Universal bank, North America .

As banks focus on the fundamentals of their market, they should use their insights to:

- Optimize risk by leveraging information
- Increase revenues by becoming more client centric
- Enhance operations by managing cost and complexity.

Research methodology

For this IBM Institute for Business Value study, we partnered with the Economist Intelligence Unit to conduct a global survey of the top 200 banks based on tier 1 capital. Of our responses, 28 percent were from the Americas, 36 percent from Europe, and 36 percent from Asia and Australia. We also conducted interviews with approximately 50 executives in the banking industry and did secondary research to develop quantitative models of the top 200 banks based on financial information from the last five years.

The banking ecosystem

We define the traditional banking system as deposit-taking institutions that provide financial services to retail and institutional clients. We classify organizations within that system into three categories:

- ***Universal banks*** are large global banks that typically have significant operations in 12 or more countries or trading regions and have assets of US$800 billion or more. These banks realize at least 2 to 2.5 percent of their revenue from each of their different countries (or trading regions) of operation. They manufacture, process and distribute diverse products to multiple client segments globally.
- ***Multinational*** and ***national banks*** include banks with significant operations in 11 or fewer countries with an asset base between US$250 billion and US$800 billion that receive 50 percent of their revenue from their home base. They manufacture, process and distribute a large set of products to multiple client segments within a country or trading region.
- ***Specialized banks*** and ***regional banks*** include specialized banks that operate in one or more countries, have an asset base of less than US$250 billion and gain 75 percent of their revenue from one or two major countries or lines of business. They manufacture, process and distribute a very focused set of products over a small region.

The world today

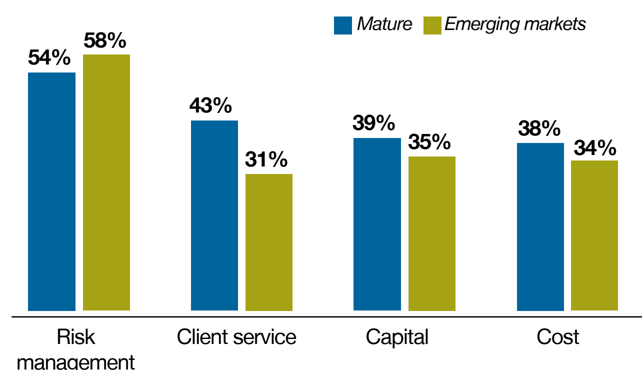
Today's economic environment is characterized by divergent growth forecasts and inflation prospects. Currently, worldwide growth is being driven by the emerging markets, which averaged 6 percent GDP growth in 2010 – far surpassing the mature economies' 2 percent GDP growth.[7] These emerging markets are also likely to experience increased development, inflationary pressures, a growing market segment of high-net-worth individuals and a huge pool of unbanked and under-banked populations.

In comparison, mature markets are faced with the prospect of low growth with low inflation coupled with debt, deficit and deleveraging. While government intervention in many mature markets helped end the financial crisis, a number of Western economies are now faced with a fiscal crisis. In 2010, public debt as a percentage of GDP was more than 80 percent in both the United Kingdom and Germany and 60 percent in the United States.[8] Simultaneously, household debt as a percentage of disposable income was close to 150 percent in the United States and over 140 percent in the United Kingdom.[9] Concurrently, governments facing budget deficits are competing with banks for consumers' deposits and savings. As a result, banks will have to be innovative and make their deposit business much more attractive as they compete with government for funds.

In this unique economic environment, the top 200 banks have returned to precrisis levels of income, while their profits and return on assets have settled lower, with profits across the industry 15 to 20 percent below their 2007 highs.[10] Further, banks in many countries have potential funding problems as a result of mismatched maturity periods in short-term borrowing and long-term lending. Hence, many banks are confronted with a funding crisis of nearly US$1 trillion per year in each of the next five years.[11] At the same time, banks face a variety of new regulations along with higher capital and liquidity requirements. Consequently, in the next few years, most banks will have to bolster their capital, stabilize their funding and improve their liquidity, all of which will impact profitability.

In the face of these challenges, banks in both emerging and mature markets will need to transform their operations to drive future profits. As part of our research to determine the nature and direction of this transformation, we asked bankers what top attributes they believe are critical to shareholder value. The top four areas they identified are superior risk management, client service excellence, capital management and cost efficiency, with risk management holding the number one spot in both markets (see Figure 1).

Top attributes critical to shareholder value
Emerging and mature markets



Notes: n=235; Top four responses shown; Question asked: Which attributes do you think will be most critical in creating shareholder value for your financial institutions in the next three years? Select up to three.
Source: IBM Institute for Business Value/Economist Intelligence Unit Business Analytics in Banking Survey 2010.

Figure 1: **Bankers worldwide believe risk management is the top attribute critical to shareholder value.**

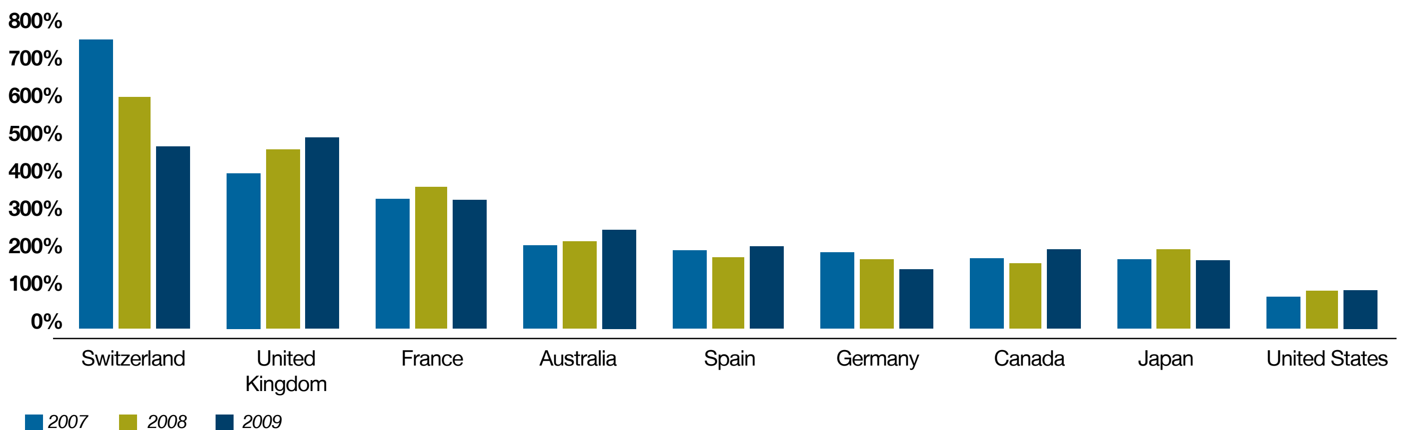
Our survey also reveals that most bankers understand the need for change, as less than 10 percent indicated that the status quo is a viable option for building future profits. With close to 90 percent of bankers calling for either incremental or transformative changes, the majority of bankers understand that business as usual is no longer a viable option. However, to actually achieve the necessary changes, banks need to invest in insight to more effectively manage risk and build a holistic view of the client, while managing cost and complexity.

Leveraging information, reducing risk

Banks continue to face varying dimensions of risk associated with financial crime, operations, governance and compliance. Thus, improving risk management techniques by eliminating operational silos, increasing transparency and implementing consistent risk management practices will almost always be a mandate for banks.

Financial risk: In preparation for regulations requiring higher capital, many banks have increased their capital base. In addition, the assets of the top 200 banks have recovered from their 2008 lows by more than 5 percent to nearly US$82 trillion. However, the top 30 banks have actually increased their asset size postcrisis.[12] Further, in many countries, banks' assets are more than 200 percent of their national GDP (see Figure 2).[13] As a result, many of the biggest banks have become bigger, and systemic risk is higher.

Bank assets as a percentage of national GDP 2007 to 2009



Note: GDP of country based on the bank's domicile.
Sources: "Global Financial Stability Report." International Monetary Fund. October 2010; IBM Institute for Business Value analysis. 2010.

Figure 2: **Bank assets in many countries far exceed national GDP.**

Financial crime: Bank fraud continues to be a problem, with the many types of fraud becoming more sophisticated and prevalent. In fact, fraud attempts have grown exponentially. For example, according to the 2009 American Bankers Association Deposit Account Fraud Survey Report, card fraud from data breaches, data spoofing and phishing has doubled in the last two years, with the value of debit card fraud estimated at US$788 million.[14] As a result, banks continue to increase their fraud prevention budgets annually.

Operational risk: Banks across the world are more interconnected than ever before. Globalization and continuous financial activity have resulted in higher transaction volumes and transaction values overall. The average daily turnover in the global foreign exchange market alone has increased dramatically to US$4 trillion a day.[15] Payments and settlements volumes are rising in parallel. This has contributed to greater demands on system capacity and increased the risk of failure.

Governance and compliance: Banks are facing more and more regulations. In the United States alone, 70 new studies by 11 different regulators were underway in late 2010, as well as 240 new rule-making processes.[16] In parts of Europe, banks are faced with multiple regulations in multiple jurisdictions. While the policy and spirit of the regulations might be in alignment, the actual implementation of policies varies by country. The majority of financial institutions are ill-prepared to face the burden of compliance. In a recent survey, almost 80 percent of financial firms reported they had not integrated their governance, risk and compliance processes.[17]

"As we implement the new international regulations, we should not forget the unique needs of the small regional banks and their clients."

Senior executive, Specialized regional cooperative bank, Asia

Risk and income

Banks need to become more risk savvy and invest in risk analytics to optimize risk and profits. Exposure to "high-risk" income sources can result in income volatility, as risky income has the potential for significant profits or losses. Reducing a bank's risk profile by decreasing exposure to risky businesses can affect the bank's income and profit outlook. We estimate that for every 1 percent reduction in income from riskier businesses, banks will have to more than double or triple their low-risk income to maintain profits at the same level. By using risk analytics, banks could improve insight into their income and asset portfolios, improve their risk management techniques, and better understand the impact of economic conditions on the banks' clients and investments.

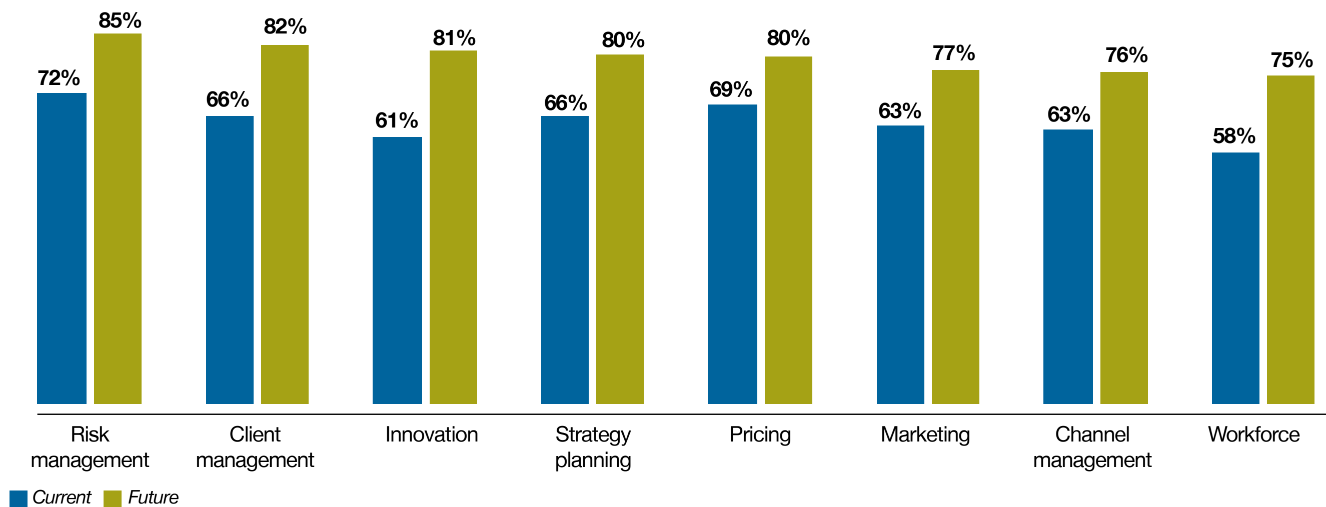
Source: IBM Institute for Business Value analysis of top 200 banks in study. February 2011.

This perceived increase in risk actually represents an opportunity for banks that invest in predictive analytics to differentiate themselves. Many banks have the information they need to better manage risk – they just aren't using this valuable resource effectively. Banks need to leverage their information by investing in the right tools and analytics, an investment that will help deliver sustainable, long-term results.

Recognizing the value of analytics in optimizing risk, bankers in our survey rated risk management as the number one area where analytics could best deliver long-term benefits (see Figure 3).

Responses to our survey indicate that in conjunction with the overwhelming need for risk analytics, more than 40 percent of banks suffer from information overload and a lack of tools. For example, banks have information on a clients' family profile, savings profile, income profile, etc., much of which might be duplicated. Yet, many banks are often unable to build services to meet client needs. To effectively use analytics, as well as the wealth of information available, banks require additional tools and processes (see Figure 4).

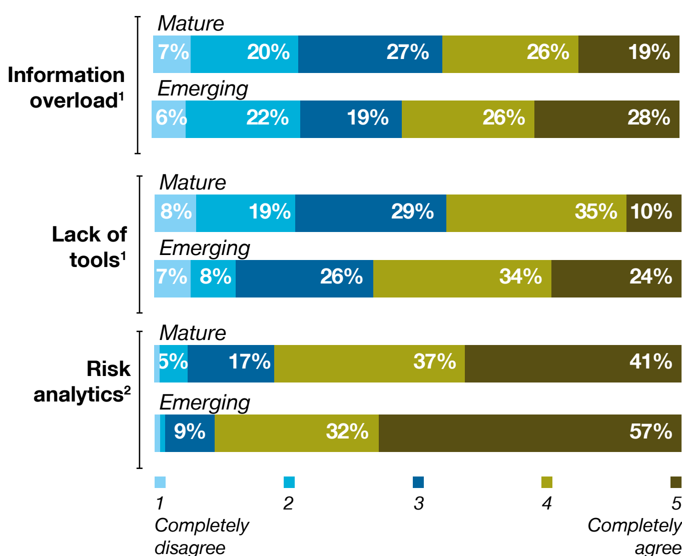
Which function will yield maximum benefits as a result of an investment in analytics?



Notes: n=235; Questions asked: To what extent does your organization apply analytics to the following activities? Rate each function on a scale of 1 to 5, where 1 = significant extent and 5 = insignificant extent. For each of the following functions what is the likelihood an investment in analytics will deliver long-term sustainable profits for the bank? Rate each function on a scale of 1 to 5, where 1 = high potential and 5 = low potential.
Source: IBM Institute for Business Value/Economist Intelligence Unit Business Analytics in Banking Survey 2010.

Figure 3: **Bankers believe investing in predictive analytics can deliver long-term benefits.**

Use of information and tools and focus of analytics investment



Notes: n=235. Question asked: 1. To what extent do you agree with the following statements? Rate on a scale of 1 to 5. "The bank has more information than it knows how to use effectively." "The bank lacks the tools and processes for rigorous use of analytics." 2. Top most selection shown; Question asked: For each of the following functions what is the likelihood an investment in analytics will deliver long-term sustainable profits for the bank? Rate each function on a scale of 1 to 5, where 1 = high potential and 5 = low potential. Source: IBM Institute for Business Value/Economist Intelligence Unit Business Analytics in Banking Survey 2010.

Figure 4: **Banks need to effectively leverage information and invest in tools to reap the full benefits from risk analytics.**

Risk-savvy banks will invest in analytics to help them leverage the vast information available to them, improving their insight, lowering their risk profile and optimizing their profits.

Becoming more client centric

As banks strive to better understand their clients, they should focus on:

- Enhancing pricing models to meet client needs in the different segments
- Modernizing client segmentation techniques
- Improving client experience in the different channels of interaction.

Pricing to win

Few banks have consistently used pricing as a competitive differentiator in their client relationships. More often than not, they have priced products and services by merely following or matching their local competitors – much like gas stations on opposing street corners. To effectively price their services, banks need to move beyond a "one-size-fits-all" pricing model and toward more innovative models – ones that take into account factors such as risk and client need, as well as those that offer client choice and flexibility.

According to our survey, approximately 25 percent of banks in mature markets and 28 percent in emerging markets currently employ standard "across-the-board" pricing regardless of the client relationship. Reflecting a future move toward more innovative pricing, only 13 percent of mature and 12 percent of emerging market banks plan to retain "across-the-board" pricing.

"We change the price of our products and services by channel. And then we focus on lowering our costs and maximizing client satisfaction."

Senior Executive, Universal bank, Europe

Indeed, more than 60 percent of bankers believe that pricing innovation will help build client loyalty and improve profits in the new environment (see Figure 5). Banks in both markets are looking at more granular pricing and self-service bundling. To achieve more granular pricing, banks will have to segment their clients to accommodate varying risk profiles and differing abilities to pay. We believe banks will also offer self-service pricing bundles as an option to empower clients to choose price, channel and level of service.

To create effective pricing models, banks must utilize in-depth data relating to:

- Client risk
- Costs associated with delivering products and services in each of the channels
- Client motivation for buying products and services
- Elasticity of pricing in different markets.

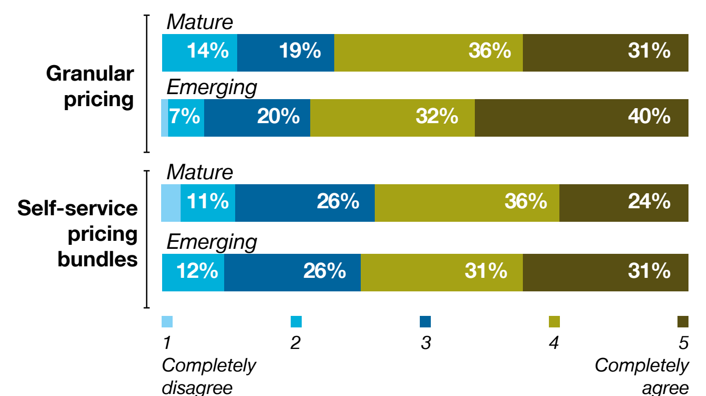
When asked what additional information was needed to effectively price services to better meet client needs, more than 70 percent of bankers identified the need for more client-level risk information – followed by information on the cost of service and price elasticity of the market.

The good news is that these barriers to acquiring the data necessary to enhance pricing models are within the banks' control. Banks can overcome most of these challenges by investing in infrastructure to analyze the vast volumes of data they have collected to date.

"The under 30 segment of our population is very large. We just need to understand their attitudes and preferences better, as they start to seek financial services."

Senior executive, National bank, Asia Pacific

Innovations in pricing



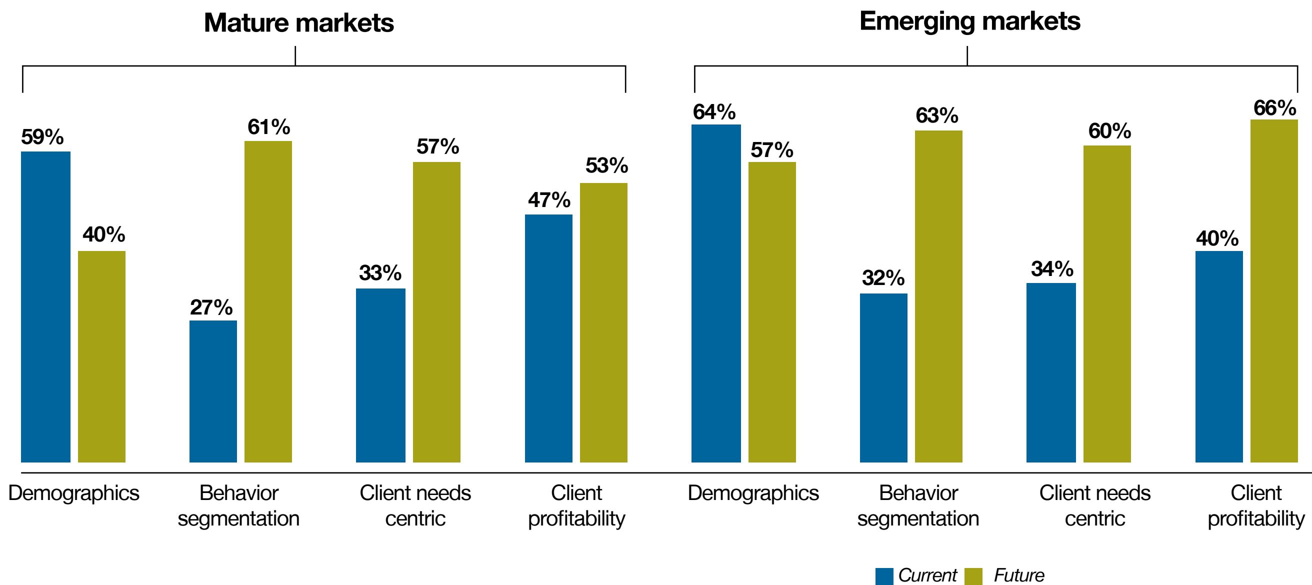
Notes: n=235; Questions asked: To what extent do you agree with the following statements? Rate on a scale of 1 to 5, where 1 = completely agree and 5 = completely disagree. More granular pricing (i.e., customized prices developed individually based on individual client needs) will help win clients. Banks can improve profitability by introducing self-service bundles that let clients chose a bundle of products and channels at pre-set prices.
Source: IBM Institute for Business Value/Economist Intelligence Unit Business Analytics in Banking Survey 2010.

Figure 5: **A majority of bankers believe pricing innovation will build client loyalty and profits.**

A fresh look at the client

Banks' traditional methods of client segmentation are based on demographics. But demographics are only part of the story. Today, banks need to get inside a client's head, so to speak. They need to move toward more psychographic segmentation.

Our research indicates that banks – particularly in emerging markets – are poised to move toward needs-based and behavior-based segmentation in the next three years (see Figure 6). Rather than focusing primarily on demographics, banks worldwide plan to focus more intensely on behavior segmentation and client needs.



Notes: n=235; Question asked: On what basis does the bank (your line of business) segment its clients today? Select all that apply. On what basis will the bank (your line of business) segment its clients in three year's time? Select all that apply.
Source: IBM Institute for Business Value/Economist Intelligence Unit Business Analytics in Banking Survey 2010.

Figure 6: **Banks in both mature and emerging markets plan to change their segmentation methods.**

This is an encouraging trend, as we believe future success will hinge on segmenting clients by attitude, interests and behavior patterns, rather the familiar demographics of age, gender, ethnicity, etc. However, inconsistent client information and insight pose a challenge for many banks as they try to link client profitability and client behavior to better segment the market.

Bankers worldwide identified behavior segmentation and client needs-based segmentation as the top two methods that would require information not available today. This need for additional information is not the only barrier banks face in implementing new segmentation methods. In fact, our survey participants indicated the biggest barriers to gaining client insight are:

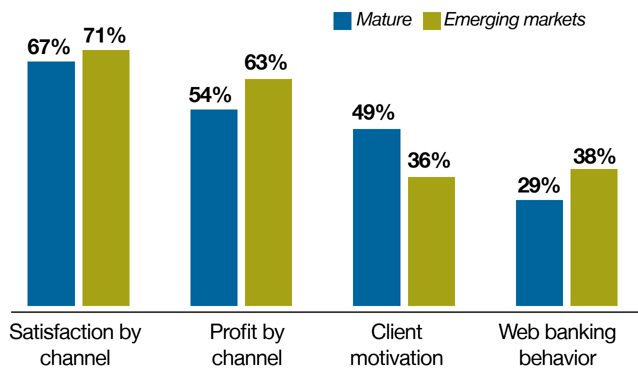
- Constraints in systems and processes
- Time/willingness of clients to provide information
- An absence of tools to do follow up.

Many of these barriers are largely within the banks' control and exist due to internal shortcomings. To break through these barriers, banks are going to have to invest in their infrastructure to improve their processes, analytical tools and ability to share information across the organization.

In search of channel satisfaction

Channels represent an essential piece of the puzzle that brings together the major elements of a bank: Channels provide the link between clients and the bank's products and services. Bankers clearly understand the importance of channel interaction. When asked in which areas they need better insight in the future to sustain profits, bankers cited satisfaction by channel, followed by profit by channel (see Figure 7).

What better insight is needed to sustain profits?

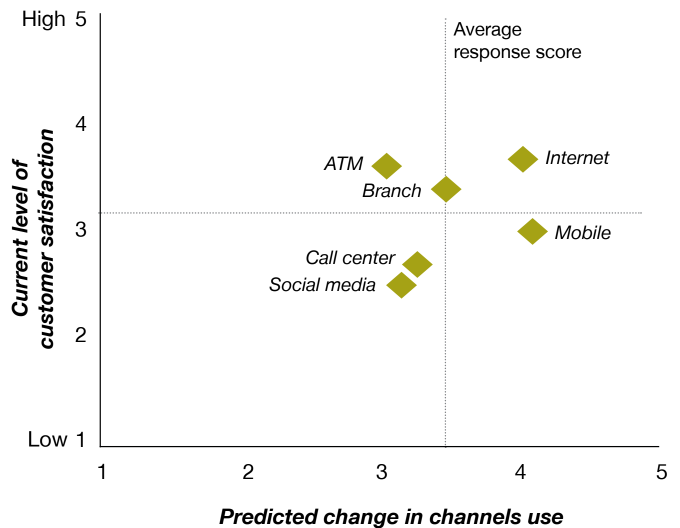


Notes: n=235; Top four selections shown; Question asked: In the future, in which of these areas will your bank need better insight to sustain profits? Select up to three.
Source: IBM Institute for Business Value/Economist Intelligence Unit Business Analytics in Banking Survey 2010.

Figure 7: **Bankers recognize the need for better insight regarding their channels.**

Unfortunately, for many banks, current client satisfaction in the channels is, at best, mediocre (see Figure 8).

Predicted change in channel use and current levels of satisfaction



Notes: n=235; Questions asked: Which of the following channels will experience the most change in client usage over the next three years? Rate on a scale of 1 to 5. To what extent do you believe clients are satisfied with service levels in the following channels? Rate on a scale of 1 to 5.
Source: IBM Institute for Business Value/Economist Intelligence Unit Business Analytics in Banking Survey 2010.

Figure 8: **Banks have an opportunity to increase client satisfaction in the channels.**

Call centers are a challenge for most banks, with below average client satisfaction and little change expected in terms of client usage. The Internet and mobile, on the other hand, are relatively better in terms of client satisfaction but are still below the top tier (top tier being a ranking greater than four). However, banks expect the greatest changes in use will occur in the Mobile and Internet channels – with branch banking coming in third. Branches and ATMs are both ranked high in client satisfaction and average to low in terms of change.

Bankers do not perceive social media as a true delivery platform today. In the words of one executive we interviewed, "In many ways, social media is at the same stage the Internet was 15 years ago. We expect it will evolve in the coming years, as will new policies and regulations associated with it." According to another executive, banks are using social media today for "social proofing." By participating in the social media experience and encouraging clients to participate, banks hope others will follow suit. For example, by creating a social networking profile and amassing "fans" or "friends," a bank hopes to demonstrate loyalty, trustworthiness and client commitment.

"We have unique prices and distinct services in our different channels. We look at all interaction in our channels to improve satisfaction and focus on our profitable client segments."

Operations executive, Universal bank, Europe

To improve performance in their channels and increase client satisfaction, banks must understand:

- How people bank
- How often they bank
- What products and services they seek when banking.

Banks can use this information to increase client satisfaction by:

- Determining which channels are appropriate for which sets of clients
- Developing prices to attract clients
- Ensuring that service delivery is aligned with clients' choice of channels
- Building a consistent user experience across the channels.

In summary, banks must focus on client satisfaction across all channels. To do so, they need to radically improve their client insight and eliminate barriers, particularly those within their own systems. The future will belong to sophisticated banks that use superior segmentation and pricing methods to deliver best-in-class service in their channels.

Shrinking complexity, growing revenue

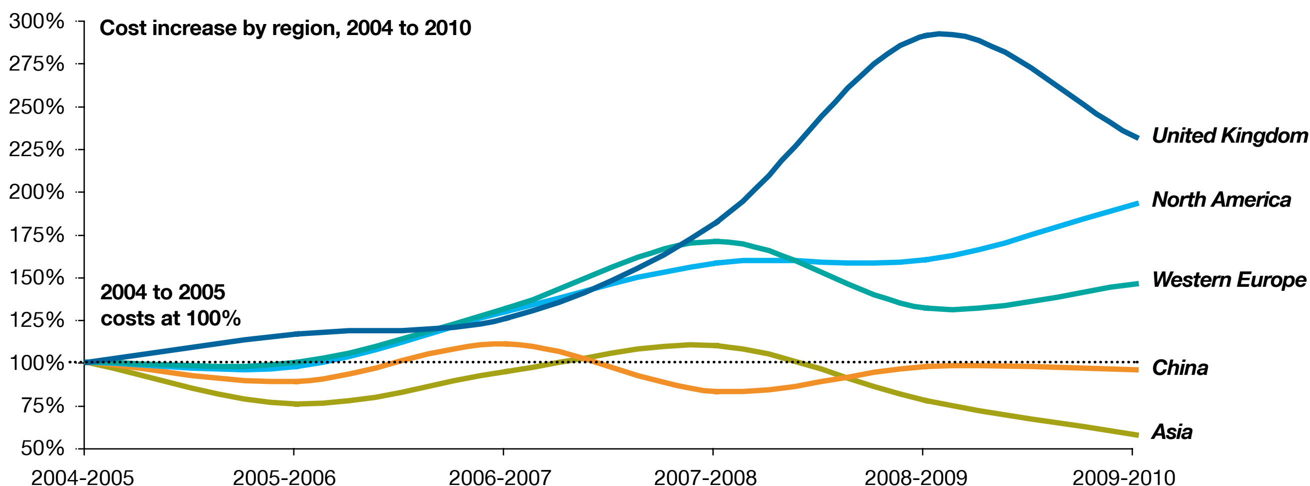
Banks, like other successful organizations, must continually evaluate their operations, seeking ways to increase efficiency, decrease costs and create new revenue opportunities.

Today, the operational issues faced by mature market banks are different than those faced by emerging market banks. In general, banks in mature markets need to focus on the complexity of their operations, while banks in emerging markets should focus on expanding their revenue sources and reaching out to the unbanked and underbanked.

The complexity conundrum

As previously mentioned, banks in the emerging markets are leading growth. In fact, emerging markets are the leaders in terms of profitability and cost efficiency – and they have maintained their cost efficiencies over the last five years (see Figure 9). In contrast, mature market banks have not fared as well in controlling costs and operate overall at a much higher cost-to-income ratio.

> *"Cost efficiency is in our DNA. We continuously optimize our processes as close to the customer as possible…and then we continuously measure customer satisfaction to ensure we are moving in the right direction."*
>
> Executive, Universal bank, Europe



Source: IBM Institute for Business Value analysis of Economist Intelligence Unit Business data. 2010.

Figure 9: **Emerging market banks are cost efficiency leaders.**

A large part of the mature market banks' increased costs can be attributed to complexity (e.g., complexity due to operational silos, customization of IT systems, etc.). To prepare for success in the new economic environment, they must reduce both complexity and costs to remain competitive.

Through our research, we discovered a group of outperforming banks we call exemplars. These banks have managed to lead their peers in costs and profits in each of the last three years. By focusing on sophisticated insight in their areas of specialization, the exemplar banks were able to streamline their operations – avoiding complexity and leading to cost savings and higher profits. These banks have leveraged their superior insight to deliver the right products at the right price to the right client segments (see sidebar: Exemplars outperform peers through specialization).

Following the lead of the exemplars, mature market banks should focus on increasing their incomes while also reducing the complexity that has been a drag on their profits. To determine the cost of complexity, we compared the exemplars in each class against the other banks (see sidebar: Method for calculating complexity). We determined that banks in mature markets could reduce complexity – estimated to cost the industry US$200 billion – to possibly increase pre-tax profits by up to 20 percent (see Figure 10).[18]

US$ billion	10 billion to 200 billion	200 billion to 500 billion	500 billion to 1 trillion	Above 1 trillion
Average cost	$3	$6	$10	$34
Complexity percentage of cost	55%	40%-	30%	25%
Complexity reduction percentage	30%-40%	30%-40%	30%-40%	30%
Potential extra profit from reducing complexity	**20%**	**30%**	**25%**	**20%**
Potential extra profit $ from reducing complexity	**$200 billion**			

Notes: n=50 mature market banks compared with the top 200 exemplars; Extra profit = Incremental profit / Original profit; Complexity cost derived by comparing exemplars against the other banks in the ecosystem and comparing channel costs and branch network of the exemplars against the other banks in the ecosystem; All percentages rounded to the nearest multiple of 5.
Source: IBM Institute for Business Value analysis.

Figure 10: **Mature market banks could increase profits by decreasing complexity.**

Exemplars outperform peers through specialization

In our study, we identified a group of outperforming banks we call exemplars. These banks have outperformed their peers in costs and pre-tax profits in each of the last three years by focusing on their areas of specialization. They all use insight to achieve client centricity and improve operations.

Specialized and regional exemplars

Specialized and regional exemplars have several clear distinguishing factors in common that helped them achieve nearly 20 percent higher pre-tax profits than their competitors. These banks have in-depth knowledge of their clients and markets, and they utilize this knowledge to design products and services dedicated to meet their clients' needs. They distribute their products through a branch network that provides saturation coverage over small geographical areas.

Some of the specialized exemplars are auto-finance specialists, and others specialize in developing credit solutions. The regional specialists have a strong distribution network focused on a specific region, accompanied by a set of products and services tailored to local needs. Many of these banks target clients within a set risk rating while simultaneously avoiding high-risk operations such as securitization. Typically, these exemplars have a cost-to-income ratio of 25 to 30 percent and a compensation-to-income ratio of 30 percent.

National and multinational exemplars

The national and multinational exemplars outperformed their competition – with approximately 10 percent higher pre-tax profit. These exemplars have strong client insight and market knowledge within a country or trading bloc. They have a wide range of diverse products and services that are designed to meet the needs of multiple client segments within the country or trading area. These exemplars deliver services across multiple distribution channels. They also typically have strong regulatory oversight, which discourages excessive risk taking while encouraging domestic champions. Typically, these banks operate at about a 40 to 50 percent cost-to-income ratio and have a compensation-to-income ratio of approximately 50 percent.

Universal exemplars

Exemplars among the universal banks averaged a 15 percent higher pre-tax profit than their competition. These exemplars have strong market insights into varied client segments in multiple countries or trading blocs. They design products and services that focus on multiple markets and economies, as well as specific segments within those economies. Because their products and services are designed based on superior client and market insight, they vary from country to country.

The universal exemplars can be categorized into two groups. The first group excels at tailoring products and distribution channels for specific markets and client segments. This group operates at a cost-to-income ratio of 50 to 55 percent and a compensation-to-income ratio of approximately 55 percent. The second group focuses on standardized processes and centralized infrastructure services to deliver cost advantages globally. These banks operate at a cost-to-income ratio of 35 percent, while their compensation-to-income ratio is close to 35 to 40 percent.

Source: IBM Institute for Business Value analysis. November 2010.
Note: Bank exemplars are the list of banks common to the top 30 according to pre-tax profit and cost-to-income ratio for the period 2007 to 2010.

Method for calculating complexity

- Bank exemplars are the list of banks common to the top 30 according to pre-tax profit and cost-to-income ratio for the period 2007 to 2010.
- Best-in-class operations costs for the exemplars were determined.
- The number of retail branches and the size of loans and deposits were obtained from 2009 and 2010 annual reports.
- Cost of complexity was determined as the difference in cost between the exemplars and the other banks in the same asset category.

Mature market banks that reduce complexity in operations and use sophisticated insight to identify areas of innovation and revenue will likely emerge as the market leaders. Emerging market banks, on the other hand, should continue their focus on cost efficiency and avoid duplicating the complexities faced by the mature markets.

Rebalancing the portfolio

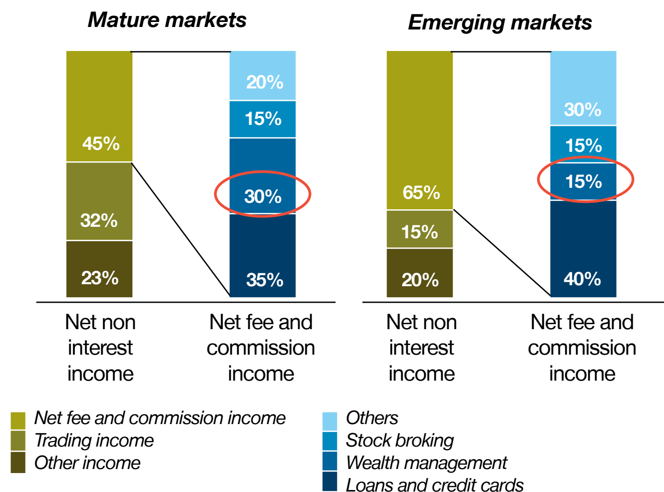
The emerging market banks' focus on the traditional retail business has positioned them strongly in today's environment. However, their profits are over reliant on interest income business and subject to interest rate risks. To help ensure long-term growth and profitability, emerging market banks need to rebalance their income portfolio to reduce their exposure to economic cycles and interest rate changes.

"Complexity is a result of "multiple layers of governance, too many customized systems platforms, poor integration after multiple acquisitions…"

Senior executive, Multinational/national bank, Asia Pacific

Our research suggests emerging market banks should embrace sophisticated insights – or analytics – to help drive their wealth management business. Today, wealth management only represents 15 percent of emerging markets' net fee and commission income, compared with 30 percent in mature markets (see Figure 11).[19]

Components of net non interest income, 2009-2010
Select mature and emerging market banks



Notes: 1: N=16, i.e., 20 percent of emerging market banks in the top 200 compared against the "average" universal bank in the mature market with emerging markets/Asia Pacific exposure; "Other income" includes one-time income, income from nonregular activities, fair valuation changes, rental income, etc.
Sources: IBM Institute for Business Value analysis.

Figure 11: **Emerging markets banks should grow their share of wealth management business.**

According to our research, household wealth in emerging economies is poised to grow at an average of US$900 billion per year until 2015.[20] And by 2013, Asia is poised to have more millionaires than the United States.[21] We believe banks in the region with insight into local markets could each potentially cultivate US$150 million of wealth management business annually for the next few years.[22] However, in many of these regions, the wealth management business was more or less nonexistent five years ago. Hence, to grow in these markets, banks must – among other things – pay attention to the varying risk profiles of their clients, their clients' appetite for financial and nonfinancial assets, and the currency controls and regulations of the regional markets.

Simultaneously, banks in emerging market should focus on servicing the underbanked and unbanked sections of the population. This segment represents a sizeable opportunity – one that could help maintain long-term profits (see Figure 12).

For example, The Republic of Maldives, 200 inhabited islands in the Indian Ocean, stands poised to become the first country in the world to provide universal financial access, even for the poorest villager on the most remote island. Using mobile phone networks and a network of local retail establishments serving as banking agents, Consultative Group to Assist the Poor, the World Bank and the Maldives' central bank are working together to reach the unbanked and underbanked.[23] As another example, banks in Brazil established 95,000 banking correspondents (e.g., local merchants, lottery dealers, post offices, etc.) with point-of-sale terminals and increased services across 1,600 municipalities that had no service less than seven years ago.[24] These are only two examples of numerous methods emerging market banks can employ to service the underbanked – without losing their focus on cost efficiency.

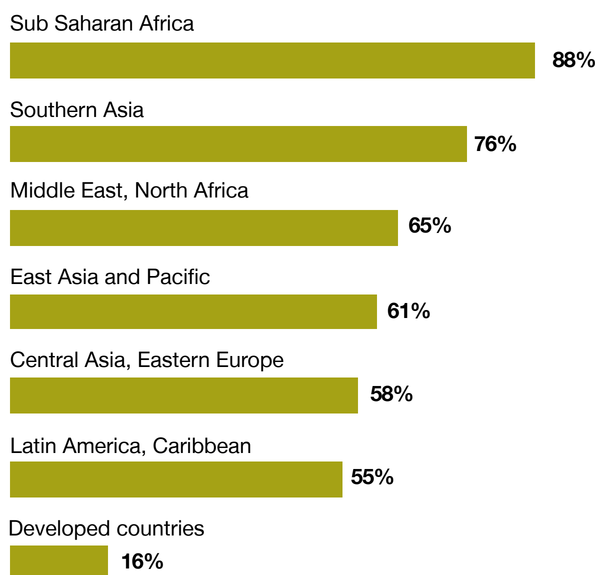


Figure 12: **The unbanked represent a sizeable percentage of the population in many emerging markets.**

Using superior insight will help banks position themselves for growth and new income sources in the emerging markets. Simultaneously, banks in the region should continue to focus on cost efficiency and avoid the operational complexities that plague many of their counterparts in the mature markets.

We believe the future belongs to banks that effectively manage their costs, balance risk with return and focus on financial innovation to meet client needs.

Taking action

So, how can banks begin the transformation necessary to succeed in the new economic environment? Below are some specific actions to help spark critical changes.

Banks worldwide should invest in sophisticated insight to:	
Client centricity	• Enhance their client segmentation techniques and develop more focused services aligned with client needs • Optimize their channel investments to enhance the effectiveness of their distribution networks • Innovate their pricing models to build stronger client relationships • Differentiate themselves through client service excellence.
Operations	• Effectively manage the cost and complexity of operations • Specialize their operations • Eliminate barriers that prohibit business insight.
Risk	• Leverage existing information to optimize risk • Efficiently manage sources of funding and levels of capital and liquidity.
Banks in mature markets should:	
• Invest in insight to develop new sources of revenue • Eliminate the cost of complexity in their operations • Reduce their operating costs • Reduce their exposure to risky assets and significantly reduce the volatility in their income portfolios • Address their funding risk for the next three years.	
Banks in emerging markets should:	
• Increase revenues and diversify sources of income – Focus on burgeoning segments, such as private banking and wealth management, to build profits in the next few years – Innovate channels and services to include the unbanked and underbanked sections of society • Continue their leadership in cost efficiency • Avoid complexity in their operations and governance.	

Conclusion

Globally, banks need to be more business savvy, client centric and efficient in their operations. By investing in sophisticated insight, banks can more effectively increase their client focus, improve risk management strategies, innovate pricing techniques, optimize channel performance and foster client satisfaction.

Because banks in emerging markets and those in mature markets face disparate challenges due to differences in market conditions, their strategies will vary, despite their common need for sophisticated insight to meet these challenges. While mature market banks should focus on eliminating complexity and reducing costs, banks in emerging markets need to diversify their income sources, while maintaining costs. And banks worldwide need to invest in analytics to help specialize operations and deliver superior products and services that best meet clients' needs.

To learn more about this IBM Institute for Business Value study, please contact us at *iibv@us.ibm.com*. For a full catalog of our research, visit:

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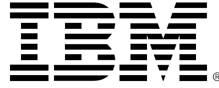

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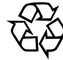

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