Perspectives on the Future of Swiss Banking

Priorities and preconditions for the evolution of Swiss banks' value creation models

June 2021

Swiss banks' current value creation models are highly integrated and make only limited use of technological possibilities ...

Background and new reality

Swiss banks' operating earnings are a representative indicator of the performance of their value creation models. In 2019 they were a little over a third (-34%) below the pre-crisis level of 2005. A gradual uptrend between 2008 and 2014 was halted by a combination of the low interest rate environment/ introduction of negative interest rates and the strong franc, as well as increasing regulatory requirements.

This is chiefly explained by loss of income due to regulation in investments (-13%) and trading (-34%) as well as a systematic erosion of margins across all business areas (-39%), and thus constitutes a new reality 15 years on from the 2007 financial crisis. Since 2010, banks have responded by refining their value creation models, a trend reflected in a shift from personnel expenses (-13%) to general and administrative expenses (+58%), partly as a result of increased outsourcing and automation. However, the degree of evolution remains low.

Current value creation models

Overall, Swiss banks' current value creation models are therefore characterised by a highly (85-90%) integrated value chain coupled with minimal product and service differentiation, high staff resource intensity, limited use of technologies and low technological agility, as well as persistently rigid organisational structures.

As a result, the external change potential opened up by new technologies or forms of partnership has had only limited scope to impact the value creation models. According to the bank representatives surveyed, however, this is largely explained by the lack of market scalability—despite significant growth over recent years—together with monolithic core bank systems and insufficient cost pressure.

Drivers of change

Nevertheless, that same outside pressure will, in the coming years, accelerate the evolution of value creation models. While the low interest rate environment is likely to persist, competition can be expected to intensify, as what are still in some cases novel, foreign participants enter the market, and rivalry between existing market players grows.

At the same time, changes in customer behaviour that are currently viewed simply as "trends" will increasingly lead to new standards and require corresponding end-to-end adjustments to existing value creation models (for example in digital self-service). One positive outcome is likely to be that technology, which has already become a key change factor, comes to be seen less as an obstacle and more as an enabler (e.g. as increasingly mature APIs and cloud applications break up the value chain).

... but there is already a move towards more open models, which are being developed in nine priority areas that are independent of bank type

Nine priorities

Hence, while the margin erosion is likely to continue, over 60% of banks—across the four main types in Switzerland (universal, retail, private and "other")—are planning to actively refine their value creation models in nine priority areas (each with a different focus), and in particular transform their cost structures.

The priorities are as follows:

1. Optimising the distribution bank model in the context of ecosystems,
2. expanding partnering by means of open banking/ API integration,
3. raising employee productivity,
4. optimisation of customer interaction points,
5. expanding the digital product and service offering,
6. optimising and refining data analytics,
7. expanding and optimising cloud computing,
8. creating agile organisational capabilities, and
9. accelerating "digital as enabler".

Future value creation models

The priorities show a clear shift from the current situation, where resources and capabilities are mostly in-house or physical, towards greater digitalisation and externalisation in order to increase or maintain competitiveness and profitability. The future value creation models that embrace the new reality will therefore be digital, modular, open and agile.

In concrete terms, Swiss banks' future value creation models will be based on open infrastructures with data and systems integrated end to end. The differentiating factors will then be digital capabilities, and technical and organisational agility. At the same time, non-differentiating resources and capabilities will be obtained via partners and ecosystems, in order to optimise cost structures. When it comes to the precise shape of value creation models, the customer interface will however remain key.

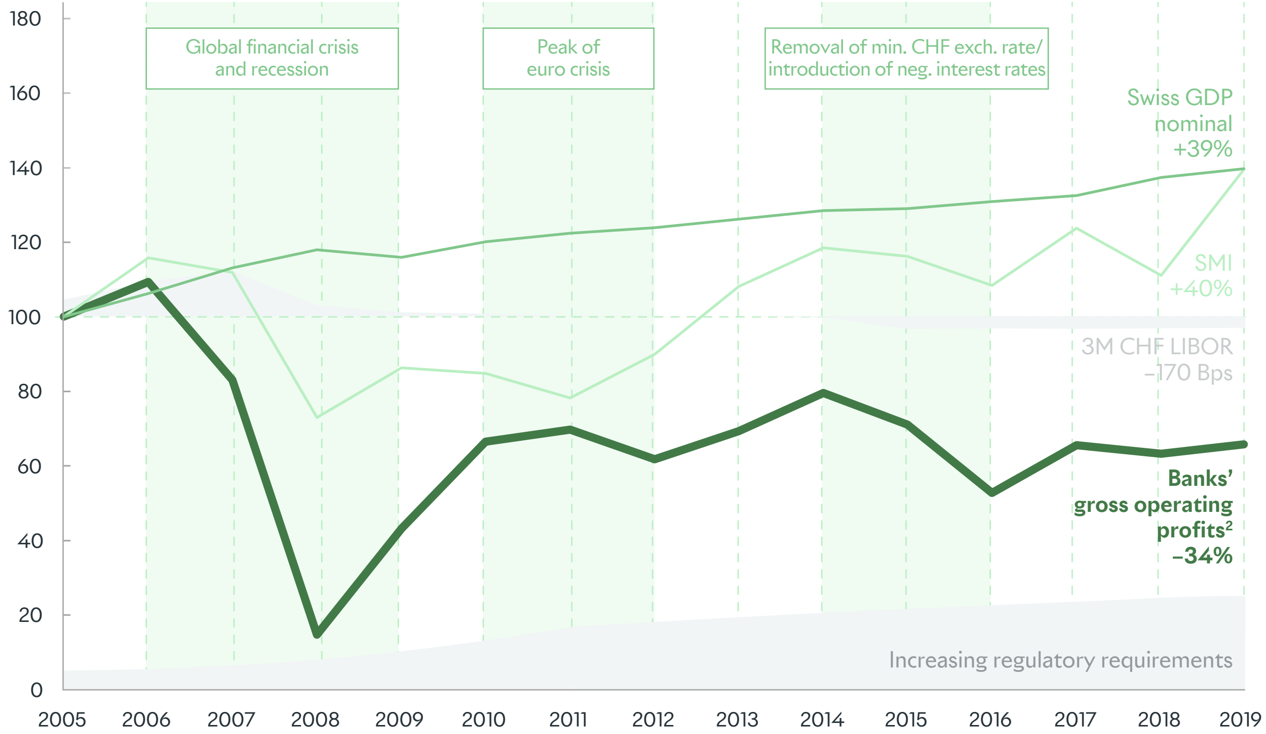
Regulatory environment

The current regulatory regime has a strong influence on the shape of banks' value creation models. While not a decisive obstacle to future development, it makes it more difficult and expensive for banks to innovate and adapt. Switzerland's largely principles-based and technology-neutral regulatory regime means that when banks implement new applications, there must be a mechanism for reviewing their permissibility.

Banks view cloud applications, artificial intelligence and data analytics along with standardised interfaces/open finance as particularly useful key technology enablers. The current regulations allow banks to use them, but a number of requirements need to be taken into account.

Today, Swiss banks face a new reality, with their value added still more than a third below pre-crisis levels…

Value added[1] by Swiss banks compared with selected indicators, 2005–2019
indexed, 2005 = 100



[1] Value added represented by Swiss banks' gross operating profits according to the SNB's banking statistics
[2] Gross profits excluding income from participations (to eliminate double counting due to profit distributions between legal entities forming part of individual banks)

Swiss banks' value added1) is still more than a third below the pre-crisis level of 2005; by comparison, Swiss GDP has grown by significantly more than a third, which points to structural problems affecting the banking industry more than other sectors.

This argument is chiefly supported by systematic losses of earnings resulting from more stringent regulatory requirements (outflows of foreign assets, disclosure of retrocessions, scaling back of proprietary trading, etc.).

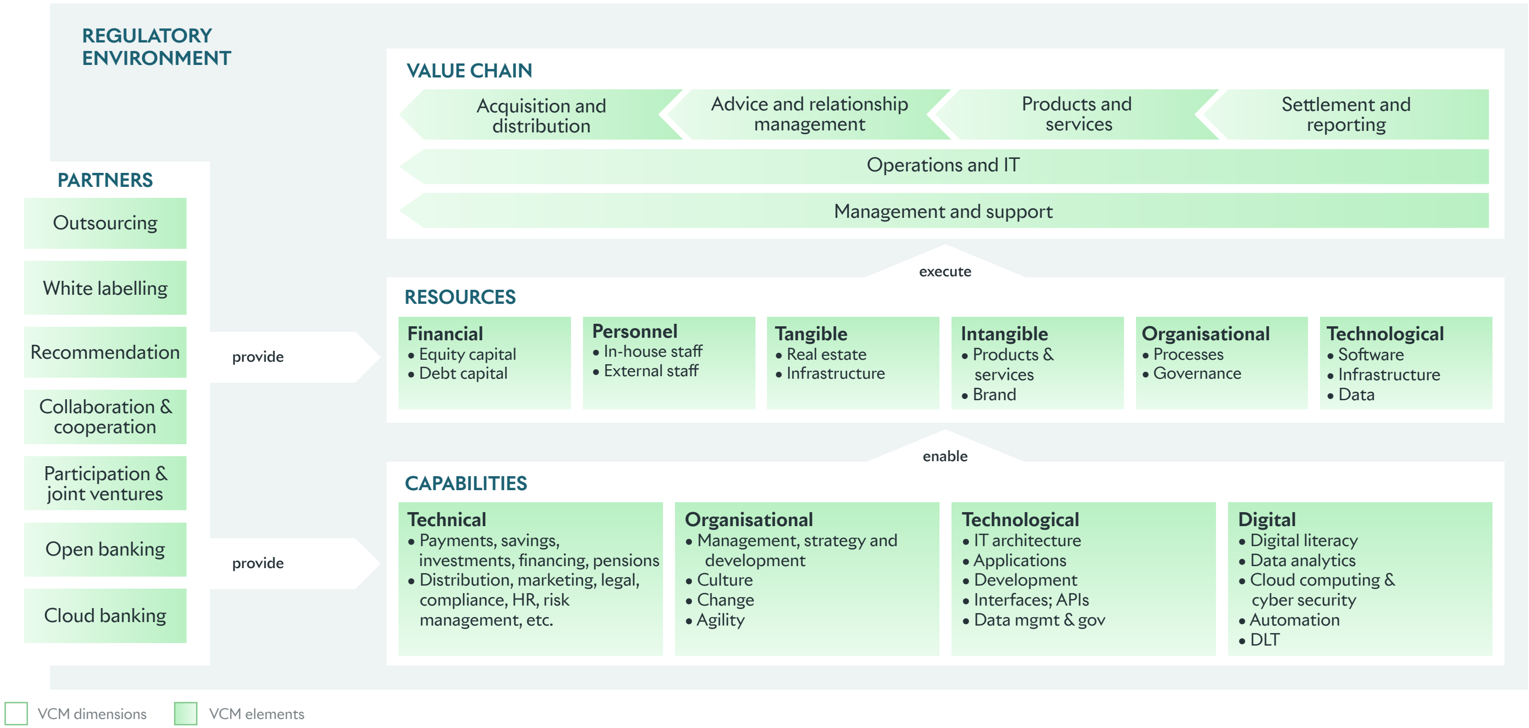
Added to this is a significant erosion of margins across all business areas, influenced by macroeconomic and monetary policy developments, changed customer behaviour and fiercer competition.

Meanwhile, costs have remained stable in absolute terms, although there has been a fundamental shift from personnel to general and administrative expenses, partially explained by increased outsourcing of activities to external providers.

All this adds up to a new reality, to which banks are responding by adapting their value creation models. However, this is of limited effectiveness and/or is part of an ongoing transformation process.

... which raises the issue of the future value creation model in terms of five core elements

Future value creation model (VCM)



Central survey question

How are Swiss banks configuring the value creation models of the future?

Above all, Swiss banks' future value creation models will need to be digital, modular, open and agile ...

Alongside macroeconomic and regulatory influences, changes in customer behaviour, increasingly intense competition and the central importance of technology will place the following four main demands on Swiss banks' future value creation models, which were cited by the bank executives as the core elements of their strategic orientations in this context:

DIGITAL: Digital interaction with customers will not only continue to grow but will become the prevailing model, as it already is in retail banking. Offering a differentiating customer experience and optimising efficiency, however, requires end-to-end digitalisation of processes from distribution to processing throughout the value chain, with working models to match.

MODULAR: Increasingly, customers are choosing products and services separately from each other and independently of their house bank, while more and more competitors are entering the market to meet that demand. Future value creation models must therefore be transformed into the right mix of resources, capabilities and partners so that banks can offer modular, customer-centred products and services in a cost-efficient way.

OPEN: Opening up the still largely monolithic core banking system is key to enabling innovation to flourish and refining value creation models, but an ecosystem approach also needs to be developed in collaboration with partners to meet the challenge of limited scalability within the Swiss market.

AGILE: Agility is increasingly becoming a key differentiator to accommodate requirements and influences that are constantly changing at increasing speed. This is especially true of organisation and technology, and enhances crisis resistance while at the same time delivering major competitive advantages.

While a number of studies are already analysing the COVID-19 pandemic and its impact on Swiss banking, it is clear that the need for banks' value creation models to be refined in line with the four main requirements has risen sharply.

Traditional physical interaction with customers has been suspended, and almost 20% of retail banking customers have used a digital bank service for the first time. Bank representatives believe this will accelerate the trend towards digital banking now that old habits and scepticism have been overcome.

The crisis has also highlighted the importance of organisational agility and technology. Banks may have weathered the pandemic well, but that is mainly due to employees' willingness to go the extra mile. They will need to follow this up by strategically introducing agile structures.

The need for modularity and openness has grown far more indirectly through the crisis: both complement an increasingly digital business model and/or reflect the preconditions for it.

...but nine closely linked priorities are driving the targeted evolution of existing value creation models

Nine priorities and their shifts in VCM

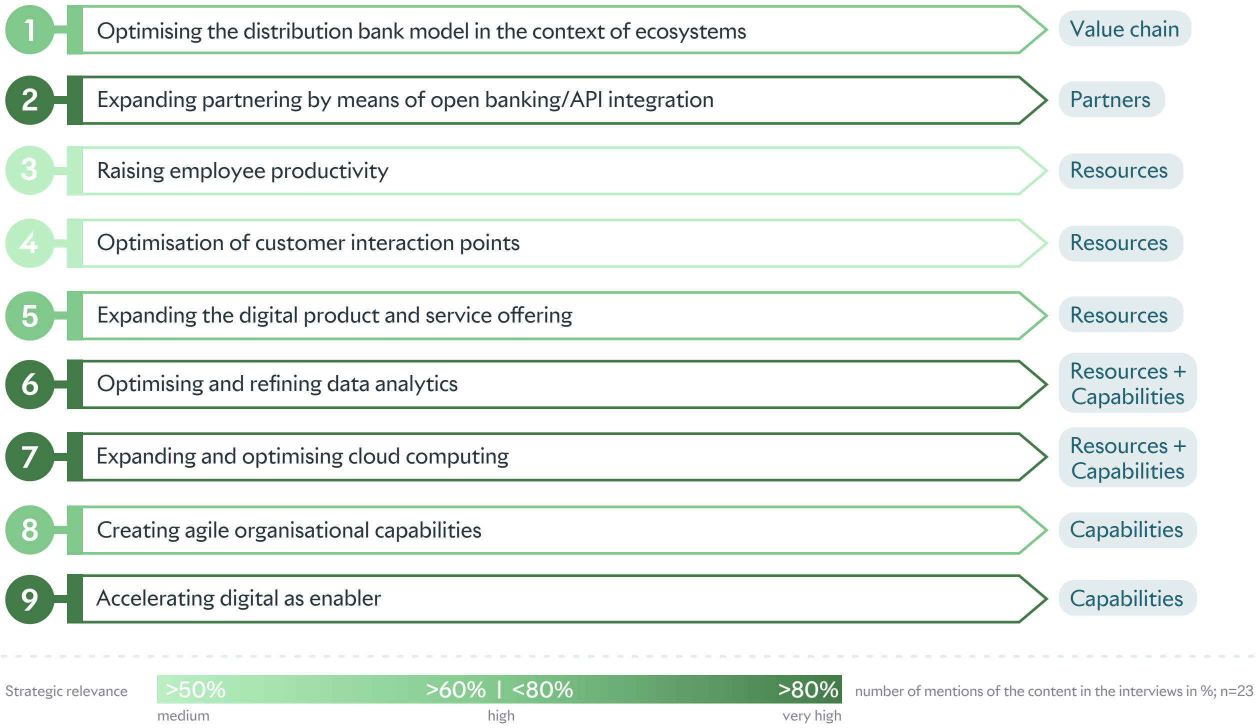
Irrespective of the type of bank, all (100%) of the interviews with bank representatives show that the status quo is not a strategic option when it comes to the shape of future value creation models.

Instead, all of them plan to actively refine their value creation models in similar directions, with the main requirements cited above (digital, open, modular and agile) being the common denominator despite differences in strategic emphasis.

Numerous relevant studies of the Swiss market support the finding that value creation needs to be rethought and brought into line with the new reality.

The interview results enable us to identify nine priorities (1 – 9) (see illustration right), which are examined in the main study. The main focus is on changes in the the resource dimension of the value creation model by influencing five dedicated priorities (3 – 7).

The initiatives with the greatest strategic relevance (green boxes in the chart right) are being planned and implemented first.



* Impacts or shifts within the dimensions of the future value creation model (VCM).

Future value creation models are arising out of the shift in resources and capabilities, with the "technology as enabler" function being central

VCM DIMENSION	VCM ELEMENT	DEGREE OF EVOLUTION* 1	2	3	4	5
Value Chains	Degree of integration (%)	High integration (>75%)		Partial integration (>50%)		Low integration (< 50%)
Partners	Outsourcing	Moderate outsourcing		Some outsourcing		Mostly outsourcing
	White labelling/open banking	Limited use		Some use		Extensive use
Resources	Equity ratio	Regulatory minimum		Partially optimised to risk/ return profile		Largely optimised to risk/ return profile
	Employee productivity	Little exploitation of productivity levers		Some exploitation of productivity levers		Productivity levers mostly exploited
	Customer interaction points (CIPs)	Few CIPs, not integrated		Several CIPs, integrated		Multiple CIPs, integrated
	Products/services	Individual digital products/ services across individual customer segments		Several digital products/ services across several customer segments		Multiple, digital product offering across all customer segments
	Data analytics	Individual data analytics capabilities used		Several data analytics capabilities used		All data analytics capabilities used
	Technological	Infrastructure as a Service (IaaS)		Platform and Software as a Service (PaaS/SaaS)		Business as a Service (BaaS)
Capabilities	Technical	Mostly generalists		Mix of generalists/ specialists		Optimised mix gen/spec
	Organisational	Line/matrix organisation (RTB), Classic project mgmt (CTB)		Line/matrix organisation (RTB), Scrum team/ agile at scale (CTB)		Agile bank (RTB & CTB)
	IT architecture	Monolithic IT architecture		Partially modular IT architecture		Mostly modular IT architecture
	Digital	Limited use		Enabler for transformation		Differentiation factor

- Area of bank-specific development of current to future value creation models
- Profile of most current value creation models
- Profile of future value creation models

* Degree of evolution from 1–5; 5 indicates digital, open, modular, agile

The Swiss banks' current and planned future value creation model can be deduced from the interviews conducted with bank representatives in terms of the value creation dimension.

This reveals that the aim is to break up the previous, highly integrated value chain by making greater use of open banking rather than increased outsourcing; in most cases, the goal is to accentuate the distribution bank model.

There will also be significant shifts of resources and capabilities which will evolve in a digital, open, modular and agile manner in response to requirements, leading to greater efficiency and flexibility.

Technology will be key, and in order to be successful will switch from its current role as a slow-moving monolith that often holds back change and innovation to become an enabler.

The area between the degree of evolution of each institution's current and future value creation models will be subject to change, depending on the institution's strategic focus.

The regulatory environment makes the desired evolution possible, but its principles-based and technology-neutral nature makes the adjustment process more difficult

Background

The current regulatory regime has a strong influence on the shape of banks' value creation models. While not a decisive obstacle to future development, it makes it more difficult and expensive for banks to innovate and adapt.

Switzerland's largely principles-based and technology-neutral regulatory regime means that when banks implement new applications, they have to be reviewed for permissibility. When employing cloud applications or open finance, the bank must, for example, ensure that bank-client confidentiality is maintained or is only waived with the customer's consent. This places greater hurdles in the way of banks than non-banks when it comes to refining value creation models, though they apply equally to all banks in Switzerland.

Developments

Regulatory requirements increase the barriers to entry and have long served to protect the banks. Today, however, they are increasingly jeopardising their business models over the long term, since they restrict the banking industry's innovation and adaptation processes, or at least make them slower and more expensive. Rules such as KYC, AML, FATCA, formal requirements and bank-client confidentiality are designed to provide security, protect consumers and prevent crime, but do not encourage banks to adopt the most innovative solutions.

In most areas, Switzerland's regulatory system is good and internationally competitive. In some areas relevant to innovation (such as digital identity), Switzerland lags behind.

The large number of regulatory changes over recent years (AEOI, Basel III, FinSA, etc.) has tied up significant resources within the banks, slowing the process of developing future-oriented solutions. It has, for instance, affected investments in E2E digitalisation and automation of internal processes, integration of digital signatures and innovative ways of handling data using modern analytical methods.

Three focus areas

When it comes to refining value creation models, the interviewees view cloud technology, artificial intelligence and automated data analytics, as well as standardised interfaces/open finance as key technology enablers.

The current regulatory regime in principle allows banks to use them, but a number of challenges are involved.

Conclusion

Swiss banks are in a transitional phase. Historically evolved, highly integrated and resource-intensive value creation models face a new and constantly changing reality:

- More stringent regulation, combined with macroeconomic factors, has led to shifts, restrictions on business models and a more than 30% lower earnings base.
- Technology has become a central element of change throughout the value creation model and therefore via the value chain and the resources, capabilities and partnerships needed.
- Meanwhile, the intensity of competition and the dynamics of innovation combined with changes in customers' behaviour and expectations are being impacted by the growing importance of technology, increasing as the business becomes progressively more digital and putting pressure on costs and investments.

This requires value creation models that are digital, open, modular and agile—which does not apply to the structures of many Swiss banks today. Despite efforts to improve matters, they are often slow-moving and dominated by rigid organisational structures and cultures as well as monolithic core banking systems.

In the bank representatives' view, however, these developments are still relatively slow, or else substantial only in certain customer segments, meaning that the pressure to make transformative changes to value creation models has so far been insufficiently strong. Moreover, some institutions do not have the scope to scale innovations and investments in Switzerland's domestic market.

The pressure to act is therefore growing as new rivals progressively make inroads into existing banks' income generators, increasingly questioning even the traditional house bank model and the customer interface that goes with it, which is seen as a key success factor.

An evolutionary approach centred on technology therefore needs to be adopted, pursuing the following goals via nine priorities:

- Systematically digitalised distribution, using hybrid advice and relationship management models (priorities 1 4 5 6)
- Competitive cost structures leveraging partnerships within the ecosystem coupled with productivity optimisation through targeted management of resources (priorities 2 3 7)
- Agile organisational structures aligned with customer-centric business drivers and value streams (priorities 8 and 9)

Transformation projects of this magnitude are under immense implicit pressure to succeed. The following success factors should be prioritised as guidelines:

- A company-wide acceptance that constant change is a cornerstone of the new reality and thus needs to be embedded in the corporate culture
- The priorities must be partially self-financed by optimising existing value creation.
- Alignment of the business and technology visions coupled with orchestration of the transformation from beginning to end of the value chain
- Rigorous controlling of the value delivered by the individual priorities as well as the courage to change course where necessary if some priorities fail to achieve the desired results

The current regulatory system is not a decisive obstacle, but it does make it more difficult and expensive for banks to innovate and adapt. Switzerland's largely principles-based and technology-neutral regulatory regime means that when banks implement new applications, they have to be reviewed for permissibility in order to ensure that the regulatory framework is complied with.

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*Title of the banking executives surveyed at the time of the interviews

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As the umbrella association of Swiss banks, the Swiss Bankers Association (SBA) represents the Swiss financial centre's interests vis-à-vis politicians, the authorities and the general public. We are committed to entrepreneurial freedom and open markets and work towards an environment in which an innovative and diverse banking sector can grow. We are a forward-thinking knowledge hub, setting the agenda and steering the industry towards a sustainable future.

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